NO. 2002-0089-3S

INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF THE MASSACHUSETTS STATE LOTTERY COMMISSION

TABLE OF CONTENTS/EXECUTIVE SUMMARY

INTRODUCTION 1

The Massachusetts State Lottery Commission (MSLC) is authorized by Chapter 10, Sections 22 through 35, of the Massachusetts General Laws to raise revenues for cities and towns by conducting various lottery games. MSLC may establish, and from time to time revise, such rules and regulations for these activities as it deems necessary or desirable.

On September 27, 1971, legislation was enacted to create a state lottery that would provide a source of revenue for the 351 cities and towns of the Commonwealth. This legislation created a State Lottery Commission (Commission), whose membership is composed of the State Treasurer, who serves as Chairman; the Secretary of Public Safety; the State Comptroller; and two members appointed by the Governor for terms coterminous with the Governor. These Commission members have the responsibility of approving rules and regulations, contracts, and overall policy decisions for MSLC.

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, we conducted an audit of certain activities of MSLC for the period, January 20, 1999 through June 30, 2002.

Our audit was conducted in accordance with applicable generally accepted government auditing standards and, accordingly, included such audit procedures and tests as we considered necessary under the circumstances.

The objectives of our audit were to determine the extent to which MSLC had taken measures to address the deficiencies that were identified in the OSA's last audit of the agency (Audit No. 99-0089-3) and assess the adequacy of controls MSLC had established relative to measuring, reporting, and monitoring its effectiveness and its compliance with applicable state and federal laws, regulations, and other pronouncements as well as its own policies and procedures.

As a result of our audit work, we found that although MSLC has taken some measures to adequately address certain issues we identified during our prior audit, it had not fully addressed other issues. We also found areas where internal controls over certain aspects of MSLC's operations still need to be improved and several instances where MSLC was not complying with certain provisions of state law, regulations and its own internal policies and procedures resulting in potentially millions in state revenues being subject to loss, theft, or misuse.

Our overall recommendations, as a result of this report, generally fall into three interrelated areas needing improvement: (1) lost revenue enhancement opportunities; (2) management controls and security; and (3) compliance with laws, rules and regulations. The MSLC could generate more revenue for the Commonwealth if it controlled ticket cashing schemes to avoid taxes, charged higher fees to cover agent non-performance, improved collections, and reduced revenue write-offs. Management controls and security need to be improved and consistent for all agents to curtail suspicious activities,

including unusual scanning, cashing, and claim patterns, and comply with the law to report all lost and stolen tickets for investigation to preclude this continuing problem. Specifically, we identified the continuing condition of individual ticket cashers cashing large amounts of lottery tickets with minimal or no state and federal taxes being withheld. To put an end to this practice, we believe that MSLC should pursue efforts to withhold appropriate taxes and that a task force be established with law enforcement and tax agencies, to both investigate any illegal activities and to develop measures deemed necessary to prevent similar occurrences in the future. In addition, due to the findings concerning suspicious ticket cashing activities, questionable controls over sales agents, and ineffective collections efforts, we believe that MSLC must bolster its internal security activities and implement stronger controls over sales agent activities. Further, MSLC should report any unusual sales or claim activity to the appropriate law enforcement authorities.

AUDIT RESULTS 6

1. ABUSE OF SYSTEM BY PROFESSIONAL GAMBLERS, CASHERS AND OTHER MULTI-PRIZE CLAIMANTS RESULTED IN FAVORABLE TAX WITHHOLDINGS VERSUS THE ORDINARY WINNER OR WAGE EARNER AND THE POTENTIAL LOSS OF MILLIONS OF DOLLARS IN FEDERAL AND STATE TAX REVENUES 6

MSLC's current tax withholding practice is to withhold state and federal taxes only when individual prizes exceed $5,000. Because prize claims are not accumulated and because each claim is treated as a separate occurrence, many so-called professional cashers, gamblers, and others are able to cash hundreds of tickets a year with minimal or no taxes being withheld. This practice creates tax withholding inequities, advantages, and loopholes that are not available to the average law-abiding wage earner. For example, one person over the period January 1999 through April 2002 claimed 679 prizes for $1,168,378 in winnings and had only $8,400 (.72%) and $1,300 (.11%) withheld in federal and state taxes, respectively. Another person over the period 1999 through 2001 claimed 543 prizes for $805,746 in winnings and had only $2,883 (.36%) and $524 or (.065%) in federal and state taxes withheld, respectively. There are many other instances of individuals who received between $200,000 and $500,000 over a 16-month or 28-month period who also had minimal or no taxes withheld. During fiscal year 2001 certain multi-casher claimants (58) had $4,759,550.25 in winnings and only $248,140 or 5.21% withheld in federal and state taxes. Further, we noted one instance in which an individual with an outstanding state tax lien of $133,417 made 104 claims totaling $167,760 over a 12-month period and had only $1,000 in state taxes withheld. The claims were not used to offset the liens.

MSLC should pursue efforts to withhold taxes similar to the ordinary wage earner on a pay-as-you-earn basis in order to close these tax loopholes and generate more revenue.

MSLC pays out approximately $2.8 billion each year in prizes, of which taxes are withheld on only approximately $400 million, leaving $2.4 billion from which no taxes are withheld by MSLC. If Massachusetts were to tax an additional $200 million per year it could generate approximately $64 million per year in additional federal and state tax revenue. This would leave $2.2 billion in prizes not subject to withholding.

