



OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

Financial Audit Division Report

Minnesota State Lottery
July 1, 2004, through December 31, 2005



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 forty 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.

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.

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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

Clint Harris, Executive Director
Minnesota State Lottery

We conducted an audit of the Minnesota State Lottery for the period July 1, 2004, through December 31, 2005. Our audit scope included financial management, employee payroll, operating expenses, and direct costs excluding prize payouts and retailer commissions. Our objectives focused on a review of the Lottery's internal controls over these financial activities and its compliance with applicable legal provisions. This has not been a comprehensive audit of the Lottery.

The enclosed Report Summary highlights our overall audit conclusions. The specific audit objectives and conclusions for each area are contained in the individual chapters of this report.

We would like to thank staff from the Minnesota State Lottery for their cooperation during this audit.

/s/ James R. Nobles

/s/ Cecile M. Ferkul

James R. Nobles
Legislative Auditor

Cecile M. Ferkul, CPA, CISA
Deputy Legislative Auditor

End of Fieldwork: May 5, 2006

Report Signed On: September 20, 2006

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Audit Participation

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

Cecile Ferkul, CPA, CISA	Deputy Legislative Auditor
Brad White, CPA, CISA	Audit Manager
Joan Haskin, CPA, CISA	Auditor-in-Charge
Laura Peterson, CPA	Auditor
Tesfaye Negash	Auditor

Exit Conference

We discussed the results of the audit with the following representatives of the Minnesota State Lottery at an exit conference on September 8, 2006:

Clint Harris	Executive Director
Dale McDonnell	Assistant Director and General Counsel
Joe Pahl	Chief Financial Officer

Report Summary

Key Conclusions:

The Minnesota State Lottery's financial management controls provided reasonable assurance that it operated within legal spending limits established in Minnesota Statutes, adequately safeguarded cash held outside the state treasury, and accurately recorded its financial activities in the accounting records. However, we have four findings related to internal controls and legal compliance.

Findings:

- Lottery management did not document its resolution of concerns revealed in a criminal background check. (Finding 1, page 13)
- The Lottery did not always comply with state purchasing policies and procedures for some goods and services it procured. (Finding 2, page 14)
- The Lottery did not always retain evidence to support management authorization for changes to employee pay rates. (Finding 3, page 18)
- The Lottery did not adequately document its monitoring of payroll transactions and changes made to payroll data. (Finding 4, page 20)

The audit report contained four findings related to internal control and legal compliance.

Audit Scope:

Audit Period:

July 1, 2004, through December 31, 2005

Programs Audited:

- Financial Management
- Direct Costs and Operating Expenses
- Employee Payroll

Agency Background:

The Minnesota State Lottery was created in June 1989. The current executive director of the Lottery is Clint Harris, who was appointed by Governor Tim Pawlenty in October 2004. Lottery proceeds benefit the state's General Fund and the Environmental and Natural Resources Trust Fund. For fiscal year 2005, the Lottery's administrative operating costs totaled \$22.6 million.

Program Evaluation:

The Office of the Legislative Auditor issued a February 2004 program evaluation report that was critical of Lottery operations. As a result, the Lottery ended questionable sponsorships and promotions, terminated certain contracts, and reduced administrative personnel and space. In July 2004, the Lottery issued a formal report showing resolution of each audit concern.

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Chapter 1. Introduction

The Office of the Legislative Auditor selected the Minnesota State Lottery for audit based on its annual risk assessment of state agencies and programs. We used various criteria to determine the entities for selection, including the size and type of each agency's financial operations, length of time since the last audit, changes in organizational structure and key personnel, and available audit resources.

Agency Background

The Legislature created the Minnesota State Lottery (Lottery) in June 1989. *Minnesota Statutes* 2005, chapter 349A govern the Lottery and its operations. The Lottery defines its mission as “to offer fun, innovative and secure games that create excitement, reflect Minnesota values, and maximize contributions to the state.” During the audit period, the Lottery sold several types of instant scratch tickets and operated several online numbers games.¹ Statutes require the Lottery to transfer net proceeds to the state beneficiary funds within 30 days after the end of each month. Beneficiaries of proceeds from the Lottery include the state's General Fund and the Environmental and Natural Resources Trust Fund, which receive 60 and 40 percent of the Lottery's net proceeds, respectively.

The Lottery is organized into six divisions: research and planning, marketing, security, operations, financial services, and legal services. Divisional managers report to the Lottery's executive director. Governor Tim Pawlenty appointed Clint Harris as the Lottery's executive director in October 2004.

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. In addition, the firm performed *SysTrust* audits² of Lottery computer operations for the past two years and found Lottery controls over security and processing integrity to be effective.

Table 1-1 shows the Lottery's financial activities for fiscal years 2003, 2004, and 2005.

