Minnesota State Lottery

Selected Scope Financial Audit
For the Three Years Ended June 30, 1997

August 1998

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Financial Audit Division
Office of the Legislative Auditor
State of Minnesota

98-45

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

Senator Deanna Wiener, Chair
Legislative Audit Commission

Members of the Legislative Audit Commission

Mr. George R. Andersen, Director
Minnesota State Lottery

We have audited selected components of the financial operations of the Minnesota State Lottery (Lottery) for the three years ended June 30, 1997, as further explained in Chapter 1. Our audit scope included: prize expense and unclaimed prize transfers, operating expenses and transfers to state agencies, and employee payroll. Therefore, we emphasize that this has not been a complete audit of all programs of the Lottery. The following Summary highlights the audit objectives and conclusions. We discuss these issues more fully in the individual chapters of this report.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we obtain an understanding of internal controls relevant to the audit. The standards also require that we design the audit to provide reasonable assurance that the Lottery complied with provisions of laws, regulations, contracts, and grants that are significant to the audit.

We were unable to audit certain fiscal year 1996 prize expense transactions of the Lottery retailer activity because electronic retailer billing information for the first six months of the fiscal year had been purged. These records are necessary to verify the propriety of the underlying transactions.

This report is intended for the information of the Legislative Audit Commission and the management of the Lottery. This restriction is not intended to limit the distribution of this report, which was released as a public document on August 14, 1998.

James R. Nobles
Legislative Auditor

Claudia J. Gudvangen, CPA
Deputy Legislative Auditor

End of Fieldwork: May 8, 1998

Report Signed On: August 7, 1998

SUMMARY

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Minnesota State Lottery

Selected Scope Financial Audit For the Three Years Ended June 30, 1997

Public Release Date: August 14, 1998 No. 98-45

Agency Background

The Minnesota State Lottery (Lottery) provides various gaming opportunities to the public, under the authority of Minn. Stat. Section 349A. The Lottery's headquarters are located in Roseville. It also has six regional offices throughout the state. George Andersen is the director of the Lottery.

Effective July 1, 1995, statutes were amended requiring the Lottery to maintain accounts within the state treasury (except for nominal accounts for day to day operating expenses). The Lottery records financial transactions on its own accounting systems. The Lottery records payroll and employee expense reimbursements on the state's accounting system. The Lottery transferred approximately $60 million in net proceeds to the beneficiary funds each fiscal year from 1995 to 1997. Additional amounts ranging from $24 to $29 million were transferred each year for taxes in lieu of sales tax, unclaimed prizes and transfers for compulsive gambling programs.

Selected Audit Areas and Conclusions

Our audit covered the three years ended June 30, 1997. The scope included prize expenses and unclaimed prizes, operating expenses, transfers to state agencies, and employee payroll. The scope of our audit was limited, however, because the Lottery could not provide detailed electronic transactions for six months of fiscal year 1996. The loss of data was due to noncompliance with the Lottery's internal computer system change control procedures.

With respect to the remaining periods in our scope, the Lottery met minimum prize payout percentages and administered unclaimed prize dollars in accordance with state statutes. Prize expenses were appropriately classified in the accounting records. The Lottery also complied with state statutes in transferring net proceeds, payments of taxes in lieu of sales tax, and funds for compulsive gambling programs to state agencies. .

The Lottery complied with statutory limits for operating and advertising expenses. These expenses were appropriately classified in the accounting records. The Lottery also administered employee payroll in compliance with bargaining unit provisions.

In its response, the Lottery agreed with the audit recommendation that it needs to ensure compliance with its system change control procedures to ensure completeness of electronic data.

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Audit Participation

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

Claudia Gudvangen, CPA	Deputy Legislative Auditor
Jim Riebe, CPA	Audit Manager
Ken Vandermeer, CPA, CFE	Audit Director
Terry Hanson	Auditor
Mike Byzewski	Auditor

Exit Conference

The issues in this report were discussed with the following staff of the Lottery on July 28, 1998:

George Andersen	Director
Dale McDonnell	Legal Counsel
Mary Ellen Hennen	Director for Administration
Lyle Mueller	Accounting Manager
Joann Townsend	Financial Planning Manager

Chapter 1. Introduction

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

The mission of the Lottery is to provide secure gaming opportunities, while offering fun and entertainment to the public within the guidelines of the Lottery statute. Beneficiaries of proceeds from the Lottery include the state's General Fund and the Environment and Natural Resources Trust Fund which respectively receive 60 percent and 40 percent of the Lottery's net proceeds.

