MINNESOTA STATE LOTTERY
FINANCIAL AUDIT
FOR THE YEAR ENDED JUNE 30, 1991

OCTOBER 1992

Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

92-75

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

MINNESOTA STATE LOTTERY

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FOR THE YEAR ENDED JUNE 30, 1991

Public Release Date: October 9, 1992 No. 92-75

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: instant ticket sales, prize expense, retailer commissions and incentives, advertising, on-line vendor expense, and promotions.

CONCLUSIONS:

We found two areas where the Lottery did not comply with applicable legal provisions:

- The Lottery does not have specific authority to maintain equity reserve accounts.
- The Lottery is not in compliance with statutory and procedural guidance governing employee use of state cars.

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

- The Lottery inappropriately gave promotional items to its employees.
- The Lottery is not in compliance with state records retention policy.

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

STATE OF MINNESOTA
OFFICE OF THE LEGISLATIVE AUDITOR
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JAMES R. NOBLES, LEGISLATIVE AUDITOR

Representative Ann Rest, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Ms. Grace Nelson, 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 fiscal year ended June 30, 1991. Section I provides a brief description of the agency's activities and finances. Section II discusses current audit concerns.

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:

- instant ticket sales,
- prize expense,
- retailer commissions and incentives,
- advertising,
- on-line vendor expense, and
- promotions.

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 1992.

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 fiscal year ended June 30, 1991. The firm issued an unqualified opinion on the Lottery's financial statements for the period. We reviewed the auditor's workpapers and relied on their work, where appropriate, in determining the extent of our testing.

Conclusions

Our review disclosed the conditions discussed in findings 3 and 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 September 8, 1992.

The results of our tests indicate that, except for the issue discussed in findings 1 and 2, 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 October 9, 1992.

James R. Nobles
Legislative Auditor

John Asmussen, CPA
Deputy Legislative Auditor

End of Fieldwork: April 17, 1992

Report Signed On: October 5, 1992

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Audit Participation

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

John Asmussen, CPA	Deputy Legislative Auditor
Claudia Gudvangen, CPA	Audit Manager
Michael Hassing	Auditor-in-Charge
Janet Knox, CPA	Auditor
Dan Quandt, CPA	Auditor
Christina Weiss	Auditor

Exit Conference

The findings and recommendations in this report were discussed with the following staff of the Minnesota State Lottery on September 8, 1992:

George R. Andersen	Director
Mary Ellen Hennen	Assistant Director for Administration
Dale McDonnell	Legal Counsel
Robert Okerlund	Fiscal Manager

Introduction

The Minnesota State Lottery was created in June 1989. Minn. Stat. Chapter 349A 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, and advertising. It also may approve additional compensation for the director.

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 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, 25 percent to Lottery beneficiaries, 14 percent to the operating fund, 6 percent to 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 for the year ended June 30, 1991:

Revenue	
Ticket Sales	$321,487,363
Other Income	1,381,107
Total Revenue	$322,868,470
Expenses and Other Disbursements	
Prize Expense	$179,428,852
Distributions to Beneficiaries	66,880,273
Tax in Lieu of Sales Tax	19,289,242
Retail Commissions and Incentives	18,236,198
Advertising	12,239,184
Promotions	3,111,985
On-line Vendor Expense	4,812,590
Other Expenses	18,870,146
Total Expenses and Other Disbursements	$322,868,470

Source: 1991 Minnesota State Lottery Annual Report.

Current Findings and Recommendations

1. The Lottery does not have specific authority to maintain equity reserve accounts.

The Lottery has withheld approximately $2 million from distributions to beneficiaries to establish two types of reserve accounts. As of June 30, 1991, approximately $1.1 million was held in reserve for the retailer incentive program and over $700,000 was held for future on-line game prizes. At February 29, 1992, the reserves were $1.2 and $1.1 million, respectively.

The Lottery is required to deposit net proceeds in the state treasury within thirty days after month end. Net proceeds are the balance in the Lottery fund after transfers to the Lottery prize fund and credits to the Lottery operations account. The Lottery classifies the reserve accounts as liabilities and charges them to expense as tickets are sold. As a result, the Lottery can hold onto these proceeds for future needs. There is no specific authority allowing the Lottery to hold proceeds for future use. Lottery staff argue that establishment of the reserves is a prudent business practice. They believe that the general statutory provisions, which allow the director to establish rules necessary for the efficient operation and administration of the Lottery, provide authority for such actions.