¹ Online numbers games include Powerball®, Hot Lotto®, and Gopher 5®, among others, where the numbers are transmitted electronically to the Lottery, and the Lottery or a national lottery organization selects the winning numbers. Online numbers games cannot be purchased over the Internet.

² SysTrust is an assurance service that was jointly developed by the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants. It is designed to increase the comfort of management, customers, and business partners with systems that support a business or particular activity. In a SysTrust engagement, the auditor evaluates and tests whether or not a specific system is reliable when measured against four essential principles: availability, security, integrity, and maintainability.

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Table 1-1
Statement of Revenue, Expenses, and Changes in Net Assets
Fiscal Years 2003 through 2005

	<u>2003</u>	<u>2004</u>	<u>2005</u>
Operating Revenues:			
Scratch Ticket Sales	\$210,919,223	\$215,696,083	\$253,425,269
Online Ticket Sales	140,897,381	171,222,688	154,585,149
Total Operating Revenues	351,816,604	386,918,771	408,010,418
Less: In-Lieu-of-Sales Tax	22,868,079	25,149,720	26,520,677
Gross Receipts	<u>\$328,948,525</u>	<u>\$361,769,051</u>	<u>\$381,489,741</u>
Direct Costs:			
Scratch Ticket Prizes	\$137,281,912	\$141,353,134	\$166,740,541
Online Ticket Prizes	67,763,872	84,175,584	74,553,796
Online Vendor Expense	9,931,627	10,506,715	9,447,919
Ticket Costs	5,273,205	4,649,504	4,287,651
Retailer Commissions and Incentives	22,192,549	22,814,588	24,967,304
Total Direct Costs	<u>\$242,443,165</u>	<u>\$263,499,525</u>	<u>\$279,997,211</u>
Gross Profit	\$ 86,505,360	\$ 98,269,526	\$101,492,530
Operating Expenses:			
Salaries and Benefits	\$ 12,271,807	\$ 11,003,729	\$ 10,080,101
Advertising	7,503,607	5,069,953	4,701,021
Promotion	3,299,586	2,563,982	2,364,686
Occupancy Costs	1,974,079	1,932,388	1,760,919
Other Expenses	6,392,360	2,600,175	3,664,757
Total Operating Expenses	<u>\$ 31,441,439</u>	<u>\$ 23,170,227</u>	<u>\$ 22,571,484</u>
Operating Income	<u>\$ 55,063,921</u>	<u>\$ 75,099,299</u>	<u>\$ 78,921,046</u>
Non-operating Revenues (Expense):			
Investment Income	\$ 1,329,727	\$ 461,033	\$ 734,555
Other Income	141,539	0	0
Payments to the State of Minnesota:			
Net Proceeds to State	(48,120,080)	(66,703,798)	(69,982,049)
Unclaimed Prizes to State	(6,619,107)	(6,960,534)	(7,777,552)
Compulsive Gambling			
Contribution from Prize Fund	(1,796,000)	(1,896,000)	(1,896,000)
Total Non-operating Rev (Exp)	<u>(\$ 55,063,921)</u>	<u>(\$ 75,099,299)</u>	<u>(\$ 78,921,046)</u>
Net Income	\$ 0	\$ 0	\$ 0
Net Assets at Beginning of Year	0	0	0
Net Assets at End of Year	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

Source: Minnesota State Lottery's Comprehensive Annual Financial Reports for fiscal years 2003, 2004, and 2005.

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February 2004 Lottery Evaluation

The Office of the Legislative Auditor's Program Evaluation Division released a critical evaluation report on Lottery operations in February 2004. The evaluation found lack of external oversight and governance, inappropriate relationships with contractors, poor promotional strategies, and some administrative waste. The evaluation contained 49 recommendations for improvement and prompted reform in Lottery financial operations. As a result of the evaluation, the Lottery ended questionable sponsorships and promotions, terminated certain contracts, and reduced administrative personnel and space.

In July 2004, Interim Director Michael Vekich reported to the Governor that action on all recommendations had been completed. A formal follow-up report was developed by the Lottery itemizing resolution of each cited finding. While our current audit does not directly verify the Lottery's implementation of recommendations made in the Program Evaluation Division's report, it does assess the new administration's financial controls, compliance methods, and outside relationships with vendors/contractors in place since July 2004.

Audit Approach

Our audit was conducted in accordance with *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of the office's internal controls relevant to the audit objectives. We used the guidance contained in *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations of the Treadway Commission,³ as our criteria to evaluate agency controls. The standards also require that we plan the audit to provide reasonable assurance that the office complied with financial-related legal provisions that are significant to the audit. In determining the Lottery's compliance with legal provisions, we considered requirements of laws, regulations, and contractual agreements.