During the audit period, the Lottery sold instant scratch tickets and operated four on-line number games: Daily-3, Gopher-5, Daily Millions, and Powerball. Table 1-1 highlights the Lottery's financial activities for each of the three fiscal years ended June 30, 1995, 1996, and 1997. An independent certified public accounting firm annually audits the financial statements prepared by the Lottery.

Table 1-1
Financial Summary
For Fiscal Years Ended June 30

	1995	1996	1997
Income:			
Ticket Sales	$335,875,077	$375,650,142	$368,516,685
Other Income	1,736,956	2,851,954	4,308,819
Total Revenue	$337,612,033	$378,502,096	$372,825,504
Expenses and Distributions:			
Prize Expense	$196,083,422	$230,848,350	$224,447,929
Compulsive Gambling Transfers to State	1,000,000	0	800,000
Unclaimed Prizes Provided to State	1,355,277	2,556,178	4,396,537
Beneficiary Distributions	59,922,592	61,171,579	59,297,797
Tax in Lieu of Sales Tax	21,831,883	24,417,263	23,953,615
Retailer Commissions/Incentives	18,235,373	19,904,003	19,044,874
Advertising	7,913,383	8,656,860	8,294,001
Promotions	3,165,246	3,368,456	4,126,501
Other Expenses	28,104,857	27,579,407	28,464,250
Total Expenses/Distributions	$337,612,033	$378,502,096	$372,825,504

Source: Minnesota State Lottery audited financial statements and supporting accounting records.

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Chapter 2. Prize Expense and Unclaimed Prizes

Chapter Conclusions

The Lottery met minimum prize payout percentages and returned unclaimed prize dollars to subsequent games as required by statute. The Lottery properly classified items as prize expense transactions in the accounting records. We could not, however, audit transactions for six months in fiscal year 1996 because detailed electronic retailer information had been purged from active system files.

The Lottery recognizes prize expense from ticket sales according to the established prize payout structure for each game. The number and amount of prizes vary by game, allowing the Lottery flexibility in having different types of games available for sale at any given time. During fiscal years 1995 to 1997, the Lottery provided 52 new games for wagering.

Minn. Stat. Section 349A.10, Subd. 2 (b) (2) (ii) provided that prizes had to be at least 60 percent of gross receipts for instant games and 45 percent of gross receipts for on-line games. The prize levels for the Daily-3 game remain constant, based on the type and amount of wager. The Gopher-5 and Powerball on-line games have minimum jackpot amounts of $100,000 and $10,000,000, respectively. The jackpots continue to grow, based on sales volume, until someone purchases a winning ticket. The low tier (non jackpot) prizes for these games include both pre-established and pari-mutuel amounts.

Players have up to one year following the date of the drawing or close of an instant game to claim a prize. Thereafter, players forfeit all rights to prizes, and the prizes become unclaimed. Prior to the 1995 legislative session, Minn. Stat. Section 349A.08, Subd. 5 required the Lottery to return all unclaimed prize money to the prize pool of subsequent games. This increased the prize payout percentage for the instant games. For on-line games, the Lottery used the unclaimed prizes to develop additional opportunities to win, like the Daily-3 bonus spin. The Lottery director determined the amount of unclaimed prize money allocated to current games when developing the prize structures.

The 1995 Legislature enacted a law change affecting unclaimed prize money. Minnesota Laws of 1995, Chapter 254, Article 1, Section 84 required the Lottery to transfer to the state 70 percent of all unclaimed prize money at the end of each fiscal year. The Lottery returns the remaining 30 percent to the prize pools of subsequent games. The General Fund receives 60 percent of all unclaimed prize money transfers from the Lottery and the Environment and Natural Resources Trust Fund receives the remaining 40 percent. The change applied to all unclaimed prize money not committed to a prize pool on June 2, 1995. Table 2-1 shows unclaimed prize financial activity of the Lottery from inception to June 30, 1997.

