

Financial-Related Audit

Minnesota State Lottery
July 1, 1997, through June 30, 2001



Financial Audit Division

The Office of the Legislative Auditor (OLA) is a professional, nonpartisan office in the legislative branch of Minnesota State government. Its principal responsibility is to audit and evaluate the agencies and programs of state government (the State Auditor audits local governments).

OLA's Financial Audit Division annually audits the state's financial statements and, on a rotating schedule, audits agencies in the executive and judicial branches of state government, three metropolitan agencies, and several "semi-state" organizations. The division also investigates allegations that state resources have been used inappropriately.

The division has a staff of approximately fifty auditors, most of whom are CPAs. The division conducts audits in accordance with standards established by the American Institute of Certified Public Accountants and the Comptroller General of the United States.

Consistent with OLA's mission, the Financial Audit Division works to:

- Promote Accountability,
- Strengthen Legislative Oversight, and
- Support Good Financial Management.

Through its Program Evaluation Division, OLA conducts several evaluations each year and one best practices review.

OLA is under the direction of the Legislative Auditor, who is appointed for a six-year term by the Legislative Audit Commission (LAC). The LAC is a bipartisan commission of Representatives and Senators. It annually selects topics for the Program Evaluation Division, but is generally not involved in scheduling financial audits.

All findings, conclusions, and recommendations in reports issued by the Office of the Legislative Auditor are solely the responsibility of the office and may not reflect the views of the LAC, its individual members, or other members of the Minnesota Legislature.

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If you have comments about our work, or you want to suggest an audit, investigation, evaluation, or best practices review, please contact us at 651-296-4708 or by e-mail at auditor@state.mn.us



OFFICE OF THE LEGISLATIVE AUDITOR
State of Minnesota • James Nobles, Legislative Auditor

Senator Ann H. Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. George R. Andersen, Director
Minnesota State Lottery

We have audited selected components of the financial operations of the Minnesota State Lottery (Lottery) for the period July 1, 1997, through June 30, 2001. Our audit scope included operating expenses and employee payroll. We emphasize that this was not a complete audit of all programs at the Lottery. The audit objectives and conclusions are highlighted in the individual chapters of this report.

We conducted our audit in accordance with *Government Auditing Standards*, as issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of management controls relevant to the audit. The standards require that we design the audit to provide reasonable assurance that the Lottery complied with provisions of laws, regulations, contracts, and grants that are significant to the audit. The management of the Lottery is responsible for establishing and maintaining the internal control structure and complying with applicable laws, regulations, contracts, and grants.

This report is intended for the information of the Legislative Audit Commission and the management of the Lottery. This restriction is not intended to limit the distribution of this report, which was released as a public document on May 23, 2002.

/s/ James R. Nobles

James R. Nobles
Legislative Auditor

/s/ Claudia J. Gudvangen

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: February 26, 2002

Report Signed On: May 20, 2002

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Audit Participation

The following members of the Office of the Legislative Auditor prepared this report:

Claudia Gudvangen, CPA	Deputy Legislative Auditor
James Riebe, CPA	Audit Manager
Laura Peterson, CPA	Auditor-in-Charge
Patrick Phillips, CPA	Auditor
Irene Hass	Auditor

Exit Conference

We discussed the results of the audit with the following staff of the Minnesota State Lottery at an exit conference on May 17, 2002:

George Andersen	Director
Joe Pahl	Chief Financial Officer

Report Summary

Audit Conclusions on Operating Expenses and Employee Payroll

- The Lottery’s controls provided reasonable assurance that it adequately safeguarded assets, complied with finance-related legal provisions governing operating expenses and employee payroll, and accurately recorded these expenses in the accounting records.
- For the items tested, the Lottery complied with applicable legal provisions governing employee payroll, procurement, and operating expenses, including statutory limits on operating and advertising costs.

Background

The Minnesota State Lottery (Lottery) was created in June 1989. The director of the Lottery, who is appointed by the Governor, is George R. Andersen. The mission of the Lottery is to provide secure gaming opportunities, while offering fun and entertainment to the public within the guidelines of the Lottery statute. The Lottery sells instant scratch tickets and operates four on-line number games. Beneficiaries of proceeds from the Lottery include the state’s General Fund and the Environmental and Natural Resources Trust Fund.

Financial-related audit reports address internal control weaknesses and noncompliance issues noted during our audits of state departments and agencies. The scope of our audit work included operating expenses and employee payroll. Therefore, we emphasize that this was not a complete audit of all programs at the Lottery.

Minnesota State Lottery

Chapter 1. Introduction

The Minnesota State Lottery (Lottery) was created in June 1989. Minn. Stat. Section 349A (2001) governs the Lottery's operations. The director of the Lottery, who is appointed by the Governor, is George R. Andersen.

The mission of the Lottery is to provide secure gaming opportunities, while offering fun and entertainment to the public within the guidelines of the Lottery statute. During the audit period, the Lottery sold instant scratch tickets and operated four on-line number games: Gopher 5®, Daily 3®, Powerball® and Cash4Life™. Beneficiaries of proceeds from the Lottery include the state's General Fund and the Environmental and Natural Resources Trust Fund, which respectively receive 60 and 40 percent of the Lottery's net proceeds.

