MINNESOTA STATE LOTTERY
FINANCIAL AUDIT
FOR THE PERIOD OCTOBER 9, 1989 - JUNE 30, 1990

SEPTEMBER 1991

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

91-65

Centennial Office Building, Saint Paul, Minnesota 55155 ● 612/296-4708

MINNESOTA STATE LOTTERY

FINANCIAL AUDIT
FOR THE PERIOD OCTOBER 9, 1989 - JUNE 30, 1990

Public Release Date: September 13, 1991 No. 91-65

OBJECTIVES:

- TEST COMPLIANCE WITH CERTAIN FINANCE-RELATED LEGAL PROVISIONS, INCLUDING CONSIDERING WHETHER FINANCIAL ACTIVITIES WERE CONDUCTED IN A REASONABLE AND PRUDENT MANNER FOR A PUBLIC ENTITY.
- REVIEW INTERNAL CONTROL STRUCTURE POLICIES AND PROCEDURES IN THE FOLLOWING CATEGORIES: cash and investments, instant ticket sales, retailer commissions, prize expense, distributions to beneficiaries, payroll, materials and supplies, advertising, and inventory of promotional items.

CONCLUSIONS:

We found two areas where we question whether the Lottery complied with applicable legal provisions:

- We question whether the Lottery complied in fiscal year 1990 with the statutory provision limiting operating costs to 15 percent of gross revenue.
- The Lottery is not in compliance with statutory and procedural guidance governing employee use of state cars.

We found three areas where the internal control structure needed improvement:

- The Lottery inappropriately gave promotional items to its employees.
- The Lottery did not formally document an amendment to a contract for the purchase of equipment.
- Controls over lottery promotional item inventory need improvement.

Contact the Financial Audit Division for additional information.
(612) 296-1730

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
CENTENNIAL BUILDING, ST. PAUL, MN 55155 • 612/296-4708
JAMES R. NOBLES, LEGISLATIVE AUDITOR

Representative Ann Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. Gene A. Bier, Chair
Minnesota State Lottery Board

Members of the Minnesota State Lottery Board

Mr. George R. Andersen, Director
Minnesota State Lottery

Audit Scope

We have conducted a financial related audit of the Minnesota State Lottery as of and for the period October 9, 1989 (commencement of operations) through June 30, 1990. Section I provides a brief description of the agency's activities and finances.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial activities attributable to the transactions of the Minnesota State Lottery are free of material misstatements.

We performed tests of the Minnesota State Lottery's transactions to obtain reasonable assurance that the lottery had, in all material respects, administered its programs in compliance with applicable laws and regulations. However, our objective was not to provide an opinion on overall compliance with such provisions.

Management Responsibilities

The management of the Minnesota State Lottery is responsible for establishing and maintaining an internal control structure. This responsibility includes compliance with applicable laws and regulations. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that:

- assets are safeguarded against loss from unauthorized use or disposition;

- transactions are executed in accordance with applicable legal and regulatory provisions, as well as management's authorization; and

- transactions are recorded properly on the Minnesota State Lottery and the statewide accounting systems in accordance with Lottery and Department of Finance policies and procedures, respectively.

Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

Internal Control Structure

For purposes of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- cash and investments,
- instant ticket sales,
- retailer commissions,
- prize expense,
- distributions to beneficiaries,
- payroll,
- materials and supplies,
- advertising, and
- inventory of promotional items.

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation. Our review was more limited than would be necessary to express an opinion on the Minnesota State Lottery's system of internal accounting control taken as a whole. We also considered whether the Minnesota State Lottery's financial activities were conducted in a reasonable and prudent manner for a public entity. To achieve this objective, we reviewed selected financial policies and practices in effect during the audit period and as of the time of our fieldwork in April 1991.

Reliance on the Work of Other Auditors

As provided in Minn. Stat. Section 349A.14, the lottery contracted with a certified public accounting firm to conduct a financial audit of lottery financial activity for the period October 9, 1989 (commencement of operations) through June 30, 1990. The firm issued an unqualified opinion on the lottery's financial statements for the period. We reviewed the firm's workpapers and relied on its work, where appropriate, in determining the extent of our testing.