The audit scope selected for this audit included financial management, employee payroll, operating expenses, and direct costs; our scope did not include prize payouts or retailer commissions. For each area, we designed key internal control and legal compliance audit objectives.

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 noncompliance with relevant legal provisions. We obtained and analyzed the Lottery's accounting data to identify unusual trends or significant changes in financial operations. We examined documents supporting the Lottery's internal controls and compliance with laws, regulations, and contract provisions.

³ The Treadway Commission and its Committee of Sponsoring Organizations (COSO) were established in the mid-1980s 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.

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Chapter 2. Financial Management

Chapter Conclusions

The Minnesota State Lottery's financial management controls provided reasonable assurance that it operated within its legal spending limits and management's authorization, adequately safeguarded cash held outside the state treasury, and accurately recorded its financial activities in the accounting records.

The Lottery kept the Department of Finance and legislative staff informed of its operating budget plan and strategies. The 2005 Legislature modified the formula for determining the Lottery's legal spending level and provided a clearer distinction between direct lottery-related costs and operating expenses necessary to administer and oversee the Lottery's activities.

For the items tested, the Lottery complied with legal spending limits and advertising constraints established in Minnesota statutes and laws.

Audit Objectives

Our objectives were to answer the following questions:

- Did the Lottery's financial management controls provide reasonable assurance that it operated within legal spending limits and management's authorization, adequately safeguarded cash held outside the state treasury, and accurately recorded its financial activities in the accounting records?
- Did the Lottery adequately involve and inform legislative and Department of Finance staff about its operating budget plan and strategies?
- Did the Lottery operate within the legal overall operating level specified in *Minnesota Statutes*⁴?

Legal Spending Limits

The Lottery funds its operations from gaming revenues and does not receive state appropriations. It has two types of costs: direct lottery-related costs and operating expenses. Direct costs vary proportionately with lottery sales and include prize payouts, online vendor expenses, scratch ticket costs, and retailer commissions. Operating

⁴ *Minnesota Statutes* 2005, 349A.10, subd.10

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expenses include administrative costs for the Lottery's payroll, advertising, promotions, space rent, and other expenses.

The size of Lottery operations was restricted in two ways during fiscal years 2005 and 2006. First, Minnesota laws⁵ limited the Lottery's operating budget to \$27,419,000 for fiscal year 2005 and to \$26,700,000 in fiscal year 2006. The Lottery's actual operating expenses for fiscal year 2005 totaled \$22,571,484, which was below its legal spending limits. Second, the 2005 Legislature revised the formula for determining the Lottery's legal spending level for its operations. The new legal spending formula provided a clearer distinction between direct lottery-related costs and general operating expenses necessary to administer and oversee the Lottery activities. It also reduced the Lottery legal spending limit for operating expenses from 15 to 9 percent of gross revenue for each fiscal year. Advertising cost limits remained at 2.75 percent of each fiscal year's gross revenue. The Lottery's actual operating and advertising costs were well within these legal spending percentages.

Budgetary Controls

The Lottery's prize payout levels and operational budget limits are specified in statute. *Minnesota Statutes*⁶ require the Lottery to submit its biennial budget to the Department of Finance. Also, the Lottery's executive director must annually present and explain the Lottery's budget and spending plans before the Senate and House of Representatives committees having jurisdiction over gambling policies.

The Lottery sent monthly financial and budget summary information to Senate and House analysts and to the Department of Finance. It also provided the Department of Finance with more detailed financial information. Staff from the Department of Finance indicated they were pleased with the level of financial information received from the Lottery.

The Lottery allocated spending budgets to its various operating divisions, each having separate cost centers allowing them to monitor their spending status. The Financial Services Division distributes budget reports monthly with actual to budget comparisons. In addition, the Financial Services Division prepares an operating variance report that compares current year actual expenses to the prior year's amounts. Finance staff review and discuss all variances with the appropriate division directors.

Cash Monitoring and Reconciliations

The Lottery holds the majority of its money in the state treasury, but it has statutory authority to maintain funds outside of the state treasury. The Lottery has three outside bank accounts: a general operating account, an accounts payable account, and a prize account. The general account accumulates lottery proceeds for transfers to the accounts payable and prize accounts, and ultimately the state treasury. The accounts payable and prize accounts hold money until vendor payments and prize claims clear the bank.

⁵ *Laws of Minnesota* 2004, chapter 233 and *Laws of Minnesota* 2005, chapter 156

⁶ *Minnesota Statutes* 2005, chapter 349A.10, subd. 6

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Outside bank accounts often pose a greater responsibility to the agency since they are not subject to warrant controls and collateral requirements used for state treasury accounts. The Lottery developed the necessary warrant clearing controls and had a collateral agreement for its outside bank accounts.