Table 2-1
Unclaimed Prizes
For Fiscal Years 1995-1997

Fiscal Year	Unclaimed Prizes	Returned to Games	Transferred to State	To be Added to Future Games
Prior to FY 95	$15,381,808	$11,242,938		$4,138,870
FY 95	3,360,167	(*) 1,424,057	1,355,277	580,833
FY 96	3,652,682	1,000,000	2,556,178	96,504
FY 97	6,280,767	1,500,000	4,396,537	384,230
Total	$28,675,424	$15,166,995	$8,307,992	$5,200,437

(*) This amount was assigned to new games prior to final enactment of Minnesota Laws 1995, Chapter 254A.1, Section 84.

Source: Minnesota State Lottery accounting records and supporting documentation.

Minnesota Statutes require the Lottery to transfer the net proceeds to state beneficiary funds within 30 days after month end. Net proceeds are the balance in the Lottery account after transfers to the Lottery prize account and credits to the Lottery operations account. The Lottery has withheld from these distributions the amounts used to fund two types of reserve accounts, retailer incentive and on-line reserves. The Lottery classifies the reserve accounts as liabilities and charges them to expenses as ticket sales occur. As a result, the Lottery retains these proceeds for future payouts.

We focused our review of prize expense and unclaimed prizes on the following objectives:

- Did the Lottery comply with statutory requirements for prize payout percentages and the administration of unclaimed prizes?

- Did the Lottery properly classify expenses as a prize expense?

Our audit procedures included inquiries of staff and a reconciliation of subsidiary ledgers to the Lottery's general ledger and financial statement amounts. We also verified detailed ticket sales on a limited basis to ensure the integrity of the computer system, the subsequent posting to the general ledger, and ultimate recording in the financial statements. In addition, we reviewed a sample of prize expense transactions to determine if the Lottery properly classified the transactions in the accounting system.

Our review of prize expense found that the Lottery is in compliance with Minn. Stat. Sections 349A.10, Subd. 2(b) and 349A.08, Subd. 5. The Lottery met minimum prize payout percentages and returned unclaimed prize money to subsequent games and to state beneficiary funds as specified in statute. For the items tested, we found the Lottery properly classified transactions as prize expense in the accounting records. However, we could not test the first six months of fiscal year 1996 transactions as explained in Finding 1.

1. The Lottery purged detailed electronic retailer billing transactions from the ACCLAIM system for six months in fiscal year 1996.

The Lottery could not provide an electronic copy of detailed sales and prize expense transactions for the period of July 1, 1995, to December 31, 1995, from the ACCLAIM (Andersen Consulting Comprehensive Lottery Accounting and Information Management) system. The Lottery purged the electronic files during a routine process to create a backup copy of the original transactions.

The Lottery contracts with approximately 3,300 retailers to sell instant and on-line tickets. The computer system that records the accounts receivable activity for retailer transactions is the ACCLAIM system. The ACCLAIM system records the transactions dealing with ticket issuances, returns, adjustments, claims, electronic fund transfers (billings), and other accounts receivable activity. Retailers scan transactions at the point of sale using bar code technology.

The Lottery typically maintains a backup copy of original transactions by purging data from an archive tape at established intervals. At the time of the purge for the last six months of calendar 1995, the purge process was undergoing revisions by an employee not ordinarily involved in application development. The employee did not follow the change control procedures for computerized systems established by the Lottery. Change control procedures exist to ensure that changes to computerized systems are authorized, executed, and properly recorded.

The lack of compliance with these procedures resulted in a significant loss of detailed electronic data. If required, the Lottery could have created a hard copy of the information; however, that information would have been costly to produce and would not have been conducive to efficient audit analysis Without access to the detailed transaction data, we could not attest to the accuracy of the financial activity.

