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Accounting, Audits, and Recordkeeping

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I. Introduction

Developing an effective i-gaming regulatory regime should begin with an understanding of the underlying purposes for regulations and the i-gaming business model. There are several underlying purposes of the regulations which govern the gaming industry. The regulation of the gaming industry in the United States has historically been a response to the influence of organized crime, notably efforts to curtail involvement of organized crime in the gaming industry. Consequently, regulations developed to assure that unlicensed individuals did not share in the profits of a licensed gaming operation and that the government received the proper tax revenue.¹ Similarly, efforts were undertaken to ensure that games were actually fair and not merely rigged for the owner to always win.² As the gaming industry has evolved into a major economic force,³ gaming regulations are also generally designed to ensure an economically healthy and viable industry. Regulations relating to accounting, audit, and recordkeeping play an

¹ See Anthony N. Cabot, CASINO GAMBLING: POLICY, ECONOMICS, AND REGULATION 395 (1996).

² See *id.*

³ See American Gaming Association, State of the State 2011 for comprehensive information concerning the economic impact of the commercial gaming industry in the United States.

important role in maintaining the integrity of operations and ensuring a healthy, viable gaming industry.

Accounting, audit, and recordkeeping rules are largely now contained in minimum internal control systems ("MICS").⁴ Internal controls derive from accounting and audit concepts.⁵ The particular internal control systems ("ICS"), which embody any required MICS of a regulating jurisdiction, define the procedures for operating a casino game, including the procedures and methods for determining income/loss generated from gambling activity. In the brick-and-mortar casino industry,⁶ ICS have a significant impact concerning how casino staff responsibilities are assigned, the recording of revenue, and how the games are conducted. ICS likewise provide procedures for assigning responsibilities, recording revenue and offering games for the i-gaming industry.⁷

The lessons learned from the regulation of the brick-and-mortar casino industry can serve as a logical resource to develop best practices in the regulation of i-gaming.⁸ The rationale for

⁴ See, e.g., Nev. Rev. Stat. Ann. § 463.157; Nev. Reg. 6.090; and British Columbia TGS5, Technical Gaming Standards for Internet Gaming Systems (IGS) (2009).

⁵ See, e.g., _____.

⁶ The terms "brick-and-mortar" and "land-based" are used interchangeably throughout this Chapter to refer to physical casinos that offer in-person gaming.

⁷ See, e.g., Alderney Gambling Control Commission, Technical Standards and Guidelines for Internal Control Systems and Internet Gambling Systems (2010) (*hereinafter* "Alderney ICS").

⁸ See Ian Abovitz, "Why the United States Should Rethink its Legal Approach to Internet Gaming: A Comparative Analysis of Regulatory Models that have Been Successfully Implemented in Foreign Jurisdictions," 22 Temp. Int'l & Comp. L.J. 437, 451 (2008). Abovitz suggests that "[a]n effective scheme for internet gambling should be similar to that of traditional gambling and should be based on a balance between government's right to tax and supervise and its duty to protect the industry's actors." *Id.* As explored in depth below, many of the principles of brick-and-mortar gaming regulation are adaptable to the regulation of i-gaming. In some respect, developing i-gaming regulations in major emerging jurisdictions -- notable the United States -- offers an opportunity to improve upon regulatory approaches advanced in other i-gaming jurisdictions and regulatory practices which have traditionally been employed in the brick-and-mortar industry.

examining the regulatory approach used in the brick-and-mortar industry is simple: both brick-and-mortar casinos and i-gaming operators have the same, common attribute. That is, the ultimate activity which is subject to regulatory oversight is gambling. The prospective universe of gambling games offered online and on a casino floor are identical.⁹ While i-gaming and land-based gaming share a common underlying activity, the practical means of conducting gaming and the business model differ. The economic model, cost structure, means of operating games and the roles of suppliers differ in the i-gaming industry from that of the land-based gaming industry. Accordingly, effective i-gaming laws and regulations must be sensitive to these differences and embrace regulatory approaches that adhere to the realities of the i-gaming industry.

Developing best regulatory practices for accounting, audit, and recordkeeping requirements of regulated i-gaming, are influenced by several factors. At the macro-level, policy goals and the regulatory philosophies/attitudes can, and will, effect the scope of accounting, audit, and recordkeeping rules. To that end, this Chapter first explores the policy goals sought to be achieved by implementing accounting, audit, and recordkeeping rules for regulated i-gaming. Regulatory tools which have been used are then introduced in summary fashion. Next, the Chapter embarks on a discussion of the theory and history of casino accounting, auditing, and recordkeeping requirements. The discussion is presented in the context of subscribing to the notion that an appreciation of the history and theories of accounting, audit and recordkeeping can

⁹ For example, whether on a casino floor or through the virtues of the Internet, the universe of games which can be offered run the gambit of table games -- baccarat, blackjack, craps, poker, roulette and the numerous permeations of these table games -- and "slot-machines." In the modern gaming industry, the use of the "slot-machine" nomenclature is an archaism of the early gambling devices where gamblers deposited coins into devices which were operated by electro-magnetic spinning-reels with randomly produced characters. A modern slot-machine has evolved into a highly sophisticated computerized device, capable of offering extensive games and functions.

assist in developing efficient and effective i-gaming regulatory practices. Third, this Chapter then presents a more detailed discussion of mechanisms used in the field of gaming accounting, audit, and recordkeeping regulations. We end our journey by enumerating aspirational best practices for the regulation of accounting, audit, and recordkeeping functions within the field of regulated i-gaming.

II. The i-Gaming Business Model, Identifying Policy Goals and Regulatory Tools Used to Implement Policy Goals

The regulation and operation of a regulated business conceptually is similar to three-tiered pyramid, as illustrated in figure 1. At apex of the pyramid is the public policy developed by policymakers. Typically the policymakers are the legislative body and the policies are adopted in the forms of laws. In the middle tier of the pyramid lies implementing rules adopted by regulatory agencies. The regulations add flesh to the policies through interpretative guidance with respect to actions which should, or should not, be undertaken by the regulated business in the conduct of its affairs.¹⁰ Administrative agencies are charged with the task of interpreting and enforcing the policies embraced in the laws and enforcing regulations promulgated under the governing law. At the base of the pyramid are actual operating systems adopted by the regulated business intended to comply with the legal requirements.

¹⁰ An entire body of law has developed in the United States dedicated to administrative law. *See, e.g.*, Ronald M. Levin, "The Administrative Law Legacy of Kenneth Culp Davis," 42 San Diego L. Rev. 315 (2005) (providing a discussion of the development of United States administrative law practice). Issues commonly encountered in the field of administrative law include the binding nature of a rule to the level of deference afforded the rules promulgated by the administrative agency. *See, e.g.*, Matthew C. Stephenson, "Mixed Signals: Reconsidering the Political Economy of Judicial Deference to Administrative Agencies," 56 Admin. L. Rev. 657, 658-660. Not infrequently, persons subject to regulations will challenge the validity of a rule, often asserting that the rule exceeds the authority granted to the administrative body under an enabling law. *See, e.g.* Stephenson at 658-660. A comprehensive discussion of the basic tenets of administrative law is well-beyond the scope of this Chapter. Suffice to say, regulators must be cognizant of the legal limitations on scope of rules adopted in the course of developing i-gaming regulations. *See id.*

Understanding the business model, in addition to the policy goals embraced in authorizing laws, is essential in order to develop efficient and effective regulations. A failure to appreciate the business mode can inadvertently lead to the implementation of non-sensical or impractical rules. One could easily envision the well-intentioned gaming regulator pushing for a rule that requires an agency staff person to be physically present any time cash from poker rakes is physically counted by an i-gaming operator. With an understanding of the business model, our well-intentioned regulatory would quickly recognize that the i-gaming operators collect its "cash" through electronic fund transfers. The discussion below first provides an overview of the typical i-gaming business model. Second, policy goals applicable to accounting, audit, and recordkeeping requirements for the regulated i-gaming industry are identified. Finally, a summary overview of regulatory mechanisms implemented to achieve the policy goals is set forth.