The Lottery transfers money from bank accounts set up by retailers who sell lottery tickets. Funds owed to the retailer for prizes paid out and for earned commissions are subtracted from the amount transferred by the Lottery. Retailers receive a commission of 5.5 percent of the price of each ticket sold and 1 percent on the amount of each winning ticket cashed in. The Lottery also moves money to and from the national lottery organization to fund prizes for certain online games. Each month, the Financial Services Division reconciles actual cash balances (state treasury and local bank accounts) to the cash reported in its accounting general ledger. We reviewed the reconciliations during the audit scope and found that the Lottery reconciled all accounts in a timely manner.

*Minnesota Statutes*⁷ require the Lottery to transfer net proceeds to the state beneficiary funds within 30 days after the end of each month. It requires that the Lottery transfer 40 percent of the net proceeds to the Environment and Natural Resources Trust Fund and 60 percent to the state's General Fund. The Lottery calculates net proceeds using monthly revenues minus prizes, retailer commissions, operating expenses, payments in lieu of sales tax, payments to the state for unclaimed prizes, and transfers for problem gambling treatment programs. For fiscal year 2005, the Lottery transferred \$27,993,000 and \$41,989,000 to the Environment and Natural Resources Trust Fund and the General Fund, respectively.

The Lottery remitted in-lieu-of-sales taxes totaling \$26,520,667 to the Department of Revenue for fiscal year 2005. *Minnesota Statutes*⁸ also require the Lottery to transfer all unclaimed prize money at the end of each fiscal year to the state's General Fund. The Lottery transferred \$7,777,552 in unclaimed prizes for fiscal year 2005. In addition, the Lottery was required by law⁹ to transfer \$2,187,000 on July 1, 2005, for unclaimed prize funds that it had accumulated before July 1, 2003.

Security Access

The Lottery does not use the state's accounting system and instead uses a proprietary general ledger accounting system for purchasing, inventory, and accounts payable. The Lottery's chief financial officer works with the security division to restrict users' access into the accounting system in order to create separation of duties. During our review of security access controls, we noted that three employees had incompatible access to the accounts payable module. Lottery management developed mitigating detective controls to compensate for the incompatible access granted to these three employees.

There were no audit findings resulting from our review of these areas.

⁷ *Minnesota Statutes* 2005, chapter 349A.10, subd. 5

⁸ *Minnesota Statutes* 2005, chapter 349A.08, subd. 5

⁹ *Laws of Minnesota* 2005, chapter 156, sec. 20

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Chapter 3. Direct Costs and Operating Expenses

Chapter Conclusions

The Minnesota State Lottery's internal controls provided reasonable assurance that it accurately paid for goods and services received, properly procured lottery services contracts, accurately recorded direct costs and operating expenses in the accounting system, and complied with applicable finance-related legal provisions and management's authorization. Lottery procurement controls provided reasonable assurance of an open bid process for selection and screening of vendors, contractors, and security specialists. However, the Lottery did not document its resolution of concerns revealed in a criminal background check of one contractor's employee.

For the items tested, the Lottery generally complied with finance-related legal provisions governing procurement and disbursement of goods and services. However, the Lottery did not consistently comply with the Department of Administration's purchasing manual for certain purchases.

Audit Objectives

Our audit of direct costs and operating expenses focused on the following questions:

- Did the Lottery's internal controls provide reasonable assurance that it accurately paid for goods and services received, properly solicited lottery procurement contracts, accurately recorded direct costs and operating expenses in the accounting system, and complied with applicable finance-related legal provisions and management's authorization?
- Did the Lottery's controls provide reasonable assurance of an open bid process for selection and screening of vendors, contractors, and security specialists?
- Did the Lottery comply with finance-related legal provisions governing procurement and disbursement of goods and services?

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Background

As shown in Table 1-1, the Lottery's direct costs include prizes, ticket costs, vendor expenses for online numbers games, and retailer commissions and incentives. Direct costs vary according to the volume of Lottery ticket sales that occur. Operating expenses involve Lottery administrative costs for payroll, advertising, promotions, space rent, and other expenses.

Lottery Procurement Contracts

*Minnesota Statutes*¹⁰ exempt the Lottery from state purchasing requirements for its "Lottery Procurement Contracts."¹¹ Statutes define lottery procurement contracts as a "contract to provide lottery products, computer hardware and software used to monitor sales of lottery tickets, and lottery tickets." This would include such things as contracts for manufacturing, delivery, and security of scratch-off tickets and equipment and services for connections to online games. For lottery procurement contracts, *Minnesota Statutes*¹² require the Lottery to request the director of the Alcohol and Gambling Division of the Department of Public Safety (DPS) to investigate criminal backgrounds of potential Lottery vendors and contractors. At the completion of the investigations, DPS sends the Lottery a summary letter stating the background checks and any concerns they may have found. The Lottery can then request a full detailed report from the DPS Alcohol and Gambling Division, as needed.