Recommendation

- *The Lottery should ensure compliance with change control procedures, including testing changes outside the production environment, in order to maintain the integrity of its computerized applications.*

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Chapter 3. Operating Expenses and Transfers to State Agencies

Chapter Conclusions

The Lottery complied with statutory limits for operating and advertising expenses. The Lottery properly classified items as operating and advertising expense transactions in the accounting records for the transactions tested. The Lottery also properly transferred net proceeds, payments in lieu of sales tax, and special transfers to support compulsive gambling programs to beneficiary funds and applicable state agencies.

Minn. Stat. Section 349A.10, Subd. 3 (b) limits the Lottery's operating costs to 15 percent of gross revenue. Administrative expenses include all operating costs of the Lottery except for prize expense, tax in lieu of sales tax, and retailer commissions and incentives. Gross revenue includes ticket sales and all other income less tax in lieu of sales tax. (During the 1998 legislative session, the Lottery received approval to spend each year 25 percent of the average difference between the 15 percent limit on operating expenses and the amount actually spent on operating expenses during the previous three years.)

In addition to an overall limitation on administrative expenses, the statutes limit the amount the Lottery may spend annually on advertising. Minn. Stat. Section 349A.10, Subd. 3 (c) limits the amount the Lottery spends on contracts for the preparation, publication, and placement of advertising to 2.75 percent of gross revenues.

Minn. Stat. Section 349A.10, Subd. 5 requires the Lottery to transfer net proceeds to the state beneficiary funds within 30 days after the end of each month. The statutes define net proceeds as the balance in the Lottery account after transfers to the Lottery prize account and credits to the lottery operations account. Of the net proceeds, the Environment and Natural Resources Trust Fund receives 40 percent and the General Fund receives the remaining 60 percent.

In accordance with Minn. Stat. Section 297A.259, each month the Lottery transmits 6.5 percent of gross receipts from the sale of lottery tickets for the previous month to the Department of Revenue. These transfers are due by the 20th day after month end.

In addition to these routine transfers, Minnesota laws have required the Lottery to transfer money to the General Fund for the Department of Human Services (compulsive gambling programs) and the Department of Public Safety (gambling enforcement activities). As stated in Chapter 2, the Lottery also transfers funds to the state for unclaimed prizes.

Table 3-1 highlights the Lottery's gross revenues, operating and advertising expenses, and transfers to state funds for fiscal years 1995 to 1997.

Table 3-1
Operating Expenses
For Fiscal Years Ended June 30

	Fiscal 1995	Percent of Gross Revenue	Fiscal 1996	Percent of Gross Revenue	Fiscal 1997	Percent of Gross Revenue
Total Revenue	$337,612,033		$378,502,096		$372,825,504	
Sales Tax	(21,831,883)		(24,417,263)		(23,953,615)	
Gross Revenue	$315,780,150		$354,084,833		$348,871,889	
Advertising	7,913,383	2.51%	8,656,860	2.44%	8,294,001	2.38%
Other Admin	31,270,103		30,947,863		32,590,751	
Total Admin	$39,183,486	12.41%	$39,604,723	11.19%	$40,884,752	11.72%
Payments to Beneficiaries	$59,922,592	18.98%	$61,171,579	17.28%	$59,297,797	16.99%

Source: 1995-97 annual financial statements, statewide accounting reports, and Lottery general ledger.

We focused our review of operating expenses and transfers to beneficiary funds and state agencies on the following objectives:

- Did the Lottery comply with statutory requirements for operating and advertising expense limits?
- Did the Lottery properly classify operating and advertising expenses in the accounting records?
- Did the Lottery transfer net proceeds, payments in lieu of sales tax, and special transfers required by Minnesota Laws to beneficiary funds and state agencies according to statute?

Our audit procedures included inquiries of agency staff and verification of amounts transferred for net proceeds and payments in lieu of sales tax. We also verified the transfers to the state as required by Minnesota Laws for compulsive gambling programs. In addition, we reviewed a sample of administrative expense transactions to determine if the Lottery properly classified the transactions.

Our review of operating expenses indicated the Lottery limited administrative and advertising expense as required by statute. In addition, the Lottery properly transferred net proceeds, payments in lieu of sales tax, and other nonadministrative transfers required by Minnesota Laws. For the items tested, we found the Lottery properly classified transactions as administrative expense.