A. Overview of the i-Gaming Business Model

A simple rule of thumb to understand business operations is to "follow the money." In order to develop robust regulations, policymakers and regulators should gain an understanding of the flow of money in the conduct of i-gaming and the i-gaming business model. The business of i-gaming shares a common activity with its brick-and-mortar brethren, but has a different business operational model. Capital needs, operating costs, the role of suppliers, and staff needs can all substantially differ from the brick-and-mortar gaming industry.

The flow of money in the operation of an i-gaming operation differs from brick-and-mortar casinos. Typically, a player will use a credit card to transfer money to an account held in

the name of the i-gaming operator.¹¹ The credit card transfer will be effected by a money processor, which may or may not be directly affiliated with the i-gaming operator. The funds will be held on account for the player with the i-gaming operators. The funds will be held on deposit in a financial institution and may be deposited in a segregated account or commingled with funds of other player or even other funds of the i-gaming operators. Figure 2 graphically illustrates the flow of funds.

Like any other business, including land-based gaming operators, there is no one-size fits all organizational structure. There are three categories of providers operating within the i-gaming sphere: (1) business-to-business ("B2B"); (2) business-to-consumer ("B2C"); or (3) business-to-government ("B2G"). I-gaming operations normally encompass eight distinct spheres of activities. These activities consist of: the game software; the gaming license granted by a licensing jurisdiction; payment processing; liquidity management; site hosting; customer service; marketing; and back-end support. Figure 3 depicts a pie chart identifying the typical eight spheres of i-gaming business activities. What can differ among i-gaming businesses are which activities the operator will directly undertake and which functions will be provided by third-parties.

A business which obtains an i-gaming license operates as a B2C business. A licensee may enter into agreements with B2B businesses to provide certain functions in the operation of an i-gaming website. Two basic business models have developed in the i-gaming industry for the operation of i-gaming websites. The activities which the licensee assume depends will

¹¹ Players may use other methods to fund a player account, such as sending in a live-check, use of an electronic funds transfer, wire transfers, automated clearinghouse transfers, debit cards, or other means of electronic payments.

depend upon the business model adopted. The business model which an i-gaming licensee adopts will depend on a variety of business factors, such as in-house IT capabilities and payment processing expertise.

The first model used in the i-gaming industry is known as the "white label" or "skin" model. In the skin model, the licensee is purely a B2C business. The i-gaming licensee will obtain an i-gaming license for a jurisdiction and enter into licensing arrangements with one or more B2B providers to supply game software, payment processing, website hosting, liquidity management, and other services. The game software provider will necessarily be required to obtain a gaming license as a software provider.

The second business model is a B2C model or a software license model. In a B2C model the i-gaming licensee will hold a gaming license, as well as own underlying game software. The gaming licensee may also enter into agreements with B2B providers for certain services. For example, the licensee may engage third party affiliates to provider marketing services.

In summary, armed with an understanding of the i-gaming business model, policymakers and regulators can develop a robust regulatory model which can support the development of the i-gaming industry without threatening the economic viability.

B. Identifying Policy Goals for i-Gaming Accounting, Audit, and Recordkeeping Requirements

Accounting, audit, and recordkeeping rules at their root have the policy prerogative of protecting the flow of funds, but in the form of government revenue, but also to ensure only licensed persons share in profits.¹² Hence, well-designed regulations constantly have in mind the

¹² See Cabot *supra* note 1 at 395.

purpose for imposing financial-related regulatory burdens. Poorly designed regulatory practices ultimately end up requiring processes to be undertaken or materials to be provided which are tangentially related to the underlying policy.

With a starting point that accounting, audit, and recordkeeping rules are intended to assure the legitimate flow of funds from gaming operations, other policy goals may also come to light.¹³ To expound upon the ultimate goal of protecting the flow of funds, rules governing gaming accounting, audit, and recordkeeping can be classified into four categories. These four classes of policy goals include: (1) ensuring the government receives the proper tax revenue; (2) preventing unlicensed persons from sharing in the profits of the gaming operations; (3) protecting against fraud; and (4) protecting the integrity of the games. Further examination of these four policy goals is appropriate to gain a better understanding of the underlying concerns.

1. Ensuring the government receives the proper tax revenue

Regulations governing accounting, audit, recordkeeping for both the i-gaming and land-based gaming industry at the core are directed at ensuring the government actually receives the appropriate tax revenue.¹⁴ In the United States, tax laws are based on self-assessment -- or voluntary compliance -- whereby taxpayers determine their own tax liability and are responsible

¹³ See Cabot *supra* note 1 at 395. Accounting and audit regulations have traditionally been directed at ensuring the government receives its proper share of tax revenue and prohibiting unlicensed individuals from sharing in profits.

¹⁴ See *id.*; see also Michael A. Santaniello, "Casino Gambling: the Elements of Effective Control," 6 Seton Hall Legis. J. 23, 25 (1982) (noting that "[t]he reported gross profit or loss of the casino, with its accompanying tax consequences, is dependent upon the continued integrity" of the control mechanisms to ensure that cash and casino chips reach the counting process.).

for timely paying the tax liability.¹⁵ A hallmark of self-assessment systems is a requirement that taxpayers not only be required to file reports (the reporting obligation), but also maintain adequate records to substantiate the positions taken on such reports.¹⁶ Thus, requiring gaming licensees to maintain certain records is not unique to gaming laws. According, promulgating gaming regulations to embrace a policy goal of ensuring that the proper amount of tax is reported and paid has a longstanding tradition.

The unique aspect as applied to the gaming industry is the nature of the how revenue is generated. Gaming conducted in brick-and-mortar casinos occurs at a fast pace with several transactions occurring all at once. As a result, it is impractical to record most individual gaming transactions.¹⁷ To address the realities of gaming transactions in brick-and-mortar casinos, aggregate accounting methods and special rules developed to ensure procedures are in place to properly record the results of each transaction, along with the corresponding revenue and tax liability.¹⁸

¹⁵ See, e.g., IRC §§ 6001 and 6011. While the characterization of the United States tax system as voluntary may suggest that payment of taxes is only out of altruistic motivation, the legal requirement imposed by United States tax laws is not at all altruistic. Rather, qualitative "voluntary" aspect of the United States tax system means that taxpayers determine tax liability as opposed to the government computing tax liability.

¹⁶ See, e.g., IRC § ____.

¹⁷ See Santaniello, supra note 14 at 25 (noting that "[t]he reported gross profit or loss of the casino, with its accompanying tax consequences, is dependent upon the continued integrity" of the control mechanisms to ensure that cash and casino chips reach the counting process.). In the context of the brick-and-mortar casino, numerous opportunities for inaccuracies -- both intentional and unintentional -- exist which can occur in the process of collecting and recording profits. See *id.* As an example, inadequate controls which allow a dealer to pocket chips can result in underreporting of revenue and the corresponding tax.