Conclusions

Our review disclosed the conditions discussed in findings 2 - 4 involving the internal control structure of the Minnesota State Lottery. We consider these conditions to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data.

A material weakness is a reportable condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial activities being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we reported to the management of the Minnesota State Lottery at the exit conference held on August 21, 1991.

We question whether the Lottery complied with the provisions of Minn. Stat. Section 349A.10, Subd. 3(b) for fiscal year 1990. Subdivision 3 authorizes the director to establish a lottery operations account from which to pay all costs of operating the Lottery. The director is to credit to the lottery operations account amounts sufficient to pay the operating costs. Subdivision 3(b) provides that the director may not credit to the lottery operations account in any fiscal year amounts which exceed 15 percent of lottery fund gross revenue. For fiscal year 1990, operating expenses totalled $17,640,387. This was approximately 27 percent of revenue (less sales tax) which totalled $64,477,963. Lottery staff concluded the Lottery was in compliance with the statutory restriction on operating costs. They have segregated the fiscal year 1990 expenses into start up costs, which they believe are not subject to the statutory restriction, and operating costs, which are subject to the restriction. In its calculation of operating costs, the Lottery did not include $8,297,193 in expenses equal to a start-up loan from the General Fund and interest thereon. Based on the Lottery's calculation, operating costs were 14.49 percent of revenue in fiscal year 1990. The Lottery consulted with and received advice from personnel from the Department of Finance and the Office of the Attorney General in arriving at its interpretation. It is not clear to us whether the start up loan was only for cash flow or whether it was an additional funding source for operating costs.

The results of our tests indicate that, except for the issues discussed in the preceding paragraph and in finding 1, with respect to the items tested, the Minnesota State Lottery complied, in all material respects, with the provisions referred to in the audit scope paragraphs. With respect to items not tested, nothing came to our attention that caused us to believe that the Minnesota State Lottery had not complied, in all material respects, with those provisions.

This report is intended for the information of the Legislative Audit Commission and management of the Minnesota State Lottery. This restriction is not intended to limit the distribution of this report, which was released as a public document on September 13, 1991.

James R. Nobles
Legislative Auditor

John Asmussen, CPA
Deputy Legislative Auditor

END OF FIELDWORK: June 7, 1991

REPORT SIGNED ON: September 6, 1991

MINNESOTA STATE LOTTERY

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AUDIT PARTICIPATION

The following members of the Office of the Legislative Auditor participated in this report:

John Asmussen, CPA	Deputy Legislative Auditor
Claudia Gudvangen, CPA	Audit Manager
Mike Hassing	Auditor-in-Charge
Ellen Merlin, CPA	Auditor
Judy Cammack, CPA	Auditor

EXIT CONFERENCE

The findings and recommendations in this report were discussed with the following staff of the Minnesota State Lottery on August 21, 1991:

George R. Anderson	Director
Mary Ellen Hennen	Director for Administration
Robert Okerlund	Fiscal Manager
Erin Roth	Executive Assistant to the Director

INTRODUCTION

The Minnesota State Lottery was created in June 1989 under Minn. Stat. Section 349A which governs the lottery and its operations. The Lottery is under the supervision and control of a director, Mr. George R. Andersen, who was appointed by the governor. The State Lottery Board, also appointed by the governor, advises the director on all aspects of the Lottery. The Board has authority to review and comment on rules and game procedures, procurement contracts, joint lottery agreements, advertising, and to approve additional compensation for the director.

With certain exceptions, the Lottery must follow rules and regulations applicable to other state agencies. Staff of the Lottery are state employees in the classified or unclassified service. The director has authority to establish a state lottery fund and a lottery prize fund outside the state treasury. Except as the director determines, the Lottery is not subject to Minn. Stat. Chapter 16A relating to budgeting, payroll, and the purchase of goods and services. The Lottery is subject to the provisions of Minn. Stat. Chapter 16B, and related Department of Administration guidelines, except for Lottery retailer contracts and Lottery procurement contracts.