Chapter 4. Employee Payroll

Chapter Conclusion

The Lottery designed internal controls to provide reasonable assurance that it administered payroll, including salary adjustments, in compliance with bargaining unit provisions. For the items tested, payroll expenditures complied with bargaining unit provisions.

As of June 30, 1997, the Minnesota State Lottery employed approximately 130 staff at the Roseville headquarters and 70 additional staff at six regional offices located throughout the state. The total payroll costs amounted to $8,451,588 , $8,241,518 and $8,850,043 in fiscal years 1995 to 1997, respectively. The Lottery uses a positive time reporting system to record hours worked and leave requested each payperiod. Employees are responsible for keeping an accurate timesheet, and supervisors are responsible for verifying the accuracy of each employee's timesheet.

The Lottery is subject to Minn. Stat. Section 43A governing employment of state employees. Several different bargaining units represent the employees at the Lottery. The Lottery has authority to provide achievement awards and performance-based salary increases to its employees. Lottery employees also receive cost of living adjustments (COLA) as provided for in the various bargaining unit contracts. The Lottery adheres to the same guidelines as other state agencies when administering both achievement awards and cost of living adjustments.

We focused our review of employee payroll on the following objective:

- Did the Lottery design controls to provide reasonable assurance that it administered payroll, including salary adjustments, in compliance with bargaining unit provisions?

We focused our audit objectives on compliance with limits established in the various bargaining unit agreements. Specifically, the limits we reviewed addressed the number of employees eligible and the amount of funds available for salary adjustments. Our audit procedures included inquiries of agency staff and verification of supporting documentation for a sample of employee salaries.

Our review of employee payroll found that the Lottery designed controls to provide reasonable assurance that it administered payroll in compliance with bargaining unit provisions. For the items tested, payroll expenditures complied with bargaining unit provisions.

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Status of Prior Audit Issues
As of May 8, 1998

Most Recent Audit

January 17, 1996, Legislative Audit Report 95-52 focused on selected components of the Lottery's financial operations including prize expense, reserve accounts, contracts, operating expenses, and transfers to state agencies. The report contained two findings. New legislation affected one finding which recommended that the Lottery consider the impact of working capital and cash flow projections on the balance of reserve accounts. The new legislation directs the Lottery to transfer available cash to the state treasury on a weekly basis. The Lottery also implemented the remaining recommendation to rebid the on-line game services contract.

Other Audit History

The Lottery contracts with an independent public accounting firm to conduct an annual financial statement audit. The accounting firm issued an unqualified opinion on the Lottery's financial statements for the year ended June 30, 1997. The accounting firm also performs additional procedures during the financial statement audit as directed by the Lottery. In fiscal year 1997, the auditor noted several minor issues pertaining to employee expense reimbursements.

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 the Metropolitan agencies or the State Agricultural Society, the state constitutional officers, or the judicial branch.

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MINNESOTA STATE LOTTERY

Proceeds Benefit Our Natural and Economic Environments.

George R. Andersen
Director

August 4, 1998

Mr. James R. Noble
Legislative Auditor
1st Floor South
Centennial Building
St. Paul, Minnesota 55155

Dear Mr. Nobles:

We have reviewed the draft audit report on the Minnesota State Lottery for the three fiscal years ending June 30, 1997, prepared by your office, and this letter represents the Lottery's comments on that report.

As stated in the audit report, six month's of the Lottery's retailer billing information was not in a format that was easily accessible by your office. It appears that through the Lottery's routine transferring of files that data from the first half of fiscal year 1996 was deleted from electronic files. Of course, all of the financial information is available for review, although it would take considerable effort and cost to convert the data into a format that would have been easily usable by your office.

The Lottery agrees with the Legislative Auditor's recommendation that we must ensure compliance with our internal change control procedures in order to prevent the reoccurrence of this or similar events.

Your audit was thorough and professional. Thank you for the review, your insights and the opportunity to comment.

Very truly yours,

George R. Andersen
Director

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