¹⁸ See *id.* at 24. "Due to the impracticality of recording each gaming transaction, a [brick-and-mortar] casino must rely on aggregate amounts of cash, checks, and gaming chips to determine its gross profits or loss." *Id.* For further discussion of the control procedures used in brick-and-mortar casinos to ensure income and loss is properly reported, see generally Santaniello, supra note 14.

Like the regulation of brick-and-mortar gaming operations, i-gaming laws share the common goal of ensuring the proper tax is paid by licensees. The means by which revenue is received from the conduct of i-gaming differs from traditional brick-and-mortar operations. By virtue of having electronic transactions, i-gaming affords the opportunity to depart from aggregate accounting. From a practical standpoint, this distinction will lead to very different regulatory content with respect to developing best practices to ensure that revenue is properly recorded in an effort to determine the proper tax liability.

2. Protecting against unlicensed individuals sharing in profits

The protection of the public integrity of the gaming industry has long-been an underlying public policy of the regulation of the gaming industry.¹⁹ Measures to prevent unsavory or unsuitable persons from having a direct or indirect involvement in the gaming business further the public integrity of the gaming industry.²⁰ Accounting, audit, and recordkeeping rules help fulfill this policy goal by offering the opportunity to trace revenue and the distribution of revenue to ensure that money is not being skimmed from gaming operations.

3. Protecting against fraud

The emergence of Internet commerce presents new threats for fraudulent activity.²¹ Internet-based fraudulent activities range from money-laundering and terrorist financing

¹⁹ See Robert W. Stocker II and Peter J. Kulick, "Gambling with Bankruptcy: Navigating a Casino Through Chapter 11 Bankruptcy Proceedings, 57 Drake L. Rev. 361, 369 (2009).

²⁰ See Stocker & Kulick *supra* note 19 at 369.

²¹ See generally Edward M. Roche, "Internet and Computer Related Crime: Economic and Other Harms to Organizational Entities," 76 Miss. L.J. 639 (2006) (discussing the costs of Internet crime).

activities, payment fraud, to identity theft.²² Online fraud often centers on electronic identity theft and payment fraud.²³ The very nature of i-gaming being an activity conducted through the Internet, which can involve significant and frequent monetary transactions, exposes the i-gaming industry to threats of criminal activity through electronic means.²⁴ Accordingly, advancing the integrity of i-gaming includes having protocols which assure the public that i-gaming sites have safeguards to reasonably protect against unwittingly becoming mechanisms for online fraudulent activities.

4. Protecting the integrity of the games

The ICS developed to satisfy accounting, audit, and recordkeeping can further be used to detect irregularities in the conduct of games. For example, surveillance controls can detect uncommon or unusual moves in the play of a game, which, in turn, may indict the integrity of the game has been compromised.²⁵ Therefore, accounting, audit, and recordkeeping requirements can also be utilized to further the policy goal of protecting the integrity of the online games. As an example, software may be used to detect unusual betting patterns or wagers.

5. Summary

²² See Sonya Crites, "Best Practices in Addressing Online Cash Management Security," 23 Com. Lending Rev. 21, 23-24 (2008). Crites notes that many organizations lack "appropriate controls needed to adequately protect a company's financial assets" from electronic fraud involving identity theft and payment fraud. *Id.*

²³ See Crites *supra* note 22 at 23.

²⁴ Beyond offering gambling games through the Internet, i-gaming is intertwined with online banking and cash management systems. Wager amounts are transferred by payment processors to the operators and from the operators to players. Consequently, i-gaming regulations will necessarily touch on practices designed to ensure the integrity of the payment processing systems.

²⁵ See Santaniello *supra* note 14 at 34.

Four basic policy goals have been identified above. Jurisdictions may have additional policy goals which can be advanced through accounting, audit, and recordkeeping requirements.²⁶ Public policy can be influenced by a variety of factors, such as cultural or political proclivities.

The policy goals of a particular i-gaming jurisdiction will impact the content of accounting, audit, and recordkeeping requirements. In the purest sense, the accounting, audit, and recordkeeping functions should be designed with the initial goal of protecting the legitimate flow of funds. Ultimately, the i-gaming regulations must be reflective of the policy goals embraced in the enabling laws. A careful balance must be maintained with respect to the scope of the regulatory requirements. If i-gaming regulations unduly burden operators with unnecessary or requirements, or those which are impractical, the viability of the i-gaming industry can be undermined.

C. Overview of Regulatory Tools to Achieve Accounting, Audit, and Recordkeeping Requirements

Regulations are the means to effectuate general policy goals embodied in enabling laws. Regulations can interpret the laws and offer guidance with respect to fulfilling the statutory, or code based, requirements. The land-based gaming regulatory field has utilized several different regulatory tools in order to carry-out these financial policy goals. These regulatory tools which

²⁶ As an example, a particular jurisdiction may decide to implement a stringent problem-gambling policy which allows for self-exclusion for a specified period of time. Theoretically, it could be argued that accounting, audit, and recordkeeping should be limited simply to protecting the flow of money. While a theoretically pure regulatory approach has many positives, the adopting of public policy is not always as simple as common sense approaches. The point being, regulations governing accounting, audit, and recordkeeping can be adapted to assist with achieving secondary policy goals beyond protecting the legitimate flow of funds. Consequently, in order to further the self-exclusion policy, a jurisdiction may require i-gaming operators to maintain records that identify players that which have opted to self-exclude. The scope recordkeeping may further identify such information as the date of self-exclusion and the length of the self-exclusion period.

have been used to further accounting, audits, recordkeeping policy goals can be adapted for use in the regulation of i-gaming.

Regulatory mechanisms which can be implemented to effectuate the oversight of i-gaming accounting and audit controls include:

- (1) *Active governmental participation in the accounting process;*²⁷
- (2) *Government conducted audits;*²⁸
- (3) *Independent audits;*²⁹
- (4) *Development of minimum internal control systems (or MICS);*³⁰
- (5) *Imposition of financial and operational recordkeeping requirements;*³¹ and
- (6) *Reporting requirements.*³²

²⁷ See Cabot *supra* note 1 at 396-97. Governmental involvement in the accounting process raises a practical, and philosophical, question with respect to the governmental regulators' level of intrusiveness during the accounting process. For example, regulations could call for onsite regulatory personnel to supervise accounting functions. The reliance on active governmental participation in the accounting process, consequently, can raise efficiency and economic feasibility concerns. See *id.*

²⁸ See Cabot *supra* note 1 at 396.

²⁹ See *id.*

³⁰ See *id.*

³¹ See *id.* As discussed further below, recordkeeping requirements present a question concerning the scope of records an operator must maintain. The scope consists of the type, content, and period records must be maintained.

³² See *id.* From a financial perspective, the primary reporting obligation is ordinarily a requirement to periodically file tax returns. Reporting requirements can also have significant overlap with other regulatory requirements. For instance, i-gaming regulations could impose reporting requirements to further anti-money laundering protections, suitability and licensing requirements, integrity of the games/fairness of games, and player protections/problem gambling.

Ultimately, several factors will influence the particular tools implemented to further accounting, audit, and recordkeeping goals.

III. History and Theories of Casino Accounting, Auditing, and Recordkeeping

Distinctive approaches to accounting, auditing, and recordkeeping requirements have developed in the land-based casino gaming industry. Understanding procedures utilized in the land-based gaming industry can be beneficial for developing best practices in the regulation of i-gaming. Understanding the theory for imposing regulatory requirements is beneficial in two respects. First, it reveals why certain requirements have been incorporated into rules. That is, what is the harm the rule seeks to protect against or what information is sought. Second, understanding the theory allows for the development of rules that can be adopted for the unique business differences within the i-gaming industry.