The incentive program is established to offer rewards to retailers who generate additional sales revenue. The programs are planned and timed to increase sales during slower sales periods. Minn. Stat. Section 349A.05 allows the director to establish rules for the Lottery and MCAR 7856.4030 specifically allows the director to establish retailer incentive programs. Each program has a detailed set of procedures and criteria for winning awards and compensation. Cash and merchandise totalling $583,000 were awarded as incentive prizes during fiscal year 1991. These prizes were funded through the reserve account. The timing of deposits to the incentive reserve account does not directly match the expenditure of funds. The Lottery withholds one percent of the prize structure on each game as an incentive reserve. However, there is not an incentive program associated with every game. Therefore, the Lottery accumulates a balance in the reserve account. As of June 30, 1991, the balance in the instant retailer incentive reserve account was $1,190,106. At February 29, 1992, it was $1,214,976.

Other reserve accounts are established for the Daily 3 and Gopher 5 on-line games. A percentage of sales (1 to 3 percent) is placed in reserve. The reserve account can be used for future prizes should a game not produce sufficient sales to cover all prize expense. The on-line reserve account will be allowed to accumulate to approximately $2,000,000. As of June 30, 1991, the Lottery had a balance of $707,237 in the on-line reserve account. At February 29, 1992, the balance was $1,073,351.

Recommendation

- *The Lottery should deposit reserve funds in the state treasury or obtain specific authority to maintain equity reserve accounts to fund the incentive programs.*

2. PRIOR FINDING NOT RESOLVED: The Lottery is not in compliance with Department of Administration procedures governing employee use of state cars.

The Lottery continues to provide seven administrators with their own cars for business use. The Lottery leases the cars from a private vendor. Each member of the executive staff is permanently assigned a car. The administrators commute to and from work on a daily basis in their cars. The Department of Administration has established the state policy for employee use of state vehicles pursuant to Minn. Stat. Section 16B.55.

In our prior audit, we conclude that the Lottery's practices do not follow the procedures established by the Department of Administration. We continue to hold that position. The procedures specifically state that cars are not to be assigned to department heads. Minn. Stat. Section 16B.55 and the procedures list situations allowing commute privileges. The Lottery does not meet these commuting criteria. We do not believe the Lottery has specific authority to provide each administrator with a personal car.

Recommendations

- *The Lottery should discontinue the practice of providing administrators with personally assigned vehicles.*
- *The Lottery should comply with provisions of the Department of Administration's procedures governing employee use of state cars.*

3. PRIOR FINDING NOT RESOLVED: The Lottery lacks authority to give promotional items to employees.

The Lottery has continued the practice of providing its employees promotional items. Lottery employees are state employees. Minn. Stat. Section 43A and the various bargaining unit agreements provide employees' compensation and benefit provisions. These regulations do not provide authority for the Lottery to give gifts to employees.

The Lottery purchases large volumes of promotional items to give to retailers as incentives and as prizes at Lottery marketing events. In the fall of 1991, each Lottery employee received a jacket. The jackets had an individual cost of $26. The total cost to the Lottery for jackets given to employees was over $5,400. These were part of a $650,000 jacket purchase for retailer incentives. Other prizes such as golf balls and watches have recently been purchased for future incentive programs. Last year, employees received umbrellas, sport bags, T-shirts, coffee cups, etc. The Lottery cites the promotional value these items serve to potential Lottery players and retailers.

We question the practice of providing Lottery employees with items purchased with public funds.

Recommendation

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

4. The Lottery is not in compliance with state records retention policy.

The Lottery does not have a records retention schedule. State agencies are to have a formal plan for the preservation and disposition of records and documents which support their operations. These requirements are established in Minn. Stat. Sections 15.17 and 138.17. The Department of Administration administers the records management program.

Recommendation

- *The Lottery should work with the Department of Administration to develop a formal record retention policy.*

MINNESOTA STATE LOTTERY

Proceeds Benefit Our Natural And Economic Environments.

George R. Andersen
Director

September 28, 1992

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

Dear Mr. Nobles:

We have reviewed the revised draft audit report on the Minnesota State Lottery, dated September 9, 1992, and this letter represents the Lottery's comments to that report.

Finding # 1: The Lottery does maintain certain reserve or contingency accounts, believes that it has statutory authority to maintain these accounts, and, in fact, that it is required by law to maintain such accounts. It is necessarily inherent in the Lottery's specific authority to pay prizes and commissions to retailers that there exist the means to make those payments under all contingencies. The establishment of these accounts is a prudent business practice. For the Lottery not to maintain these prize reserve accounts would certainly violate the statutory requirement that the Lottery be operated in a fiscally responsible manner. If these accounts were not maintained, the Lottery's outside auditing firm, KPMG Peat Marwick, would likely be required to issue an exception of its own as part of its audit of the Lottery's financials.

Minnesota Statutes, Section 349A.10, subdivision 2, requires the Director to establish a Lottery Prize Fund and to deposit into this fund, from the gross receipts from the sale of lottery tickets, "an amount sufficient to pay lottery prizes." Further, the Director of the Lottery is obligated by Minnesota Statutes, section 349A.92, subdivision 3, clause (7) "to take all necessary steps to ensure the integrity of, and public confidence in, the state lottery." To adequately and sufficiently pay lottery prizes to players the Director must set up a reserve sufficient to cover prizes in the event that the liability exceeds current prize pool amounts. Without such reserves the Director would be derelict in not taking all the necessary steps "to ensure the integrity of, and public confidence in the lottery."