Advertising and Promotion

For fiscal year 2005, the Lottery spent a total of \$7,065,707, or 1.85 percent of gross revenue, on advertising and promotion. These activities excluded salaries and benefits for Lottery staff engaged in advertising and promotional activities. Because differentiating between advertising and promotion can be very difficult, 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. Examples of Lottery advertising include bus signs and television and radio ads.
- The Lottery defined 'promotions' as activities that supplement sales and advertising, coordinate them, and help to make them effective. The Lottery uses several promotional methods to increase sales. Promotional methods include the sponsorships of sports teams and other events, displays, and contests.

The Lottery has developed an internal ongoing process to assess the cost-effectiveness of promotions and advertising. The Marketing Division estimates the benefits, while the

¹⁰ *Minnesota Statutes* 2005, chapter 349A.07, subd. 6

¹¹ The Lottery is required to follow the Department of Administration's purchasing manual for all acquisitions of goods and services not considered a Lottery Procurement Contract. Department of Administration procurements would include contracts for materials, supplies, equipment, or services common to the ordinary operation of a state agency.

¹² *Minnesota Statutes* 2005, chapter 349A.07, subd. 2

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Financial Services Division determines the costs and assesses reasonableness. For fiscal year 2005, the Lottery spent \$2,364,686 on promotional expenses.

Our audit of direct and operating expenses identified the following concerns.

Findings and Recommendations

1. The Lottery did not document its resolution of concerns revealed in a criminal background check for an employee of one contractor.

Lottery management did not document its follow-up on concerns cited in a letter summarizing one contractor's background check received from the Department of Public Safety's Alcohol and Gambling Enforcement Division. The letter, dated February 10, 2005, cited possible conflicts of interest and concern with incomplete and inaccurate information given on criminal history sheets by an employee of the contractor. The Lottery's executive director indicated that he reviewed the concerns with Department of Public Safety representatives but did not document the final decision.

Since the Lottery did not document the full investigative report, we requested it from the Department of Public Safety to assess the severity of the concerns. Based on our review, we were satisfied that the Lottery adequately considered the concerns in their decision to contract with that company. However, Lottery management should have taken steps to document their assessment and its impact on the final contract decision.

Lottery management must be diligent with concerns cited in background checks to ensure contractors are reputable, honest, and trustworthy. It should anticipate the effect that various types or degrees of crimes may have on their contracting decisions. For example, a speeding violation may not adversely impact the decision to hire the contractor, while a financial crime may cause the Lottery to not hire the contractor or to terminate an existing contract.

Recommendation

- *The Minnesota State Lottery should establish a process to review background check letters and obtain the full investigative report from the Department of Public Safety when they raise concerns. It should develop a policy to deal with the different levels of severity of issues cited in background checks, and document the resolution of any concerns.*

2. The Lottery did not always comply with state purchasing policies and procedures for some goods and services it procured.

The Lottery did not consistently comply with the Department of Administration's purchasing policies for certain purchases of goods and services. Typically, procurements exceeding \$25,000 requires competitive selection by the Department of Administration; however, the Lottery did not include them in promotional sponsorship decisions or obtain delegated approval for the Lottery to select the sponsors. In addition, the Lottery did not

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consistently comply with the Department of Administration's requirements for some procurements that exceeded its delegated purchasing authority.

The Lottery had the following procurement weaknesses for certain types of expenses.

- The Lottery did not include the Department of Administration on decisions for soliciting and procuring sponsorships in excess of \$25,000. For fiscal year 2005, the Lottery paid seven sponsors a total of \$235,000, including a sponsorship totaling \$79,500 with the Minnesota Twins. Sponsorships are different than procuring other professional and technical services. Besides cost, several unique factors must be considered when selecting a sponsor, such as identifying the specific group of people being targeted by the promotion. Some sponsorships are tied to particular venues only offered by one vendor and could be defined as a single source procurement. Alternatively, other venues, such as golf tournaments, may have multiple sponsors and require the Lottery to be more selective with competing sponsors.
- The Lottery did not follow the Department of Administration's procurement requirements when it purchased \$51,360 of cash register signage. The Lottery's purchasing authority is limited to \$25,000. Any purchases exceeding this amount should be handled by the Department of Administration's Materials Management Division. We found that the director of the Marketing division authorized this purchase; however, this position's delegated purchasing level is further limited to \$15,000. The executive director should have also authorized this purchase.
- Finally, the Lottery did not advertise a request for bid in the State Register, or on the Department of Administration's website, for a \$13,880 purchase of glass used to display lottery tickets. While the purchase was within the Lottery's purchase authority, it did not comply with state purchasing guidelines. These guidelines require that purchases between \$5,000 and \$25,000 be advertised in the State Register or on the Department of Administration's website.