The notion of accounting invokes the method by which a business records its receipts and expenditures. Accounting methods answer questions such as what items are considered expenses and income, as well as the timing of when items are recognized.

At the most fundamental level, an audit is a compliance check to assess the fairness of financial statements so that financial results are reflected in material respects.³³ The meaning of an "audit" has expanded in the regulatory field to include so-called "certification" audits. A

³³ See Comment, "The Toothless Watchdog: Corporate Fraud and the Independent Audit - How Can the Public's Confidence Be Restored?," 58 U. Miami L. Rev. 891, 896 (2003).

certification audit involves an auditor certifying that a business has complied with other requirements, including non-financial regulatory requirements.³⁴

Recordkeeping involves the exercise of identifying the type and scope of information businesses maintain, the medium for maintaining the information, and length the information must be maintained.

A. Casino Accounting

Accounting is an exercise of recording transactions to determine financial results. The accounting process relies upon control mechanisms to ensure that transactions are properly recorded.

1. A Background Primer on Casino Accounting

Standard accounting practice entails identifying revenue and expenses to arrive at the business' profit/loss.³⁵ Supporting data must be examined to determine the results of each transaction. For most businesses, accounting consists of a review of receipts and other records to trace the inflow of money (i.e., income) and the outflow of money (i.e., expenditures). The process of accounting requires use of internal controls to provide assurances that transactions are accurately and properly recorded.³⁶

³⁴ See Amy Shapiro, "Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives," 35 Seton Hall L. Rev. 1029, 1036 (2004).

³⁵ See, e.g., Cabot *supra* note 1 at 396.

³⁶ See Martin Lipton, et al., "Audit Committee Guide & Best Practices," ALI-ABA Course of Study Materials, Eleventh Annual Corporate Governance Institute, 19 (2004). The use of internal control systems in the casino industry -- often simply referred to using the acronym of ICS or MICS -- has evolved into special meaning vis-à-vis regulatory-mandated operations within the gaming industry. The minimum internal control systems, or MICS, are regulatory standards that establish exactly what the name means -- the minimum procedures which a licensee must employ for the ultimate purpose of recording each gaming transaction. The internal control systems,

The method of accounting is an often overlooked, but critical aspect of accounting. In the United States, the non-accountant, and even perhaps the accountant, will defer to the use of "generally accepted accounting principles" ("GAAP") without a full appreciation of what GAAP really means.³⁷ GAAP may be an easily identifiable standard; however, it is also a complex system which allows for multiple approaches to account for transactions.³⁸ Accordingly, simply dictating the use of GAAP does not necessarily provide an assurance that the accounting records will provide the information regulators are seeking.

Standard accounting practices have not historically been used in the brick-and-mortar gaming industry.³⁹ "Casinos are unique because millions of dollars continually changing hand among thousands of people on the casino floor without any record being made of how much money is exchanged, how many people are involved, or who those individuals are."⁴⁰ To record every transaction would mean that the gambling activity necessarily would come to a standstill.⁴¹ As a result, standard accounting practices have proved to be impractical in the brick-and-mortar

or ICS, are those control procedures actually adopted by a licensee to record gaming transactions. As discussed further below, MICS and ICS will actually provide sufficiently more detail and cover significantly more subject matters than simply recording an individual gaming transaction. MICS and ICS are analogous to a staircase. That is, the MICS and ICS require the licensee to undertake several steps in the process which will arrive at an accurate record of the gaming transaction. While ICS have derived special meaning within the gaming industry, the notion of internal control policies (alternatively referred to as internal control procedures) is a much broader accounting concept. Internal control policies sets forth procedures businesses implement in order to ensure transactions are accurately reported. Businesses universally rely on internal control policies. In the public company context, internal control policies are an important element in the accounting and audit process. *See* Lipton at 19.

³⁷ *See* Shapiro *supra* note 34 at 1051-52.

³⁸ *See id.*

³⁹ *See* Cabot *supra* note 1 at 396.

⁴⁰ *See* Santaniello *supra* note 14 at 23.

⁴¹ *See id.*

gaming industry.⁴² Consequently, a unique system of accounting and internal control procedures were necessary for land-based casino industry. This unique accounting method is known as aggregate accounting.

At a very basic level, the aggregate accounting method used in land-based casinos is simple to explain. Revenue results are measured over a specified period of time. Win or loss is measured by comparing the beginning chip inventory, the amount of cash or credit received and the remaining chip inventory at the end of the specified period.⁴³ The real difficulty lies with having proper, effective internal controls.⁴⁴ In a brick-and-mortar casino, chips must be delivered to tables ("fills"), money is constantly being deposited at tables and in electronic gaming devices ("drops"), and "drops" collected.⁴⁵ Lack of control procedures at each step of this process can cause inaccuracies.⁴⁶

2. Use of Internal Controls

To ensure accurate accounting, businesses rely upon internal control policies.⁴⁷ Internal control policies are a fundamental aspect of financial accounting.⁴⁸ The policies and procedures within the purview of internal controls include policies which: address the maintenance of

⁴² *See id.* at 24.

⁴³ *See id.*

⁴⁴ *See* Richard A. Meyer, "Accounting for the Winnings - Auditing Gambling Casinos," 12 Conn. L. Rev. 809, 811 (1979).

⁴⁵ *See Meyer supra* note 44 at 811-812.

⁴⁶ *See Santaniello supra* note 14 at 23.

⁴⁷ *See generally* Lipton *supra* note 36 at 19. Internal control procedures are alternatively often referred to as internal control policies. *See id.*

⁴⁸ *See* Lipton *supra* note 36 at 19.

records in reasonable detail in order to accurately reflect transactions and dispositions of company assets; provide reasonable assurances that the transactions are recorded in a manner that allows financial statements to be prepared in accordance with the accounting system; ensure that receipts and expenditures are made only in accordance with the authorization of management and directors; and to provide reasonable assurances to either prevent or allow for timely detection of unauthorized transactions involving company assets that could have a material effect on financial statements.⁴⁹

Based on the nature of operations in a brick-and-mortar casino, "special procedures to ensure that [the casinos'] financial records properly reflect the actual results of gaming transaction" must be used.⁵⁰ Similar to any other business, the purpose of internal controls in the gaming industry is to "to act as checks on the handling of financial operations."⁵¹ The benefits derived from the use of ICS in land-based gaming have been described as "assist[ing] both the state and federal governments in their efforts to control gambling operations, protect the betting public, and collect taxes and fees from the casinos."⁵²

The types of internal control procedures adopted in the gaming industry focus on documentation controls, physical/access controls, and personnel controls.⁵³ Casino internal

⁴⁹ See Lipton *supra* note 36 at 19.

⁵⁰ Meyer *supra* note 44 at 812.

⁵¹ *Id.*

⁵² *Id.* at 813.

⁵³ See Cabot *supra* note 1 at 399-401.

control policies include provisions to provide for the "separation of functions, and extradepartmental [sic] reviews of transactions."⁵⁴

3. Summary

There are common considerations between i-gaming and land-based gaming related to accounting procedures and the types of internal controls which may be used. Both in the context of Internet-based and in-person gambling, operators share the common desire to ensure that the win/loss from the operation of a game is properly recorded. While the goal is similar, the nature of how games are conducted substantially differs. As a result, while traditional casino accounting and internal controls have application in i-gaming operations, the accounting and internal controls must be adapted to reflect the reality of how i-gaming is conducted. The means by which i-gaming is conducted affords an opportunity to receive more detailed records because each gaming transaction can be readily recorded during the course of play without causing play to come to a standstill.