Minn. Stat. Section 349A.10 gives the Lottery the authority to hold funds outside of the state treasury. The statute requires the Lottery to transfer net proceeds to the state beneficiary funds within 30 days after the end of each month. An independent certified public accounting firm annually audits the Lottery's financial statements. Table 1-1 highlights the Lottery's financial activities for the two fiscal years ended June 30, 2001.

Table 1-1
Financial Summary
By Fiscal Year

	<u>2000</u>	<u>2001</u>
Income:		
Ticket Sales	\$282,463,298	\$250,865,115
Online Ticket Sales	114,823,127	115,318,650
Other Income	<u>2,995,873</u>	<u>2,521,411</u>
Total Revenue	<u>\$400,282,298</u>	<u>\$368,705,176</u>
Expenses and Distributions:		
Expenses:		
Prize Expense	\$241,517,453	\$218,564,734
Compulsive Gambling Transfers to State General Fund	1,750,000	1,888,000
Unclaimed Prizes Provided to State General Fund	6,642,803	5,761,308
Tax in Lieu of Sales Tax	25,823,618	23,801,945
Retailer Commissions/Incentives	27,134,266	23,532,411
Operating Expenses	<u>45,260,770</u>	<u>45,016,477</u>
Total Expenses	<u>\$348,128,910</u>	<u>\$318,564,875</u>
Distributions:		
Beneficiary Distributions	<u>52,153,388</u>	<u>50,140,301</u>
Total Expenses and Distributions	<u>\$400,282,298</u>	<u>\$368,705,176</u>

Source: Minnesota State Lottery audited financial statements.

Chapter 2. Operating Expenses

Chapter Conclusions

The Lottery's internal controls provided reasonable assurance that it received purchased goods and services, properly classified the operating expenses in its accounting records, and complied with finance-related legal provisions. For the items tested, the Lottery complied with management's authorization and applicable legal provisions governing procurement and operating and advertising cost limits set in statute.

Minn. Stat. Section 349A.10, Subd. 1 (2001) allows the Lottery to hold funds outside the state treasury. The Lottery uses the BPCS accounting system to track its financial activities and print checks to vendors. Minn. Stat. Section 349A.10, Subd. 3 (b) limits the Lottery's operating costs to 15 percent of gross revenue. Operating costs of the Lottery include all administrative expenses except for prize expense and retailer commissions and incentives. Gross revenue includes ticket and online game sales and all other income less tax in lieu of sales tax. During the 1998 legislative session, the Lottery received approval to annually spend 25 percent of the average difference between the 15 percent limit on operating expenses and the amount actually spent on operating expenses during the previous three years.

Table 2-1 shows the Lottery's operating expenses for the two fiscal years ended June 30, 2001. We discuss advertising and promotion expenses in the following section. In Chapter 3 we discuss the salaries and benefits expense.

Table 2-1
Operating Expenses
By Fiscal Year

Operating Expenses:	2000	2001
Online Vendor Expense	\$ 8,367,630	\$ 8,514,219
Ticket Costs	4,882,547	4,797,685
Advertising	8,721,249	8,064,407
Salaries & Benefits	10,823,923	11,163,470
Promotion	3,987,951	3,295,251
Purchase Services	3,327,448	3,351,071
Occupancy Costs	1,794,069	1,925,085
Supplies & Materials	801,269	911,137
Depreciation	1,608,358	1,507,594
Other Expense	<u>946,326</u>	<u>1,486,558</u>
Total Operating Expenses	<u>\$45,260,770</u>	<u>\$45,016,477</u>

Source: Minnesota State Lottery audited financial statements.

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Advertising and Promotion

In fiscal year 2001, the Lottery spent a total of \$11,359,658, or approximately 3.3 percent of gross revenue, on advertising and promotion. These activities excluded salaries and benefits for Lottery staff engaged in advertising and promotion activities and the various advertising and promotional goods and services the Lottery bartered for.

Minn. Stat. Section 349A.10, Subd. 3 (c) limits the amount the Lottery spends annually for the “preparation, publication and placement of advertising” to $2\frac{3}{4}$ percent of gross revenues. As an industry, the marketing profession distinguishes between advertising and promotion expenses. Differentiating between advertising and promotion can be extremely difficult because these marketing concepts are so entwined. The Lottery used marketing industry standards to develop definitions of advertising and promotion. The Lottery defined advertising as:

The presentation of the goods (lottery tickets) in a medium where the Minnesota State Lottery is directly identified and for which the Minnesota State Lottery has paid for the space or time.

For fiscal year 2001, the Lottery spent \$8,064,407, or 2.34 percent of gross revenue, on advertising expenses.

The Lottery defined promotions as activities that supplement both personal selling and advertising, coordinate them and help to make them effective. Promotions are normally short-term or nonrecurring in nature and can be targeted to the public. Lottery promotions include exhibits, displays, sponsorships, and Lottery goods such as caps, T-shirts, and cups.