Recommendations

- *The Minnesota State Lottery should work with the Department of Administration regarding decisions on solicitation and selection of sponsorships.*
- *The Lottery should ensure that all purchases made within their delegated purchasing authority are properly bid and advertised, and should work with the Department of Administration to procure items that exceed the Lottery's delegated purchasing level.*

Chapter 4. Payroll Expenses

Chapter Conclusions

The Minnesota State Lottery's internal controls provided reasonable assurance that it accurately compensated employees and maintained employee leave records, and that it properly recorded payroll transactions in the state's personnel and payroll system and its accounting general ledger. However, the Lottery did not always retain evidence to support management authorization for changes to employee pay rates. Also, the Lottery did not adequately monitor payroll transactions by documenting their review of key system reports and changes made to reported hours and types of compensation.

For the items tested, the Lottery paid employees in compliance with significant finance-related legal provisions contained in bargaining unit contracts and personnel plans.

Audit Objectives

Our audit of payroll expenses focused on the following questions:

- Did the Lottery's internal controls provide reasonable assurance that it accurately compensated employees and maintained employee leave records and properly recorded payroll expenses in the accounting system and its general ledger?
- Did the Lottery pay employees in compliance with significant finance-related legal provisions contained in bargaining unit contracts and personnel plans?

Background

Payroll is a significant expenditure for the State of Minnesota and the Minnesota State Lottery. During fiscal year 2005, the state's payroll expenses were nearly \$3.1 billion. Payroll was the largest operating expense for the Lottery, totaling \$10 million for fiscal year 2005 and comprising about 45 percent of its total operating expenses.

The commissioner of Employee Relations is the chief personnel and labor relations manager for the executive branch. In this capacity, the commissioner of Employee Relations oversees a wide array of functions, from negotiating compensation plans to maintaining the civil service classification system. To fulfill these duties, *Minnesota*

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Statutes give the commissioner of Employee Relations the authority to further delegate certain responsibilities to individual state agencies.

Personnel and payroll responsibilities are shared by the Lottery and two central oversight agencies: the departments of Employee Relations and Finance. The two oversight agencies maintain the central personnel and payroll system used by all state agencies. This computer system has many edits that ensure personnel and payroll transactions comply with legal provisions and terms in personnel contracts and plans. The system also has extensive online policies and procedures to help state agencies record their decisions. However, Lottery personnel officers and payroll staff are ultimately responsible for understanding and complying with compensation plan terms and other pertinent legal provisions.

In September 2004, Lottery employees began using a self-service electronic timesheet system to enter their hours worked and leave taken into the state's payroll system. The new process automated employee timesheets and allowed for electronic supervisory approvals.

The conclusions reached in this report are based solely on work done at the Minnesota State Lottery. In addition, the Office of the Legislative Auditor performed other audit work to assess the adequacy of centralized personnel and payroll controls administered by the departments of Employee Relations and Finance. Legislative Audit Report #03-47, issued in August 2003, focused on security controls that protect the integrity and confidentiality of data in the personnel and payroll system. It also assessed the adequacy of central controls over pay rates, leave accruals, and payroll processing. Due to the significance of payroll costs to the State, we continue to examine central personnel and payroll controls and will be issuing another report to the departments of Employee Relations and Finance at a later date.

Our review of employee payroll identified the following concerns.

Findings and Recommendations

3. The Lottery did not always retain evidence to support management authorization for changes to employee pay rates.

The Lottery did not document or retain authorizations for some personnel transactions. Management and supervisors play a critical role authorizing key personnel transactions for Minnesota State Lottery employees. Managers provide the human resources office with authorization for pay rate increases. Their official authorizations protect personnel staff from accusations of making unauthorized transactions. In some cases, the agency must obtain external approval from the Department of Employee Relations before proceeding with the transaction.

The Lottery had the following weaknesses with personnel authorizations.

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- The Lottery's personnel function needs to develop methods for documenting control over pay rate changes. The Lottery did not independently verify that new employees' job codes and pay rates were correctly determined and accurately entered in the payroll/personnel system. The same staff that entered job codes and pay rates for new employees also verified accurate entry into the payroll/personnel system. In addition, the Lottery did not retain key biweekly reports used to verify accuracy of pay rate increases entered for current staff.
- Before October 2005, the Lottery did not retain authorization forms for hiring new employees. Authorization forms were not on file for 9 of 16 items tested. The hiring form documents management's authorization to fill a position vacancy and should be identified as an official personnel record on the Lottery's records retention schedule.
- The Lottery did not retain documentation authorizing an employee's promotion. Without retaining this key document, we cannot assess management's authorization controls.
- The Lottery did not retain documented approval from the Department of Employee Relations that gave the Lottery authorization to hire a new employee at a higher pay rate. We were able to directly obtain from DOER an email it sent to the Lottery; however, this approval should have been retained in the Lottery's personnel files.