B. Casino Audits

Audits serve several important functions. Audits are beneficial for internal business purposes to serve as a check on the activities of the business.⁵⁵ Financial markets also depend on

⁵⁴ *Id.* at 812. In-person gaming occurring on the casino floor is a fast-based environment which can literally include dozens of separate gaming transactions in the course of each incidence of play. For example, depending on the number of seats at a blackjack table (typically 5 to 7 seats), a single game of blackjack could consist of over a dozen isolated wagers, not to mention players exchanging cash for chips or "coloring-up" chips to greater dollar denominations, all taking place within the course of a matter of minutes. As a result, the internal control procedures which developed in the land-based gaming environment have been designed to "guarantee that cash, checks, and gaming chips will be properly handled during the gaming day and that they will reach the counting process." Santaniello *supra* note 14 at 25.

⁵⁵ *See Comment supra* note 33 at 894-95.

audits to assess the worth and creditworthiness of companies. Audits further serve as an assurance with respect to regulatory compliance.

The United States Supreme Court has characterized the role of the auditor as one of the "public watchdog."⁵⁶ While the auditing vocation may not necessarily embrace the role of being the "public watchdog," the public relies on auditors to provide an independent assessment of the fairness of financial statements.⁵⁷ "Audits" have expanded beyond simply serving as a tool to assess the fairness of financial statements.⁵⁸ The concept of an audit is "now used in a variety of contexts to refer to new or more intense account-giving and verification requests."⁵⁹

Without an appreciation of the reason for requiring audits and the role of the auditor, the potential value of an audit can quickly disappear. Regulations and the regulators enforcing the regulations should gain an appreciation of: the role of the auditor; the purpose of the audit; and content which should be included in an audit.

1. The Role of an Auditor

The traditional role of the auditor is serve as a detective for the owner of a company.⁶⁰ "The standard task of what is now called internal auditing is to inform owners of the activities of their agents and employees."⁶¹ Over the past century, auditors have taken on a secondary role of

⁵⁶ See *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984).

⁵⁷ See Comment *supra* note 33 at 894-95.

⁵⁸ See Sasha Courville, et al, "Auditing in Regulatory Perspective," 25 Law & Pol'y 179 (2003).

⁵⁹ *Id.*

⁶⁰ See Amy Shapiro, "Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives," 35 Seton Hall L. Rev. 1029, 1034 (2004). Shapiro provides a detailed overview of the traditional role of the auditor.

⁶¹ See Shapiro *supra* note 60 at 1034.

certifying information for third-party disclosure.⁶² In the certifying function, an auditor is considered to be a gatekeeper for the third-party user.⁶³

2. Purpose of the Audit

The objective of an audit will depend on whether the auditor is acting in the role of a detective or certifier. In the "detective" function, the purpose of an audit of the financial statements of a business is to express an opinion with respect to the fairness of the presentation of financial statement in disclosing, in a material respect, the financial position and results of the business.⁶⁴ In the certification function, an audit is examining whether financial records satisfy an accounting or other standard.⁶⁵ Thus, "the audit is seen as a particularly important tool of regulation, accountability, and governance."⁶⁶

3. Audit Content

The content of the audit will turn on the purpose of the audit and the accounting system used by the business subject to the audit. At the base level, an audit will include notes explaining significant financial transactions and the accounting of those transactions. A certification audit,

⁶² See *id.* at 1036.

⁶³ See *id.*

⁶⁴ See *id.* at 896 (quoting AICPA Professional Standards, Statements on Auditing Standards No. 1, AU § 110.01 (American Inst. of Certified Pub. Accountants 2001)).

⁶⁵ See Shapiro *supra* note 60 at 1037. "Accounting standards are vital to certification auditing because the third party information user needs some way to evaluate the information received." See *id.* at 1050. Too often, policymakers, attorneys and regulators will simply express the relevant accounting standard as ensuring that financial records are prepared in accordance with GAAP -- that is, "generally accepted accounting standards" -- published by the professional society of accountants. See, e.g., Shapiro *supra* note 60 at 1051 n.90 (citations omitted). The problem with GAAP is that it "is not only complex, but provides numerous ways to account for even common items such as inventory and depreciation as well as exotic ones such as derivatives." *Id.* at 1052. Accordingly, without understanding the accounting system, a certification audit may prove to be of little value.

⁶⁶ See Courville *supra* note 58 at 179.

such as would be expected in the regulated gaming industry, may also include a summary of the licensee's ICS and a certification with respect to whether the ICS satisfy regulatory requirements.⁶⁷

4. Audits within the Gaming Industry

For the gaming industry, the function of the auditor is typically two-fold. First, the auditor -- as with any other audit engagement -- is responsible for expressing an opinion with regard to whether the income or loss of the gaming business is properly reported.⁶⁸ Second, state gaming laws typically impose additional certifications.⁶⁹ For instance, the gaming laws and regulations in several jurisdictions ordinarily require an auditor to provide an assessment the internal control procedures of the casino licensee.⁷⁰

The function of the audit, therefore, plays an important role of not only ensuring that gaming revenue is properly recorded, but also for determining compliance with the underlying gaming laws and regulations. The internal controls operate as the backbone of gaming businesses by establishing procedures for, among other matters, recording gaming transactions,

⁶⁷ See, e.g., Mich. Comp. Laws Ann. § 432.214 (requiring quarterly audits of the financial conditions of casino licensees); 2000 AACCS, R 432.11201 to 432.11209; Nev. Rev. Stat. Ann. § 463.157; see also Meyer *supra* note 44 at 817.

⁶⁸ See Meyer *supra* note 44 at 810 ("[audits] are essential parts of the proper reporting of income or loss by gambling casinos."). Beyond ensuring that income or loss is reported, the tasks of the auditor also include studying and evaluating the casino's ICS. The evaluation of ICS can be tied to the process of ensuring that the audit is performed in adherence with professional standards. In the United States, auditors typically conduct audits in accordance with Generally Accepted Auditing Standards ("GAAS").

⁶⁹ See *id.* at 817.

⁷⁰ See, e.g., Mich. Comp. Laws Ann. § 432.214 (requiring quarterly audits of the financial conditions of casino licensees); 2000 AACCS, R 432.11201 to 432.11209; Nev. Rev. Stat. Ann. § 463.157; see also Meyer *supra* note 44 at 817.

document control and access control. Casino accounting procedures and the audit requirements are intertwined within the regulatory body governing the financial aspects of casino operations.

C. Recordkeeping Requirements

Recordkeeping is simply the obligation of operators to document certain transactions, retain the documents and disclose certain information. Records are the evidence used to support the results of the transactions of the operator and demonstrate compliance with regulatory requirements. The prospective scope of records can be expansive, ranging from records relating to financial results to records which demonstrate compliance with gaming laws and rules. The regulation of i-gaming, as discussed below, recordkeeping will cover the substance of matters such as recording of wagering transactions, player verification, and the conduct of games.

