



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

FINANCIAL AUDIT DIVISION REPORT

Minnesota State Lottery

Internal Controls and Compliance Audit

**July 1, 2010, through
December 31, 2012**

June 20, 2013

Report 13-12

FINANCIAL AUDIT DIVISION
Centennial Building – Suite 140
658 Cedar Street – Saint Paul, MN 55155
Telephone: 651-296-4708 • Fax: 651-296-4712
E-mail: legislative.auditor@state.mn.us
Web site: <http://www.auditor.leg.state.mn.us>
Through Minnesota Relay: 1-800-627-3529 or 7-1-1



OFFICE OF THE LEGISLATIVE AUDITOR

State of Minnesota • James Nobles, Legislative Auditor

June 20, 2013

Senator Roger Reinert, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Edwin Van Petten, Executive Director
Minnesota State Lottery

This report presents the results of our internal controls and compliance audit of the Minnesota State Lottery for the period July 1, 2010, through December 31, 2012.

We discussed the results of the audit with the Minnesota State Lottery's staff on June 10, 2013. This audit was conducted by Brad White, CPA, CISA, CFE (Audit Manager) and Carl Otto, CPA, CISA, (Auditor-in-Charge), assisted by auditors Kelsey Nistler, CPA, and Valentina Stone.

We received the full cooperation of staff from the Minnesota State Lottery while performing this audit.

Handwritten signature of James R. Nobles in black ink.

James R. Nobles
Legislative Auditor

Handwritten signature of Cecile M. Ferkul in black ink.

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

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Report Summary

Conclusion

The Minnesota State Lottery's internal controls were generally adequate to ensure that it safeguarded cash, and retailers accurately remitted all cash for net lottery sales. The Minnesota State Lottery's internal controls were also generally adequate to ensure it created reliable financial data, and it accurately paid employees, vendors, prize claims, in-lieu-of-sales tax, and net proceeds in accordance with management's authorization and in compliance with finance-related legal requirements. However, the Lottery had some control weaknesses related to its cash, banking, and payroll.

For items tested, the Minnesota State Lottery generally complied with finance-related legal provisions. However, the Lottery did not comply with some requirements related to employee travel benefits and nonmonetary prize winners.

The Lottery resolved three of four prior audit findings related to purchasing and personnel, but it did not resolve the prior audit finding about payroll verification.

Key Findings

- The Minnesota State Lottery is unable to resolve an \$85,000 cash difference between its accounting system ledger and the balance held in the state treasury by the Department of Management and Budget. ([Finding 1, page 7](#))
- The Minnesota State Lottery did not remove limited bank file access for two former employees. ([Finding 2, page 7](#))
- Prior Finding Not Resolved: The Minnesota State Lottery did not review some key payroll reports, and two employees could authorize their own timesheets. ([Finding 3, page 8](#))

Audit Objectives and Scope

Objectives

- Internal Controls
- Legal Compliance

Period Audited

- July 1, 2010, through December 31, 2012

Programs Audited

- Cash and Accounting Controls
- Retailer Oversight
- Distributions to the State
- Direct and Operating Expenditures
- Payroll and Business Expenses

Minnesota State Lottery

Agency Overview

Created in 1989, the Minnesota State Lottery's mission is to provide secure gaming opportunities within the guidelines of state statutes.¹ The Lottery offers two types of games including: online lotto games (such as Powerball, Mega Millions, Gopher 5, Daily 3) and scratch games with a variety of ticket types, prices, and themes. The Lottery contracts with retailers to sell lottery tickets to the public.

In March 2012, Governor Mark Dayton appointed Edwin Van Petten as the Lottery's executive director. The previous executive director, Clint Harris, served from October 2004 through August 2011, and Johnene Canfield was interim director from August 2011 through February 2012.