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Such draws on the reserve occur because of the nature of the games. Guaranteed prizes in Daily 3, Gopher 5, and Powerball may exceed average statistical payouts due to customer number selection, key date preferences, etc. The inability to pay out prizes on a timely basis would, of course, severely damage the integrity of and public confidence in the Lottery, and negatively impact the sale of lottery tickets. The Lottery must never be in a position where it cannot cover the wager, and by virtue of the reserves, it should not ever be in such a situation. To cancel these amounts and return them to the state at the end of a particular accounting period would violate the statutory provision to adequately fund the Lottery Prize Fund and would contravene the Director's statutory duty to take all necessary steps to ensure the integrity of, and public confidence in, the state lottery.

The Lottery has had the need during the past year to use monies in the prize reserve account on a number of occasions. For example, there have been numerous instances in the Gopher 5 game where the Lottery was required to pay out the minimum guaranteed prize of $100,000 and the amount set aside by game rules for the jackpot prize from the prize fund was less than that amount. This is a normal, anticipated and designed circumstance.

The Powerball (and prior Lotto America) prize reserve is mandated by the Multi-State Lottery Association. Were we not permitted to maintain such reserves, Minnesota would be forced to withdraw from the game. No such restriction appears to have been contemplated, and in fact the lack of "specific authority" for specific accounts is likely beyond the normal statutory parameters for such business enterprise operations.

On the issue of the incentive reserve, the Director of the Lottery is specifically authorized by rule and statute to establish an incentive program for retailers. Rule 7856.4030, entitled compensation (which is the chapter of Minnesota Rules pertaining to Lottery Retailers), states that "the director may establish lottery retailer incentive programs for retailers and their employees." The incentive account is charged as a commission to retailers and as such is not within the net proceeds definition. Retailer incentives are critical to the successful operation of the Lottery because they are used to encourage and reward higher sales levels achieved by retailers. To adequately fund the retailer incentive programs an amount equivalent to and measured by one percent of the prize fund for each instant game is specifically designated for retailer incentive programs. The funds so designated for retailer incentives cannot be used to pay prizes to lottery players, but must be used only as incentives for retailers. The accrual of funds permits periodic incentives to be utilized across the product line. The timing of the incentive programs is determined to afford maximum sales impact. The incentive funds are a legal obligation (payable) of the Lottery from their designation, and may not be utilized as net proceeds or for other purposes.

Finding # 2: Vehicles are assigned to some senior staff and to the security staff. Cars are not, as implied in the report, merely assigned to each member of the executive staff. Cars have been assigned based on need and used in line with state guidelines, and for that reason some executive staff members have not been assigned vehicles. For instance, security staff who have been assigned vehicles must conduct investigations, answer alarms and are an integral part of the Lottery's required strict physical, logical, and administrative security operations. All senior staff who have been assigned vehicles are on-call at all times, for a variety of operational and security reasons. These include potential system failures, intrusion to facilities, required "lock-downs" under Multi-State Lottery Association rules, drawing show failures, and more. It is also routine practice for staff to visit retail locations to review, observe, discuss, and listen to retailer issues. Many of these activities require response and travel outside normal business hours. Further, the amount of travel conducted, and the time necessitated to conduct the business related to the travel is minimized if the specific employees involved are permitted to use the vehicles to travel to the employee's residence before and after traveling to the office.

The Lottery conducts its business at thousands of locations. It is essential that such access is recognized as a normal operational requirement. We are mindful of similar situations across state government wherein vehicles have been permanently assigned to certain individuals, and we fail to see a distinction involving operations as expansive as those of the Lottery.

Finding #3: Promotional items such as t-shirts, caps, jackets, pens, etc., are routinely purchased by the Lottery for retailer incentives, special events, and for general distribution to the public. The items serve as an incentive to players and retailers, but also serve as a valuable tool for the Lottery to promote its products. The Lottery believes that all of its employees, not just the marketing staff, must promote and market the Lottery's products in order for the Lottery to be successful. Lottery employee use of promotional items such as t-shirts and jackets assist them in promoting the Lottery and its games when they are outside of the Lottery's office. For these reasons, and for the reasons stated in response to the issue last year, we believe that the items do not constitute additional compensation, but serve a valid and very valuable business purpose. The Department of Employee Relations concurs with the position of the Lottery that providing these items to employees does not constitute compensation.

Finding # 4: The Lottery is currently drafting a records retention policy in coordination with the Department of Administration.

Thank you for the opportunity to comment on your report.

Very Truly Yours,

George R. Andersen

George R. Andersen
Director