IV. Regulatory Tools

Government regulation of the gaming industry represents government intervention into an economic market. Government intervention can affect economic efficiency and lead to market failures.⁷¹ The economic costs of compliance must carefully be considered when designing regulatory models. In particular, efforts should be undertaken to ensure that

⁷¹ See Tevfik F. Nas, *Cost-Benefit Analysis: Theory and Applications* 11 (1996). Economic efficiency is the goal for allocating goods in a market. See, e.g., Steven E. Rhoads, *The Economist's View of the World: Government, Markets, & Public Policy* 63 (1994). *Pareto* optimality dictates that markets reach a state of efficiency "where no one person can be made better off without simultaneously making at least one person worse off." Nas at 11. Government intervention can threaten the ability of a market to achieve *Pareto* optimality and impose welfare costs (or dead-weight losses) on markets. See Rhoads at 64.

regulations do not adversely affect market efficiency and to measure the cost-benefits of the regulations.⁷²

Various mechanisms can be implemented to effectuate accounting and audit policy goals within the i-gaming regulatory field. Accepted policy analysis principles allow for the assessment of the economic costs of regulatory requirements.⁷³ Cost-benefit analysis is particularly useful to ascertain the market costs of regulations and the impact on market efficiency.⁷⁴ Cost-benefit analysis involves identifying both the costs and benefits of a prospective regulation.⁷⁵ Quantifying the costs and benefits can often be a difficult and complicated task. In addition to examining cost-benefits, feasibility of technological requirements of a regulation must also be contemplated to avoid imposing standards which are not technologically capable of being achieved.⁷⁶

Accounting and audit regulations are ordinarily intricately intertwined with internal control procedures. Internal control procedures, whether cast in the form of required minimum internal control systems or merely the procedures adopted by i-gaming operators, can serve as a

⁷² See Australia Productivity Commission 2010, Gambling, Report no. 50, at 17.24, Canberra, Australia (2010) (*hereinafter* "Australian Gambling Study").

⁷³ See Australia Productivity Commission 2010, Gambling, Report no. 50, at 17.24, Canberra, Australia (2010).

⁷⁴ See *Nas supra* note 71 at 11.

⁷⁵ See *Nas supra* note 71 at 11. The actual application of cost/benefit analysis is simple in theory. Consider the following illustration. Suppose that a regulation is implemented requiring the jurisdiction to implement online monitoring of all interactive games, with the costs of the system being directly passed to the regulated i-gaming operators. If the costs to operators is \$200 per year, while operations can only be expected to generate \$100 per year, there is little incentive to actually engage in commercial activity. In the example, the costs of the regulation destroyed any potential economic benefit.

⁷⁶ See Eugene Martin Christiansen, Central Systems for Machine Gaming: A Good Policy? (2003) (*hereinafter* the "Christiansen Study"). The Christiansen Study outlines a classic example of regulatory requirements creating inefficient redundancies.

practical regulatory model. In the land-based gaming industry, the use of required MICS have been adopted in many jurisdictions as an effective approach to identify accounting, audit, and recordkeeping procedures.⁷⁷ The use of MICS, therefore, can serve as the main tenet of accounting, audit, and recordkeeping regulations.

Ultimately in designing an effective regulatory model, regulatory bodies should strive to keep policy goals front and center. It is far too easy to lose sight of the forest for the trees. Therefore, by constantly asking whether a regulatory requirement furthers an underlying policy goal is a good practice when developing best regulatory practices.

A. Examining Accounting and Audit Regulatory Tools: the Practicality of Direct Government Involvement, Government Audits, Independent Audits, and other Tools

As previously identified, gaming regulations have generally resorted to the use of six basic categories of requirements to effectuate accounting, audit, and recordkeeping requirements. These six tools -- government participation, governmental audits, independent audits, mandatory minimum internal control procedures, recordkeeping, and reporting -- in isolation can have individual merit. These regulatory tools also can have considerable overlap among one another. Thus, often a mix of the six regulatory often proves to be an efficient and effective regulatory approach.

⁷⁷ See, e.g., Nev. Rev. Stat. Ann. § 463.157; 2000 AACRS, R. 432.1901 to 432.1907 (Michigan gaming rules regarding ICS); see also Meyer *supra* note ___ at 815.

Government Participation

Government involvement in accounting and audit functions can take the form of direct governmental participation in gaming operations.⁷⁸ A method of government participation in the i-gaming regulatory field could entail the use of central monitoring of the conduct of games and monetary transactions.

Louisiana experimented with direct participation by means of a central monitoring system for electronic gaming devices ("EGD").⁷⁹ The lessons of the Louisiana experiment have application to the regulation of i-gaming. Specifically, the purpose of the Louisiana central monitoring system was to provide state gaming regulators with the ability to remotely monitor EGDs and related monetary transactions. Eugene Martin Christiansen conducted a study to assess the feasibility of the Louisiana experiment.⁸⁰

Louisiana has authorized both commercial gaming and video lottery terminals ("VLT"). Commercial gaming is conducted at land-based and riverboat casinos. VLT machines were authorized to be located at establishments selling alcohol, truck stops, racetracks and off-track betting facilities. The Louisiana central monitoring system was intended to be a "State-operated central *monitoring and control* system providing regulators with control over individual slot-

⁷⁸ See Cabot *supra* note 1 at 396. Cabot explains government participation can involve direct supervision of the count process and transactions involving money, credit or cash equivalents. See *id.*

⁷⁹ See Christiansen *supra* note ____ at 5-7.

⁸⁰ See Christiansen *supra* note ____ .

machines, including the ability to shut down malfunctioning machines down, in addition to audit and financial monitoring for individual machines and for slot gaming as a whole in real time."⁸¹

The Christiansen Study concluded that the Louisiana's direct participation through use of a central monitoring system of EGD ultimately "is a weak *monitoring* system ... and essentially duplicates the financial audit controls provided to licensed operators by casino computer monitoring systems designed for this purpose."⁸² Christiansen's study emphasis several salient points: (1) operators and state regulators share a common interest in accurate machine reporting and the integrity of each gaming device; (2) technological challenges add costs and compromise the strength of a regulatory system; and (3) redundancy may produce no additional benefits.⁸³

What does the Louisiana experiment mean for the development of i-gaming regulatory practices? At the threshold, the Louisiana approach introduces a potential method for monitoring compliance with i-gaming accounting, audit, and recordkeeping requirements. Specifically, the Louisiana system highlights a method for government regulators to directly monitor electronic games which could similarly be used in the regulation of i-gaming. The Christiansen Study, however, calls into question whether any added benefits can be derived from direct government participation. The Christiansen Study found that any benefits were minimal and merely duplicative of existing accounting and audit reports produced by the EGDs for the licensees.⁸⁴ Moreover, the Louisiana central monitoring system was expensive to develop and maintain.⁸⁵

⁸¹ See Christiansen *supra* note ____ at 7.

⁸² *Id.* at 7 (emphasis present).

⁸³ See *id.* at 5-8.

⁸⁴ See *id.*

⁸⁵ See *id.*

As a result, the Christensen Study reveals that the costs of government participation through monitoring games and monetary transactions are significant and outweigh the benefits. Essentially, the Louisiana system created an unnecessary redundancy when there was no evidence that current accounting and audit regulations were ineffective. Therefore, the Christiansen Study suggests that direct government participation through central monitoring is not only inefficient, but of little regulatory benefit.