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. Additionally, the Lottery intends to maximize the contributions to those projects and programs identified by the Legislature to receive Lottery proceeds. During the audit period, these programs included the Environment and Natural Resources Trust Fund, the Infrastructure Development Fund for Capital-Improvements at state higher education facilities, and the Greater Minnesota Corporation. The 1991 Legislature amended the distribution for fiscal years 1992 and 1993 to have 40 percent of the proceeds go to the Environment and Natural Resources Trust Fund and the remainder to the General Fund.

The Lottery began selling instant scratch tickets on April 17, 1990. On August 14, 1990, the Lottery introduced two on-line games, Daily-3 and Lotto Minnesota. The Lottery started its third on-line game, Gopher-5, on May 24, 1991. The distribution of a typical sales dollar shows a minimum of 50 percent for prizes, and approximately 25 percent to lottery beneficiaries, 14 percent to the operating fund, 6 percent to the General Fund in lieu of sales tax, and 5 percent for retailer commissions.

The Lottery headquarters are located in Roseville, Minnesota. There are six regional offices in greater Minnesota. The following financial information summarizes activity through June 30, 1990:

MINNESOTA STATE LOTTERY

Revenue	
Instant Ticket Gross Sales	$67,825,593
Other	721,948
Total Revenue	$68,547,541
Expenses and Other Disbursements	
Prize Expense	$34,334,800
Distributions to Beneficiaries	9,114,776
6% Tax	4,069,578
Supplies and Materials	3,963,732
Retailer Commission	3,388,000
Advertising	3,182,916
Salaries and Benefits	2,454,505
Promotions	323,807
Other	7,715,427
Total Expenses and Other Disbursements	$68,547,541

Source: Minnesota State Lottery Financial Statements - June 30, 1990.

II. CURRENT FINDINGS AND RECOMMENDATIONS

1. The Lottery is not in compliance with Department of Administration procedures governing employee use of state cars.

The Lottery does not have specific authority to provide individual cars to employees. The Lottery provides seven administrators with their own vehicles for business use. The Lottery leases the cars from a private vendor. Four members of the executive staff are permanently assigned cars, which they use for daily commuting and business related travel.

The Department of Administration policy governing the use of state cars by employees states that agency heads shall not have state cars assigned solely for their use. The operating procedure also provides that vehicle assignments will not be made on the basis of status, tradition, or as a condition of employment. Vehicles should be assigned on the basis of need, as measured by the number of miles driven or other qualifying use or need. The Department of Administration establishes operating procedures for state vehicles pursuant to Minn. Stat. Section 16B.55. The procedures apply to all vehicles, whether owned or leased by the state. The Lottery is subject to these guidelines. Minn. Stat. Section 16B.55, as well as the operating procedures, list situations when a state vehicle may be used for transportation to or from an employee's residence. We do not believe the Lottery meets these commuting criteria.

We believe that if the Lottery needs vehicles for business related activities, the cars should be available on a pool concept rather than assigned to selected employees. State vehicles should be used for commuting by employees only in accordance with applicable statutory and other guidelines.

RECOMMENDATIONS

- **The Lottery should discontinue the practice of providing administrators with personal vehicles.**
- **The Lottery should comply with all provisions of Minn. Stat. Section 16B.55 and the Department of Administration's procedures governing employee use of state cars.**

2. The Lottery inappropriately gave promotional items to its employees.

The Lottery gives all of its employees one of each type of promotional item on hand. Minn. Stat. Section 43A and the various bargaining unit agreements provide employees' compensation and benefit provisions. These regulations do not provide specific authority for the Lottery to give gifts to employees.

The Lottery purchases large volumes of promotional items for advertising, retailer incentives, and prizes at lottery marketing events. Promotional items include T-shirts, polo shirts, sport bags, umbrellas, playing cards, coffee cups, key chains, hats, etc. On an individual basis, the items are of nominal value. However, we question the practice of providing all Lottery employees with items purchased with public funds.

RECOMMENDATION

- **The Lottery should discontinue the practice of providing employees with promotional gifts.**

3. <u>The Lottery has not documented amendments to the contract which authorizes the purchase and installation of Zip Cash Units</u>.