The Lottery does not receive state appropriation funding; it operates using a portion of the gaming revenues collected. *Minnesota Statutes*² establish the State Lottery Fund and key legal provisions governing its finances, including: prize payout percentages, operations spending limits, advertising spending limits, budget requirements, and cash transfers of the net lottery proceeds. In addition, state law further limits the Lottery's annual operating budget to \$29 million for fiscal years 2012 and 2013³ and \$28.74 million for fiscal year 2011.⁴

The Lottery submits a 6.5 percent payment in-lieu-of-sales-tax on lottery tickets to the Department of Revenue. As required by state statute, the Lottery deposits 27.57 percent of the in-lieu-of-sales-tax amount to the General Fund and allocates the remaining 72.43 percent to other funds (50 percent to the Game and Fish Fund and the rest to the Natural Resources Fund for state parks and trails (22.5%), metropolitan parks and trails (22.5%), local trail grants (3%), and three zoos (2%)).⁵

The Lottery's net proceeds support the state's General Fund (60%) and the Environment and Natural Resources Trust Fund (40%). The Lottery also transfers any prizes not claimed after one year to the state's General Fund.

An independent certified public accounting firm annually audits the Lottery's financial statements. The Lottery received unqualified opinions for the past three years indicating it fairly presented balances and financial activities in accordance with generally accepted accounting principles.

¹ *Minnesota Statutes* 2012, chapter 349A, governs the lottery and its operations.

² *Minnesota Statutes* 2012, 349A.10.

³ Laws of Minnesota 2011, First Special Session, chapter 10, article 1, section 33.

⁴ Laws of Minnesota 2009, chapter 101, article 1, section 18.

⁵ *Minnesota Statutes* 2012, 297A.94 (e).

Table 1 shows the Lottery's income statement for fiscal years 2011 and 2012.

Table 1
Statements of Revenues, Expenses, and Changes in Net Assets
Fiscal Years 2011 and 2012

	2011	2012
<u>Operating Revenue:</u>		
Scratch Ticket Sales	\$354,813,430	\$355,260,670
Lotto Ticket Sales	149,622,979	164,772,867
Other Income	88,136	53,453
Total Operating Revenue	<u>504,524,545</u>	<u>520,086,990</u>
Less In-Lieu-of-Sales Tax	<u>32,788,367</u>	<u>33,802,180</u>
Gross Receipts	<u>\$471,736,178</u>	<u>\$486,284,810</u>
<u>Direct Costs:</u>		
Scratch Ticket Prizes	\$236,881,984	\$240,023,798
Lotto Ticket Prizes	73,977,591	80,584,939
Online Vendor Expense	9,077,683	9,505,892
Ticket Costs	7,608,118	8,635,277
Retailer Incentives	<u>30,347,192</u>	<u>31,468,680</u>
Total Direct Costs	<u>357,892,568</u>	<u>370,218,586</u>
Gross Profit	<u>\$113,843,610</u>	<u>\$116,066,224</u>
<u>Operating Expenses</u>		
Salaries and Benefits	\$ 10,649,595	\$ 10,264,453
Advertising	6,475,905	7,475,199
Promotions	1,525,612	1,882,002
Purchased Services	1,442,811	1,750,921
Occupancy Costs	1,363,918	1,394,649
Other Expenses	<u>3,407,420</u>	<u>3,604,648</u>
Total Operating Expenses	<u>\$ 24,865,261</u>	<u>\$ 26,371,872</u>
Operating Income	<u>\$ 88,978,349</u>	<u>\$ 89,694,352</u>
<u>Nonoperating Revenue (Expense)</u>		
Interest Earned on Investments	\$ 121,421	\$ 155,819
Payments to the State:		
Compulsive Gambling		
Contribution from Prize Fund	(2,230,000)	(2,074,948)
Unclaimed Prizes to State	(9,759,269)	(10,250,589)
Net Proceeds to State	<u>(77,110,501)</u>	<u>(77,524,634)</u>
Total Nonoperating Expense	<u>(\$ 88,978,349)</u>	<u>(\$ 89,694,352)</u>
Net Income	<u>\$ 0</u>	<u>\$ 0</u>

Source: Minnesota State Lottery financial statements for the fiscal years ended June 30, 2011 and 2012.

Access to the Minnesota Lottery Annual Report can be found at:

http://www.mnlottery.com/news__info/annual_report/.