Government Audits

A "government audit" typically evokes the tax audit by government revenue officials designed to ensure the proper payment of taxes.⁸⁶ Audits, however, can address a variety of subjects with respect to regulatory oversight, accountability, and corporate governance.⁸⁷ Accordingly, a threshold matter for a governmental audit requirement necessitates answering the question of what are regulators seeking to accomplish as a result of a government audit.⁸⁸

As a compliance check and deterrent tool, government audits can be effective.⁸⁹ The *ability* -- as opposed to a *mandate* -- to conduct governmental audits may serve a useful regulatory purpose.⁹⁰ To the extent that regulations require independent audits, requiring

⁸⁶ See _____.

⁸⁷ See Courville *supra* note ___ at 179.

⁸⁸ In the brick-and-mortar gaming industry, government audits have been explained as an enforcement mechanism to ensure compliance with required minimum internal control procedures, tracking the flow of money to ensure unlicensed individuals do not economically share in revenues, is properly reporting revenue and paying all fees and taxes. See Cabot *supra* note 1 at 397-98.

⁸⁹ See Cabot *supra* note 1 at 398.

⁹⁰ See *id.* Certainly on the tax-side, the ability of the government to conduct audits is an important mechanism to ensure that revenue is being properly reported and the proper amount of tax is paid on the revenue. This particularly the case for North American jurisdictions which depend upon voluntary compliance. The tax systems are voluntary in the sense that taxpayer compliance is voluntary.

periodic government audits will likely be an unnecessary duplication of the independent audit.⁹¹ Therefore, the flexibility to conduct discretionary and random audits can be a practical regulatory tool. Requiring the government to periodically audit all i-gaming operators, however, may not add sufficient benefits compared to the resulting costs imposed on licensees.

Independent Audits

Independent audits are an efficient method to ensure compliance with accounting, audit, and recordkeeping requirements for i-gaming businesses.⁹²

B. ICS and MICS: Internal Controls Procedures and the Role of Mandatory Minimum Internal Controls

As discussed above, internal control procedures are not simply a creation of gaming regulations.⁹³ Internal control procedures are paramount for ensuring accurate accounting of the operations of any business. The internal controls identify the procedures to carry out

⁹¹ The independent audit is designed to be an independent, unbiased check of the fairness of financial statements and certification of compliance with regulatory requirements. *See* Note, "Securities Regulation: Private Auditor Independence for Non-Audit Services - An Evolving Standard," 55 Okla. L. Rev. 513 (2002). In other words, an independent audit is not the situation where a gaming licensee presents its most optimistic and favorable explanation of the results of its operations. *See id.* That is, the independence of the audit is intended for third parties to be able to rely upon the fairness, in all material respects, of the matters subject to the audit. *See Comment supra* note ___ at 896. Accordingly, requiring annual government audits would likely not add any greater value than an independent audit. In contrast, the ability to conduct discretionary and random audits to verify information or, to conduct further investigations if red flags are raised, can be a useful regulatory tool. *See Cabot supra* note 1 at 397-98. Discretionary and random audits can serve as an incentive to ensure compliance. *See id.* That is, the threat of the government audit can serve to strike a sufficient amount of fear in the licensee to ensure the licensee uses its best efforts to remain in material compliance with regulatory requirements. Similarly, the discretionary audit can be helpful for regulators to conduct further investigation when suspected problems, be it with respect to the integrity of games or financial viability, arise.

⁹² For i-gaming operators which are part of a publicly-held company, independent audits will likely be required. *See Lipton supra* note 36 at 19.

⁹³ Albeit, the ICS receive considerable attention within the gaming industry with respect to daily operational procedures.

transactions and record the results of the transactions.⁹⁴ Not only do "[internal control procedures] prevent improprieties and promote the integrity of the transactions and the records of results," they also provide detailed procedures for the conduct of i-gaming operations.⁹⁵

Jurisdictions have promulgated regulations that set forth required MICS.⁹⁶ MICS generally serve the purpose within gaming regulations to "safeguard casino assets, ensure the reliability of financial records, and guarantee that all transactions are authorized by casino management."⁹⁷ Internal control procedures within the gaming industry cover three categories, consisting of documentation controls, access/physical controls, and personnel controls.⁹⁸

Documentation controls center on the types of records an i-gaming operator must maintain in connection with preparing financial statements and demonstrating compliance with gaming laws and rules. Examples of document control in the i-gaming regulatory field include the maintenance of records relating to deposits to and withdrawals from player accounts, summary reports of player account balances, gaming play reports, and revenue reports of i-gaming operators.⁹⁹

⁹⁴ See Alderney Gambling Control Commission, Technical Standards and Guidelines for Internal Control Systems and Internet Gambling Systems (2010) (*hereinafter* "Alderney ICS").

⁹⁵ Meyer *supra* note 44 at 812; *see also* Alderney ICS.

⁹⁶ See Nev. Rev. Stat. Ann. § 463.157; *see also* Meyer *supra* note 44 at 815-16.

⁹⁷ Meyer *supra* note 44 at 815.

⁹⁸ See Cabot *supra* note 1 at 399-401; Meyer *supra* note 44 at 815.

⁹⁹ See Nevada Interactive Gaming MICS 130 to 143.

Access/physical controls are procedures which identify the personnel that may have access to company records and assets.¹⁰⁰ As an example, access controls may provide that only certain IT personnel can be allowed access to gaming software.¹⁰¹

Personnel controls are procedures which establish an organizational structure for the approval of transactions.¹⁰² Typically, personnel controls rely on the division of duties and responsibilities.¹⁰³ Personnel control can also include the use of checks and balances to ensure that no single department or person within the i-gaming operator organization has unfettered control.¹⁰⁴

The scope of required MICS for i-gaming operators have ordinarily included a requirement for independent audits, preparation of detailed reports concerning player account deposits/withdrawals, and detailed reports concerning the conduct of games.¹⁰⁵ The content of accounting control systems typically include both general accounting procedures, as well as establishing audit and recordkeeping procedures. The Alderney ICS are illustrative of the fact that the same categories of controls -- documentation, access/physical, and personnel -- are

¹⁰⁰ See, e.g., Nevada Interactive Gaming MICS 11 ("[r]emote access to the interactive gaming system components (production services, operating system, network infrastructure, application, database and other components) should be limited to authorized IT department personnel employed by the operator of the interactive gaming system."). In the context of land-based gaming, access/physical controls have included the use of physical safeguards such as surveillance cameras and restricting the personnel which has access to slot-machine drops or other gaming equipment. See Cabot *supra* note 1 at 399. For further discussion of access/physical controls used in the land-based gaming industry, see generally Cabot *supra* note 1 at 399-400.

¹⁰¹ See Nevada Interactive Gaming MICS 11.

¹⁰² See, e.g., Alderney ICS at 4 (providing that a licensee's ICS should include administrative controls detailing organizational structure and decision-making processes).

¹⁰³ See Santaniello *supra* note ____ at 32 (discussing division of responsibilities in the context of land-based gaming operations).

¹⁰⁴ See *id.*

¹⁰⁵ See, e.g., Nevada ICS 144; Alderney ICS at 24-30.

adaptable for application in the regulation of i-gaming. The Alderney ICS provide a framework for i-gaming accounting controls. The Alderney ICS accounting control procedures require licensees to identify:

- Internal accounting controls - which consists of identifying procedures for documenting transactions, maintaining accounting records, providing controls over the safeguarding of physical and financial assets, controlling the expenditures of funds, and reconciling customer accounts and profits and losses;
- List of all accounts used in the operation of the licensee's operations;
- Internal reporting procedures;
- External reporting procedures -- includes the submission of various reports to gaming regulators, such as monthly reports concerning operations and quarterly financial reports;
- Reports evidencing that licensees meet prescribed capital ratios;
- Procedures for the preparation and approval of annual budgets and forecasts;
- Identification of the licensee's external auditor and timing for preparation of external audit;

- Description of accounting software used by the licensee, including such information as procedures for backing-up accounting software data and the secure storage of accounting data;
- Access controls for the computerized accounting systems;
- Record retention policy;
- Bank accounting information; and
- Information pertaining to how customer funds are held, such as identifying whether customer funds are held in segregated or comingled accounts.