Recommendation

- *The Minnesota State Lottery should establish standards for documentation of personnel pay rate increases and promotion. Standards should identify the method of retention for those formal authorizations.*

4. The Lottery did not adequately document its monitoring of payroll transactions, as required by the Department of Finance's policies.

The Lottery did not document its review of key system reports available through the state's payroll system to ensure that biweekly payroll transactions were accurate. The Department of Finance developed two key policies requiring agencies to monitor payroll transactions:

- PAY0017 – requires agencies to review the *Self Service Time Entry Audit Report*. This report identifies transactions that bypassed key processing controls. It identifies employees who did not complete their own timesheet and timesheets that were not approved by the employee's primary supervisor. These exceptions indicate a potential breakdown in the controls over the electronic processing of timesheets.

Minnesota State Lottery

- PAY0028 – requires agencies to document their review of the *Payroll Register*. This report allows the Lottery to independently verify all biweekly transactions being processed, including current and retroactive salary adjustments, special lump-sum transactions, and changes to earnings types, hours, and pay rates. The Lottery can correct any errors or adjustments identified as a result of this review before it pays its employees.

In addition to concerns with documenting their review of payroll system reports, the Lottery did not sufficiently document changes to payroll hours that employees submitted through the self-service time entry process. Subsequent to the approval and release of employees' timesheets, supervisors sometimes contacted the payroll office to change the hours previously submitted. Payroll staff stated that they do not always receive documentation from the supervisors approving the changes to the employees' time. The Lottery did not have documentation to support supervisor's approvals on changes in hours for 7 of 15 items tested.

The lack of documentation for reviewing reports and changes to submitted hours increases the risk that inappropriate payroll transactions or unauthorized changes could go undetected.

Recommendation

- *The Minnesota State Lottery should review the state payroll system's Self Service Time Entry Audit Report and Payroll Register each pay period. It should document its review, resolution of exceptions found, and reasons for changes made to reported hours and types of compensation.*

Status of Prior Audit Issues As of May 5, 2006

Most Recent Audits

Legislative Audit Report 02-32, issued in May 2002, covered the four fiscal years ending June 30, 2001. The audit scope included operating expenses and employee payroll costs. The report did not contain any findings.

Legislative Audit - Program Evaluation Report 04-01, issued February 2004, examined the finances and business practices of the Minnesota State Lottery. The evaluation found lack of external oversight and governance, inappropriate relationships with contractors, poor promotional strategies, and administrative waste. The evaluation contained 49 recommendations for improvement. In a follow-up response, dated July 2004, Interim Director Michael Vekich reported to the Governor that action on all recommendations had been completed. The Lottery report can be found on the Minnesota State Lottery website.¹³

Other Audit Coverage

The Minnesota State Lottery contracts with an independent public accounting firm to conduct an annual financial statement audit. The Lottery received an unqualified opinion on its financial statements for each year of our audit scope. The Lottery's financial report can be found on the Minnesota State Lottery website.¹⁴

State of Minnesota Audit Follow-Up Process

The Department of Finance, on behalf of the Governor, maintains a quarterly process for following up on issues cited in financial audit reports issued by the Legislative Auditor. The process consists of an exchange of written correspondence that documents the status of audit findings. The follow-up process continues until Finance is satisfied that the issues have been resolved. It covers entities headed by gubernatorial appointees, including most state agencies, boards, commissions, and Minnesota state colleges and universities. It is not applied to audits of the University of Minnesota, any quasi-state organizations, such as metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

¹³ <http://www.lottery.state.mn.us/govrpt/GovernorsReport.pdf>

¹⁴ <http://www.lottery.state.mn.us/ar05/AnnualReport05.pdf>

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*Proceeds Benefit Our Natural
and Economic Environments.*

September 14, 2006

James R. Nobles
Legislative Auditor
100 Centennial Office Building
658 Cedar Street
St. Paul, Minnesota 55155

Dear Mr. Nobles:

Thank you for your recent audit of the Minnesota State Lottery for the period of July 1, 2004 to December 31, 2005. We recognize the importance of having an independent audit and welcome a review of our operations. We appreciate the time and effort invested by your staff in this audit and the professional manner in which the audit was conducted.

In each of the last two fiscal years the Lottery has achieved record sales and, most importantly, has returned record amounts to our designated beneficiaries. Much of this has been accomplished through our response to the recommendations made in the 2004 Legislative Auditor's Program Evaluation. While the findings of this audit are on a much smaller scale, we will approach them in the same spirit of continuous improvements in efficiency and accountability.