Objective, Scope, and Methodology

The objective of our audit of the Minnesota State Lottery was to answer the following questions for the period of July 1, 2010, through December 31, 2012:

- Did the Minnesota State Lottery have adequate internal controls to ensure that it safeguarded financial resources, and retailers accurately remitted net lottery proceeds?
- Did the Minnesota State Lottery have adequate internal controls to ensure it created reliable financial data, and it accurately paid employees, vendors, prize claims, in-lieu-of-sales tax, and net proceeds in accordance with management's authorization and in compliance with finance-related legal requirements?
- For the items tested, did the Minnesota State Lottery comply with significant finance-related legal requirements contained in laws, statutes, or state policies?
- Did the Minnesota State Lottery resolve prior audit findings?⁶

To meet the audit objectives, we gained an understanding of the Minnesota State Lottery's financial policies and procedures. We considered the risk of errors in the accounting records and potential noncompliance with relevant legal requirements. We obtained and analyzed the Lottery's accounting data to identify unusual trends or significant changes in financial operations. We examined samples of financial transactions and reviewed supporting documentation to test whether the Lottery's controls were effective and if the transactions complied with laws, regulations, policies, and contract provisions.

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

We used various criteria to evaluate internal control and compliance. We used, as our criteria to evaluate agency controls, the guidance contained in the *Internal Control-Integrated Framework*, published by the Committee of Sponsoring

⁶ Office of Legislative Auditor's Financial Audit Division Report 06-25, *Minnesota State Lottery*, issued September 28, 2006.

Organizations of the Treadway Commission.⁷ We used state laws, regulations, and contracts, as well as policies and procedures established by the Lottery and the Department of Management and Budget as evaluation criteria over compliance.

Conclusion

The Minnesota State Lottery's internal controls were generally adequate to ensure that it safeguarded cash, and retailers accurately remitted all cash for net lottery sales. The Minnesota State Lottery's internal controls were also generally adequate to ensure it created reliable financial data, and it accurately paid employees, vendors, prize claims, in-lieu-of-sales tax, and net proceeds in accordance with management's authorization and in compliance with finance-related legal requirements. However, the Lottery had some control weaknesses related to its cash, banking, and payroll.

For items tested, the Minnesota State Lottery generally complied with finance-related legal provisions. However, the Lottery did not comply with some requirements related to employee travel benefits and nonmonetary prize winners.

The Lottery resolved three of four prior audit findings related to purchasing and personnel, but it did not resolve the prior audit finding about payroll verification.

The following *Findings and Recommendations* provide further explanation about the exceptions noted above.

⁷ The Treadway Commission and its Committee of Sponsoring Organizations were established in 1985 by the major national associations of accountants. One of their primary tasks was to identify the components of internal control that organizations should have in place to prevent inappropriate financial activity. The resulting *Internal Control-Integrated Framework* is the accepted accounting and auditing standard for internal control design and assessment.

Findings and Recommendations

The Minnesota State Lottery was unable to resolve an \$85,000 difference between the recorded cash balance in its accounting system ledger and the recorded cash balance in the state's accounting system.

Finding 1

The Minnesota State Lottery's June 30, 2012, cash balance recorded in its accounting system, totaling about \$22 million, differed from the amount recorded in the state's accounting system by about \$85,000. The discrepancy initially occurred when the state implemented a new accounting system in July 2011. Since then, although they had worked with the Department of Management and Budget, Lottery staff was unable to identify and resolve the discrepancy. The Lottery's cash balance discrepancy is part of the Department of Management and Budget's unexplained June 30, 2012, difference between the cash balance recorded in its transaction level accounting records and in its summary level general ledger, totaling about \$5 million.⁸

The reconciliation between the Lottery's recorded cash balance and the state's recorded cash balance is a fundamental control to ensure the integrity of the accounting records. The unresolved cash balance discrepancy increased the risk that error or fraud could occur without detection.

Recommendation

- *The Minnesota State Lottery should continue to work with the Department of Management and Budget to resolve the accounting systems' cash balance discrepancy.*

The Minnesota State Lottery did not remove limited bank file access for two former employees.

Finding 2

The Lottery did not remove limited bank access for two employees after they had left employment. One employee terminated Lottery employment on June 1, 2011, and the other on September 12, 2012; they both had bank access as of March 2013. The employees worked in regional offices and had limited bank access allowing them to manually update an electronic bank file of Lottery warrants issued. The update is necessary for an authorized warrant⁹ to clear bank processing when presented for payment by a prize winner. Although the Lottery would likely detect unauthorized warrant updates because it monitored the daily

⁸ Office of the Legislative Auditor, Financial Audit Division, Report 13-06, *Report on Internal Control Over Statewide Financial Reporting*, issued May 17, 2013 (Finding 2).