Similarly, the Nevada Interactive Gaming MICS require operators to have independent audits,¹⁰⁶ reconcile certain payment reports,¹⁰⁷ as well as periodically prepare and review various gaming related data.¹⁰⁸

In summary, internal control principles developed for the brick-and-mortar gaming industry are adaptable to the regulation of i-gaming. Documentation controls have application in the field of i-gaming regulation similar to the brick-and-mortar industry and can be specifically adapted with respect to the maintenance of records concerning software and gaming activity. Access/physical controls will also have application in the regulation of i-gaming operators by, for example, establishing procedures with respect to the access to software by the IT personnel of

¹⁰⁶ Nevada Interactive Gaming MICS 144.

¹⁰⁷ Nevada Interactive Gaming MICS 145, 147, 148, 151, and 154.

¹⁰⁸ Nevada Interactive Gaming MICS 146.

the software licensee or operator. Finally, personnel controls can also play an important role with regard to identifying organizational structures and describing decision-making processes.

V. Developing Best Practices for i-Gaming Accounting, Audit, and Recordkeeping Regulations

Several guiding principles from mature i-gaming jurisdictions and from brick-and-mortar gaming regulations can be elicited with respect to developing best practices for i-gaming accounting, audit, and recordkeeping regulations. Lessons learned from i-gaming jurisdictions across the global, such as Alderney, Malta, Nevada and the United Kingdom, can serve as a good resource for the development of best practices. I-gaming accounting, audit, and recordkeeping regulatory requirements are not necessarily an opportunity to recreate the regulatory wheel, but rather offer an opportunity to improve upon existing regulatory practices to develop a robust i-gaming regulatory model.

To develop effective and efficient regulations, regulators must first understand the business model of i-gaming. This means that i-gaming regulators should understand both the business organizational models, such as the skin or B2C model, and the flow of money in the operation of an i-gaming site. As the background section illustrates, the business model for i-gaming differs from traditional land-based gaming and introduces the potential for new types of suppliers. Understanding the i-gaming business model and the flow of funds can permit for the development of robust i-gaming regulations which are carefully balanced to not pervasively impinge upon the efficient operation of economic markets.

An initial guiding principle for the development of robust i-gaming regulatory practices centers on a full comprehension of the policy goals of a particular jurisdiction. Comprehending

the policy goals allows for the implementation of regulations which seek to further the governing policy goals.

The basic rationale for imposing accounting, audit, and recordkeeping regulations is to protect the legitimate flow of funds. Specifically, ensuring (1) government receives the lawfully correct tax revenue, (2) non-licensed persons do not impermissibly share in profits of i-gaming operations, and (3) player funds deposited with i-gaming operators are adequately protected.

In the process of promulgating rules, administrative agencies must consider the costs of compliance. Imposing regulatory burdens that are too costly to meet will effectively cause market failures. To that end, cost-benefit analysis should be employed to assess the costs and benefits of regulations.

The following are suggested guiding principles for developing best practices for i-gaming accounting, audit, and recordkeeping regulations:

- (1) Understand the business model of an i-gaming operator and the flow of funds.
- (2) Requesting information on the corporate structure can be a good regulatory practice.¹⁰⁹ Disclosure of the corporate structure not only reveals which individuals are potential qualifiers that are subject to a finding of suitability, but can also reveal relationships with vendors, what functions the i-gaming licensee will undertake, how decisions are made, and the individuals responsible for making decisions. A review of corporate structure can also disclose that proper

¹⁰⁹ The collapse of Full Tilt Poker is illustrative of the benefits of timely information. The independent report prepared by Peter Dean (the "Dean Report"), the former chairman of the British Gambling Commission, at the behest of the Alderney Gaming Control Commission offers some insight with respect to impact of regulatory reporting. The Dean Report is available online at <http://www.gamblingcontrol.org/userfiles/file/FTP%20Report%2026%20March%202012.pdf>.

control procedures are in place to ensure that all transactions are properly approved and recorded. In other words, regulators can quickly gain confidence in the ICS adopted by the i-gaming operators.

(3) Understand the accounting system used by the i-gaming operator. The accounting system will reveal how items are recorded as revenue, when expenses are recognized and other important financial information. For example, if regulations require GAAP, regulators should know precisely what the implications of GAAP accounting means for the presentation of financial statements and the certifications which may be provided by independent auditors.

(4) Use independent audits. Independent audits are a cost-effective and efficient means for not only obtaining an independent, unbiased opinion of the financial results of the i-gaming operator, but also certifications with respect to regulatory compliance. The independent audit is a more efficient, and less costly to the markets, as compared to requiring annual governmental audits. Allowing for discretionary and random audits can, however, serve as useful incentive to encourage i-gaming licensees to use best efforts to materially comply with the i-gaming laws and regulations.

(5) Identify the purpose(s) for independent audits. The purpose of the independent audit will guide the scope of the audit and what auditors should certify.

(6) I-gaming licensees are in a unique position to electronically record transactions and present detailed reports with respect to player accounts, the results of games, and the ability to reconcile accounts. Such records should be required to be maintained.

(7) Developing MICS is a good idea -- within reason. The Alderney MICS and Nevada Interactive Gaming MICS are examples of minimum required internal control procedures. A balance must be maintained to allow flexibility to i-gaming operators with regard the internal control processes and procedures which are implemented.

An inherent criticism of the gaming regulatory MICS leveled by auditors has been a failure to identify the overall objective of the MICS.¹¹⁰ "Routine adherence to mechanical procedures without considering the overall objectives of a casino audit may prevent an auditor from detecting a well-designed fraud."¹¹¹ Hence, in designing MICS, a fundamental question must be raised with respect to the objectives and goals the MICS are intended to achieve? Are the MICS intended to ensure the integrity of the i-gaming games, to help identify and prevent problem gambling behaviors, incorporate anti-money laundering protections, or to ensure revenue is properly recorded.

The Alderney ICS and Nevada Interactive Gaming MICS provide models for the development of best practices for i-gaming accounting, audit, and recordkeeping regulations. The Alderney ICS offer a coherent statement of objectives.¹¹² The Alderney ICS identify four objectives for internal controls: administrative control with respect to the organizational structure and decision-making process of the licensee; accounting controls to ensure transactions are executed in accordance with management authorization and transactions are properly recorded to prepare financial statements; controls are in place over the operation of customer accounts and

¹¹⁰ See Meyer *supra* note 44 at 816.

¹¹¹ *Id.*

¹¹² See Alderney ICS at 4-5.

the calculation of gaming activities; and safeguards in place in relation to physical and electronic security of the licensee's systems.

Finally, it is worth noting a few regulatory approaches that are not best practices. Most notably, as the Christiansen Study illustrates, direct government participation in monitoring activities will likely cost far in excess of any benefits received. Moreover, the accounting and audit information which can be obtained through a central monitoring system is duplicative of the information which the i-gaming operators can already obtain.

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