The Minnesota State Lottery is committed to implementing each of the recommendations in this report. Our response to each audit finding and recommendation is listed below.

Finding 1 – The Lottery did not document its resolution of concerns revealed in a criminal background check for an employee of one contractor.

Auditor's Recommendation: The Minnesota State Lottery should establish a process to review background check letters and obtain the full investigative reports from the Department of Public Safety when they raise concerns. It should develop a policy to deal with the different levels of severity of issues cited in background checks, and document the resolution of any concerns.



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Response: The Lottery agrees with this recommendation and recognizes the importance of addressing concerns raised in any background check. We will continue to vigorously evaluate any concern and document the resolution of those issues. The Lottery will implement procedures that establish a process to review background checks, follow up on concerns raised, and document that appropriate action was taken.

Staff Responsible for Implementation: Doug Wills, Chief of Security

Implementation Date: October 2006

Finding 2 – The Lottery did not always comply with state purchasing policies and procedures for some goods and services it procured.

Auditor's Recommendations:

The Minnesota State Lottery should work with the Department of Administration regarding decisions on solicitation and selection of sponsorships.

The Lottery should ensure that all purchases made within their delegated purchasing authority are properly bid and advertised and should work with the Department of Administration to procure items that exceed the Lottery's delegated purchasing level.

Response: The Lottery agrees with the recommendations and will implement policies and procedures to comply with each recommendation.

In regard to promotional sponsorship contracts, the Lottery has been working with the Department of Administration since July 2006 to develop a plan that complies with the Department's requirements. Under that plan the Lottery and the Department of Administration will develop a Request for Proposals (RFP) for promotional sponsorships, which will then be posted on the Department's web site. Any interested person can then submit a proposal, and based on the criteria stated in the RFP, the Lottery will select vendors from which it can negotiate promotional sponsorship contracts. Based on this process developed by the Department of Administration and the Lottery, the Department will delegate authority to the Lottery to select sponsors and negotiate contracts.

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With regard to the purchase of other goods and services, while each of the purchases noted by the audit were competitively bid, the Lottery failed to comply with Department of Administration guidelines. Since being informed by the auditor of this deficiency the Lottery has complied with Department of Administration requirement to post solicitations on the Department's web site for purchases within the Lottery's delegated purchasing level. The Lottery is also complying with the requirement to work with the Department for purchases over the Lottery's delegated purchasing level. The Lottery will be updating its policies and procedures to reflect these requirements.

Staff Responsible for Implementation: Dale McDonnell, Assistant Director & General Counsel

Implementation Date: November 2006

Finding 3 – The Lottery did not always retain evidence to support management authorization for changes to employee pay rates.

Auditor's Recommendation: The Minnesota State Lottery should establish standards for documentation of personnel pay rate increases and promotions. Standards should identify the method of retention for those formal authorizations.

Response: The Lottery agrees with the recommendation and will implement policies and procedures to comply with the recommendation. The Lottery agrees with the importance to document pay changes and to independently verify any changes in the pay of any employee. The Lottery has already implemented a policy to document all pay rate changes and retain authorization documents. Further, the Lottery will be implementing a policy where staff from the accounting department will independently verify pay changes made by the human resources department.

Staff Responsible for Implementation: Dale McDonnell, Assistant Director & General Counsel, and Joe Pahl, Chief Financial Officer

Implementation Date: October 2006

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Finding 4 – The Lottery did not adequately document its monitoring of payroll transactions, as required by the Department of Finance’s policies.

Auditor’s Recommendation: The Minnesota State Lottery should review the state payroll system’s Self Service Time Entry Audit Report and Payroll Register each pay period. It should document its review, resolution of exceptions found, and reasons for changes made to reported hours and types of compensation.

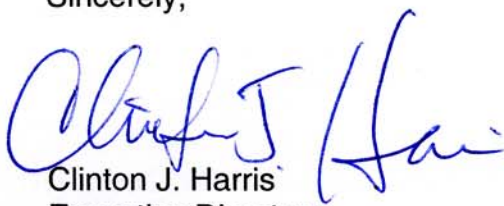
Response: The Lottery agrees with the recommendation and will implement procedures requiring that staff review the state payroll system’s Self Service Time Entry Audit Report and Payroll Register each pay period and document that such review was completed, while also documenting the resolution of exception and reasons for changes made to reported hours and types of compensation.

Staff Responsible for Implementation: Joe Pahl, Chief Financial Officer

Implementation Date: October 2006

Thank you for providing the Lottery with the opportunity to respond to this audit.

Sincerely,


Clinton J. Harris
Executive Director