The Lottery paid a vendor approximately $420,000 more than the approved $3.4 million contract. The additional funds were paid for services beyond those specified in the original contract. The Lottery did not complete contract amendments or enter into new agreements for these additional services. The original contract provides for the purchase and installation of Zip Cash units at retailer sites. Retailers process instant ticket game cards by entering information on Zip Cash units. The Zip Cash units send the information to the Lottery through an interactive telephone information system.

Adequate documentation to support the parties' agreement on the specific details of the additional services and the price the Lottery would pay for them does not exist. The contract stated that the vendor would provide additional services upon mutual agreement with the Lottery. The additional services included changes to existing software, installation of equipment for new retailers, and training seminars. Lottery staff had various correspondence with the vendor but did not document the agreements in a contract amendment.

Although the additional services provided appear reasonable, we believe the contracting process should be formalized. Without proper documentation, the Lottery could pay a vendor for unauthorized services. A contract should support these services to ensure that the parties understand their rights and obligations, reducing the risk of dispute.

RECOMMENDATION

- **The Lottery should complete amendments for any changes or additions to an existing contract.**

4. Controls over promotional item inventory records need improvement.

The Lottery did not have documentation to support promotional item inventory adjustments made during fiscal year 1990. Without this documentation, it is impossible to determine if the adjustments were valid. In particular, we are concerned about negative adjustments which represent decreases in inventory. The Lottery started to maintain these records in fiscal year 1991.

The two senior stores clerks initiate and record inventory adjustments onto the system. The warehouse manager does not regularly review adjustments. Therefore, the clerks are in a position to take inventory items and enter negative adjustments. Without the review of the daily adjustments report by the warehouse manager, an irregularity could go undetected.

The Lottery's inventory, stored in a separate warehouse, consists of gaming tickets, retailer advertising materials, zip cash machines, promotional items, and general office supplies. Several promotional items were not recorded in the inventory system. Stereo equipment consisting of 59 boom boxes, 33 compact disc players, and 32 walkmans were in the warehouse, but not on the inventory system at the time of our review. The Lottery purchased these items as premium promotional prizes. Unrecorded items are not subject to the controls which ensure that inventory transactions are documented and authorized. There is also a greater risk of undetected theft. Following our discussions, the Lottery added the items to the inventory system.

RECOMMENDATIONS

- **The Lottery should retain documentation supporting adjustments made to the inventory system.**

- **The warehouse manager should review the daily adjustment report and verify any negative adjustments.**

- **The Lottery should include promotional items on the inventory system.**

MINNESOTA STATE LOTTERY

Proceeds Benefit Our Natural And Economic Environments.

George R. Andersen
Director

August 30, 1991

James R. Nobles
Legislative Auditor
Office of the Legislative Auditor
Veterans Service Building
St. Paul, MN 55155

Dear Mr. Nobles:

We have reviewed the draft audit report and have the following comments. The conclusion regarding the start-up loan being within the 15% implies that the Lottery took the issue as to whether the loan was outside the 15% operating ceiling lightly. In fact, my own earliest reading on the statutes involved was the same as yours. Our subsequent discussions with and advice of the Attorney General's Office and Department of Finance resulted in a final and, we believe, accurate determination. Clearly, it is the documented joint opinion of the Department of Finance, Office of the Attorney General and the Lottery, confirmed by the Lottery's outside auditors, Peat Marwick, that the start-up loan was <u>outside</u> the 15%. Please note that the Lottery's Fiscal Year 1990 budgets, which were presented to the Senate Finance Subcommittee in February 1990, specifically showed two separate budget items -- (1) the start-up costs (via the loan) and (2) the operational costs (15% of gross revenue). No questioning comments about these two very distinct budget items were ever received by the Lottery during Fiscal Year 1990.

Clearly, the funds were essential to the launch of the Lottery -- especially considering the delayed appointment of the Director and the consequent delayed start of sales in April. Both resulted in a reduction of the gross sales, against which the statutory 15% cap is measured. We must assume that the legislature intended the 15% cap be applied against a normal 12-month sales period. Under the concept presented in the audit report, the security and integrity of Minnesota's entire lottery operation would have been severely restricted, inadequate and not in conformance with legislative or executive intent. Minnesota has the most efficient, secure and advanced lottery gaming system in existence, due in great part to the initial funding provided by the start-up appropriation.