⁹ If an unissued or fraudulent warrant is presented for deposit, funds will not be paid until the Lottery reviews and determines it to be valid.

updates of bank warrants issued, it could eliminate the risk by removing the bank access when an employee terminates employment.

Recommendation

- *The Minnesota State Lottery should remove bank access for terminated employees.*

Finding 3

Prior Finding Not Resolved: The Minnesota State Lottery did not review some key payroll reports, and two employees could authorize their own timesheets.

The Lottery did not review some key payroll system reports to ensure the accuracy and authorization of hours worked, as required by state policies. Lottery employees use the state's automated self service time entry system to enter and authorize payroll hours. The state's policy for self service time entry states that "the best control over the integrity of employees' payroll information is achieved when employees prepare their own timesheets and supervisors, who have direct knowledge of employees' work, review and approve timesheets."¹⁰

Payroll hours entered by employees and approved by supervisors through the self service time entry system are uploaded into the state's payroll system. Lottery payroll staff enters any payroll adjustments or business expense reimbursements for processing paychecks to employees. State policy requires the agency to review key payroll reports to ensure the accuracy of payroll payments.¹¹

The Lottery had the following weaknesses in its oversight of the self service time entry and payroll process.

- The Lottery did not review the self service time entry audit report. This exception report identifies when an employee did not enter their own time or when a backup supervisor authorized the employee's time. State policy requires agencies to complete a comprehensive review each pay period or, if that is not possible, agency staff can review representative samples of the payroll activity each pay period and conduct a comprehensive review on a quarterly basis. A comprehensive review would require payroll staff to obtain an explanation for each of the report's exceptions.
- Two employees could authorize their own timesheets in the self service time entry system. The Lottery established them as back up approvers in the self service time entry system for their division, that allowed them the

¹⁰ Minnesota Management and Budget Policy PAY0017, *Self Service Time Entry*.

¹¹ Minnesota Management and Budget Policy PAY0028, *Agency Verification of Payroll and Human Resources Transactions*.

ability to approve their own time worked. State policy prohibits employees from approving their own timesheets.

- The Lottery did not document a review of the payroll register, a key system report that identifies payroll and personnel data used to process employee biweekly paychecks each pay period. State policy requires agencies to document their review of the payroll register each pay period to verify that current and prior pay period adjustments, salary increase adjustments, special payments, earnings codes, hours, pay rates, salary amounts, and amounts of any lump-sum payments are correct. The timing of the review allows the Lottery to correct any errors identified as a result of this review before it processes employee paychecks.

The Lottery is responsible for reviewing and validating time entry reports and identifying and correcting errors, in accordance with state policies. Without a review of system reports, there is an increased risk that employees could be incorrectly paid.

Recommendations

- *The Minnesota State Lottery should routinely review the self service time entry audit report to ensure the accuracy and authorization of hours worked and leave taken and document explanations for reported exceptions.*
- *The Minnesota State Lottery should restrict the ability for employees to authorize their own timesheets.*
- *The Minnesota State Lottery should document its review of the payroll register report used to verify the accuracy of payroll data used in processing employee paychecks.*

The Minnesota State Lottery did not report nonmonetary prize winners to the Department of Revenue to determine whether they were delinquent in payment of state taxes or owed other public debts.

Finding 4

The Minnesota State Lottery did not report winners of motor vehicles or other nonmonetary prizes to the Department of Revenue to determine if they were delinquent on state taxes or other public debts, such as child support. *Minnesota Statutes* require the Lottery to report to the Minnesota Department of Revenue a winner's name, address, and social security number for any lottery prize of \$600 or more.¹² The purpose of this statute is to allow the state to withhold or recover delinquent state taxes or other debts. However, the Lottery interpreted the statute to be applicable to cash prizes only. As a result, the Lottery would allow a winner

¹² *Minnesota Statutes* 2012, 349A.08, subd. 8.

to receive a nonmonetary prize without settling past due taxes or other debts, such as child support.