Table 2-2 shows the breakdown of the fiscal year 2001 advertising and promotion expenses.

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Table 2-2
Advertising and Promotion Expenses ⁽¹⁾
For the Fiscal Year Ended June 30, 2001

Advertising Expenses:	
TV Media and Production	\$2,073,766
Radio Media and Production	3,431,112
Print Media and Production	110,766
Outdoor Media and Production	819,714
Point of Sale Production	1,224,291
Other	<u>404,758</u>
 Total Advertising	 <u>\$8,064,407</u>
Promotion Expenses:	
Sponsorships	\$1,017,281
Environmental	882,576
Premium Items Production (Lottery goods)	490,606
Beneficiary Promotional	272,802
Winner Radio Network	264,089
Promotional Tickets	178,817
Consumer Promotions	138,157
Other	<u>50,922</u>
 Total Promotional	 <u>\$3,295,251</u>

Note (1) In fiscal year 2001 the Lottery provided \$537,550 in quantifiable bartered goods and services and received \$3,287,300 of marketing services in return. In addition, it had other barter arrangements with television and radio companies that it did not assign a value to.

Source: Minnesota State Lottery accounting records.

Audit Objectives and Methodology

We focused on the following objectives during our audit of the operating expenses:

- Did the Lottery's internal controls provide reasonable assurance that it received the purchased goods and services, properly classified operating expenses in the accounting records, and complied with finance-related legal provisions?
- Did the Lottery comply with management's authorization and applicable legal provisions governing procurement, operating, and advertising cost limits as specified in statute?

To answer these questions, we interviewed the Lottery staff to gain a general understanding of the procurement and accounts payable processes. We reviewed the process of reconciling the

Minnesota State Lottery

bank activity to the general ledger and reviewed the Lottery's user security clearances over procurement. We analyzed financial data related to the operating expenses and reviewed supporting documentation for a sample of expenses.

Conclusion

The Lottery's internal controls provided reasonable assurance that it received the purchased goods and services, properly classified the operating expenses in the accounting records, and complied with finance-related legal provisions. For the items tested, the Lottery complied with management's authorization and applicable legal provisions governing procurement and statutory operating and advertising cost limits.

Chapter 3. Employee Payroll

Chapter Conclusions

The Lottery's internal controls provided reasonable assurance that its employees were compensated in compliance with applicable legal provisions and management's authorization, and payroll expenses were accurately recorded in the state's accounting system. For the items tested, the Lottery complied with various bargaining agreements, compensation plans, and statutory provisions.

Over the audit period, the Minnesota State Lottery spent an average of \$10.5 million on payroll expenses. Employee payroll accounts for approximately 24 percent of the Lottery's total operating expenses. The Lottery employed approximately 200 staff. Lottery employees belonged to various compensation plans, including the American Federation of State, County, and Municipal Employees, the Minnesota Association of Professional Employees, the Middle Management Association, the Commissioner's Plan, and the Managerial Plan.

The Lottery maintained separate human resource and payroll offices to administer the personnel and payroll functions. The Lottery used the State's Employee Management System (SEMA4) to process payroll and human resource information.

Audit Objectives and Methodology

We focused on the following objectives during our audit of employee payroll:

- Did the Lottery's internal controls provide reasonable assurance that its employees were compensated in compliance with applicable legal provisions and management's authorization, and payroll expenses were accurately recorded in the state's accounting system?
- Did the Lottery comply with various bargaining agreements, compensation plans, and statutory provisions?

To answer these questions, we interviewed the Lottery staff to gain an understanding of the internal control structure over the payroll and personnel processes. In addition, we analyzed payroll expenses to determine unusual trends and reviewed supporting documentation to determine proper authorization and compliance with the various compensation plans. Finally, we reviewed SEMA4 user security clearances and determined if the Lottery complied with the legal provision governing the director's salary.

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Conclusion

The Lottery's internal controls provided reasonable assurance that its employees were compensated in compliance with applicable legal provisions and management's authorization, and that payroll expenses were accurately recorded in the state's accounting system. For the items tested, the Lottery complied with various bargaining agreements, compensation plans, and statutory provisions.

**Status of Prior Audit Issues
As of February 26, 2002**

Most Recent Audit

Legislative Audit Report 98-45 focused on selected components of the Lottery's financial operations, including prize expenses, unclaimed prizes, operating expenses, transfers to state agencies, and employee payroll. The report contained one finding that the Lottery purged six months of electronic data from its ACCLAIMS system. The Lottery resolved this finding by enhancing its computer backup procedures to reduce the risk of losing data.

Other Audit History

The Lottery contracts with an independent public accounting firm to conduct an annual financial statements audit. The Lottery received an unqualified opinion on its financial statements each year of our audit scope. In fiscal year 2001, the auditor recommended improvements in the areas of insurance coverage and computer network security as a result of the financial statements audit. Each year, the public accounting firm also performs additional audit procedures as directed by the Lottery. In fiscal year 2001, the additional audit procedures covered employee expense reimbursements and control over promotion and sponsorship event tickets and passes. Minor exceptions were noted in the report.