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Minnesota State Lottery 2645 Long Lake Road Roseville, Minnesota 55113 (612) 635-8210 FAX (612) 297-7496
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Vehicles are, in fact, assigned to senior staff and security. Security staff must conduct investigations, answer alarms and are an integral part of our required strict physical, logical and administrative security operations. Senior staff is on-call at all times, for a variety of operational and security reasons. These include potential systems failures, intrusion to facilities, required Lotto*America "lock-downs," and drawing show failures. It is that kind of business warranting vehicle assignment under the rules. In addition, it is routine practice to visit retail locations to examine the practices of both potential and existing retailers, activities best done without large decals identifying state pool vehicles. The operational need of the Lottery, therefore, dictated that specific staff be assigned vehicles. The lease and assignment of vehicles was done through the Department of Administration, and approved by them. Appropriate income and withholding is assessed to those assigned vehicles.

Promotional items, such as t-shirts, caps, pens, key chains, etc. are routinely purchased for retailer incentives, special events, and general distribution. The items serve as a primary incentive to players and retailers, and are a stock-in-trade of the lottery industry. The Lottery further firmly believes that this marketing- and service-driven organization must also yield a staff with high morale, enthusiasm, dedication and pride. Through team building, employee recognition and identification with the mission of the Lottery, this has been accomplished. There are also occasions when staff are required to wear shirts and caps at special events. The provision of nominal cost items to staff (all emblazoned with Lottery logotypes) builds upon these objectives. The items clearly do not constitute additional compensation and serve a valid business purpose.

We believe that there is a major misunderstanding as to what services were covered by the original AGT contract. In addition to the $3.4 million purchase price (which includes software and not changes), paragraph 6.D. calls for the installation of phone jacks at all retailer locations throughout the state, to be paid for by the Lottery at a mutually agreed upon price. We negotiated a price for the installation, service and movement of the jacks with North Central Services and TBI, Inc. These charges were supervised by, billed and paid through AGT as the "prime contractor." North Central Services and TBI, Inc. acted as subcontractors to AGT under the AGT contract. The services were an integral part of the zip cash installation and were in fact covered as a part of the original contract, paragraph 6.D. We therefore disagree with the auditor's findings. The activities and amounts due were carefully monitored and documented.

Lottery automated inventory systems reflect one of the more difficult applications of standardized, "off-the-shelf" inventory systems. They are usually a poor fit. While we agree that the inventory system in effect during the period of the audit did not adequately address the retailer advertising materials, promotional items and general office supplies, the ACCLAIMS system (provided by Andersen Consulting) did, of course, provide exact accounting for all "gaming tickets." A new inventory control system has been in place since late June 1990. This new system, along with requisition procedures, provides strict control over all other inventory items.

As to the electronic items ("boom boxes," compact disc players) cited as not on inventory, we have explained to the auditors that these items were part of a group of items secured by the Carlson Marketing Group for the Lottery and were awarded as door prizes at the on-line games launch in August, 1990. The items were kept at Carlson until December, 1990. At that time they were sent to our warehouse as unclaimed prizes. There were several items that were subsequently sent out to attendees who had won the door prize, but had not picked them up at the time of the event. The items were of an inventory type (as unclaimed prizes) not contemplated by the automated system. When we finally received confirmation from the Carlson Marketing Group that all outstanding claims had been satisfied, we entered the balance into our inventory system. Nothing is missing, all has been accounted for.

As to the specific recommendations:

- The Lottery has implemented new procedures to retain all documentation supporting adjustments to inventory items.
- The warehouse manager now reviews all adjustment reports, verifies all negative adjustments and reports findings to the Director for Operations.
- All undistributed/unawarded promotional items purchased by the Lottery have always been included as inventory items.

I was disappointed that there was no significant comment regarding the Lottery's state-of-the-art accounting system. "Acclaims" represents the most accurate and sophisticated system in use, and when joined with bar code technology, establishes real time accounting and unparalleled security for the Minnesota State Lottery.

Thank you for the opportunity to comment on your report. Please contact me if you need additional information.

Very truly yours,

George R. Andersen
Director