Recommendation

- *The Minnesota State Lottery should report nonmonetary prize winners to the Minnesota Department of Revenue for recovery of delinquent taxes or other debts in accordance with Minnesota Statutes, or obtain a legal interpretation from the Office of the Attorney General.*

Finding 5

The Minnesota State Lottery allowed three employees to accumulate frequent flier miles on personal accounts without ensuring rewarded miles were used to reduce cost of future state-paid business trips.

The Lottery did not adequately monitor the accrual and use of accumulated frequent flier miles on employees' personal accounts. State statutes require agencies to develop a policy when public employees and officials use public funds to pay for airline travel, and any benefits issued by airlines be accrued to the benefit of the organization that provided the funding.¹³ Three employees accrued frequent flyer miles on several lottery-related business trips, but the Lottery did not have a policy requiring them to report those benefits so the agency can monitor and ensure they were used to reduce future travel costs.

Recommendation

- *The Minnesota State Lottery should develop a policy to require employees to report and monitor benefits accrued on state-paid travel and ensure the use of those benefits to offset future state travel costs.*

¹³ *Minnesota Statutes* 2012, 15.435.



James Nobles
Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, Minnesota 55155-1603

Dear Mr. Nobles:

Thank you and your staff for the work performed on the controls and compliance audit of the Minnesota State Lottery.

The Lottery appreciates the work of you and your staff providing information and feedback that helps improve the integrity of the Lottery. We are pleased with the conclusion of the audit, noting specifically that the Minnesota State Lottery's internal controls are generally adequate to ensure the safeguarding of cash and the accurate remittance of cash for net Lottery sales; as well as noting that the Lottery's internal controls were generally adequate and in compliance with management's authorization and with financial related legal requirements.

The Lottery recognizes that proper internal controls are essential for the safeguarding of assets as well as the proper recording and reporting of financial information. The Lottery puts forth great effort in making sure we have the proper controls in place and we appreciate suggestions and feedback noted in your findings and recommendations.

We have reviewed each finding and recommendations provided in the controls and compliance audit and have prepared a response to each on the following page.

Thank you and your staff for your time and effort on this audit.

Sincerely,

Ed Van Petten
Executive Director

Finding 1: The Minnesota State Lottery was unable to resolve an \$85,000 difference between the recorded cash balance in its accounting system ledger and the recorded cash balance in the state's accounting system.

As noted within the detail of the finding, this is part of a larger problem the State is working through since the implementation of SWIFT. The Lottery has and will continue to work diligently with the state to resolve this issue.

Responsible Party: Joe Pahl Expected Date of resolution: 06/30/2013

Finding 2: The Minnesota State Lottery did not remove limited bank file access for two former employees.

The Lottery agrees with the recommendation provided and we have updated our procedures to include a review of bank access for all employees who have terminated employment with the Lottery.

Responsible Party: Joe Pahl Expected Date of resolution: Resolution completed

Finding 3: Prior finding not resolved: The Minnesota State Lottery did not review some key payroll reports, and two employees could authorize their own timesheets.

The Lottery finds these reviews to be largely redundant when coupled with financial reviews performed on all Lottery spending, i.e., reviews currently performed not specific to just payroll. However, we also understand the need in a large organization like the state for consistent reviews performed by all agencies to ensure specific areas of concern are addressed. As a result, the Lottery agrees with the finding and will implement the recommendations noted.

Responsible Party: Joe Pahl Expected Date of resolution: 06/30/2013

Finding 4: The Minnesota State Lottery did not report non-monetary prize winners to the Department of Revenue to determine whether they were delinquent in payment of state taxes or owed other public debts.

The Lottery and the Legislative Auditors disagree on the interpretation of the Minnesota Statute in question. The Lottery will seek a legal interpretation from the Attorney General's office to resolve this issue.

Responsible Party: Dana Banwer Expected Date of resolution: 08-15-2013

Finding 5: The Minnesota State Lottery allowed three employees to accumulate frequent flier miles on personal accounts without ensuring rewarded miles were used to reduce cost of future state-paid business trips.

We agree with the Auditors findings and will implement recommended findings.

Responsible Party: Joe Pahl Expected Date of resolution: 06-30-2013