2. NONCOMPLIANCE WITH STATE REGULATIONS AND INADEQUATE CONTROLS OVER THE PAYMENT OF CLAIMS AT ONE SALES AGENT LOCATION 11

MSLC is allowing one of its sales agents, Massasoit Greyhound Association, Inc., (MGA), to pay claims of up to $49,999.99 in cash or by check even though its agreement with MSLC only allows it to pay claims of up to $600, as is the case with all other sales agents. For example, during fiscal year 2001 MGA paid claims of $5,562,743, which included 1,364 claims totaling $2,473,649 over the $600 prize limitation specified in its contract. Further, contrary to state regulations (961 Code of Massachusetts Regulations 2.15), MSLC allowed this sales agent to sell Lottery tickets at another location without providing this sales agent with a formal written authorization or license to conduct this activity. This arrangement is an unfair, inequitable, and inconsistent practice in relation to other sales agents whose business interests may also be improved by having the similar ability to pay higher claims. By not entering into formal written agreements with this sales agent who authorized these activities, MSLC has not effected adequate controls over the activities of this sales agent.

3. UNUSUAL AND EXCEPTIONALLY HIGH VOLUME OF CASH CLAIMS ACTIVITY AT ONE AGENT, WHICH HAS A UNIQUE ARRANGEMENT WITH MSLC, FOSTERS POTENTIAL ABUSE AND ILLEGAL ACTIVITY 15

During our audit, we reviewed the claims process by MGA during calendar year 2001, and the following unusual pattern became apparent. MGA has the authority to pay, in cash, up to $49,999.99 for any single Massachusetts State Lottery claim or issue an MGA check at the option of the claimant. (See Audit Result No. 2.) MGA is the only retail agent statewide that has the authority to pay out up to $49,999.99 in cash or check. During calendar year 2001 MGA paid out $5,562,743 in claims. Of this amount MGA paid 1,364 in claims of over $600 totaling $2,473,649. (Approximately 90% of claims are paid out in cash.) These winning claims can include all MSLC games such as instant tickets, Keno, Daily Numbers, Mass Millions, and Megabucks. By contrast, the MSLC Braintree Headquarters and its five regional offices do not pay out cash prizes of over $25. There was no written agreement for this type of arrangement (i.e., payments of up to $49,999.99 in cash for a single transaction). However, if for example, a person has three individual claims of $40,000 each, that person could theoretically collect $120,000 in cash under this arrangement. Also, 11 individuals made 1,056 claims totaling $1,732,151, which is 31% of the total prize payout and 70% of claims over $600 at MGA. Only $51,474 or 2.9% of taxes were withheld as compared to $571,280 or 33% that ordinary taxpayers would pay. Also, these individuals would claim a number of prizes on the same day and pay no taxes. For example, one individual had 17 claims on the same day for $35,906 with

no taxes withheld. Also, two individuals who were able to cash tickets totaling $443,335 had outstanding federal and state tax liens of $143,665.

MSLC's Compliance Unit conducted reviews of claim procedures at MGA and indicated in two reports that MGA cashes claims of up to $49,999.99 for tickets for professional cashers or, as the reports refer to them, "regular" or "known" track customers or "repeat winners only." Also, a private accounting firm hired by MSLC in its October 2001 report states that "the Lottery management has not limited MGA's ability to pay out prizes in excess of the $600 limit established for other Lottery Agents, a recommendation made in our 1999 report". Additionally, the report states "our concern is heightened by the high level of prize cashing activity that takes place there, particularly at night and on weekends when Braintree oversight functions are not operating."

4. FIVE TICKETS TOTALING $5 MILLION NOT CLAIMED, FIVE TICKETS TOTALING $5 MILLION WITH UNUSUAL PATTERN OF CLAIMS IN THE MONTE CARLO GAME, AND OTHER UNUSUAL CLAIM PATTERNS INVOLVING OVER 400 CLAIMS TOTALING OVER $6.5 MILLION **22**

During our prior audit we identified many instances in which claimants were abusing the lottery system in that they were able to receive claim payments by submitting erroneous or false information. At that time, we recommended that MSLC collaborate with other agencies in order to minimize incidents of this type and ensure that claimants appropriately report their claims information on their tax returns. Although MSLC has taken some measures to address our concerns, we believe more needs to be done in this area in order to enhance the integrity of the state's lottery system. During our follow-up audit we identified instances of unusual patterns of claims. For example, one Instant Game, the five-dollar Monte Carlo Game, had a total of 40 $1 million grand prizes. We found that five (12.5%) of these grand prize tickets that have been outstanding for long periods of time and therefore have not been claimed. Also, we noted three instances of $1 million grand prizes being claimed by two sales agents and a family member who resides with one of the sales agent's corporate officers. All tickets were purchased at the respective sales agent's locations. Moreover, another two (5%) grand prize tickets were claimed at the same store by individuals having the same last name and living at the same address. Both tickets were purchased from the same lottery agent. The probability of winning $1 million in the Monte Carlo game is 1 in 1,260,000 and is much more improbable for two individuals living at the same address who purchased tickets from the same store. In another situation during 1999 and 2000, there were 26 large prizes totaling $115,000 claimed by seven individuals who lived at the same address, six of whom had the same last name as the two Monte Carlo game winners. In addition, the owner of the residence, who was one of the claimants, was the sales agent where all the tickets were purchased. Also, individuals with the same last name during 1999 and 2000 cashed 356 Instant Game tickets for $1,401,829.

We noted that there are six instant games over three years old that still have 17 (13%) of the 130 grand prizes, with a prize value of $20 million remaining unclaimed. (See Table 1.)

5. INEFFECTIVE COLLECTION EFFORTS AND NONCOMPLIANCE WITH ITS OWN DEBT-COLLECTION PROCEDURES RELATIVE TO OVER $10 MILLION IN ACCOUNTS RECEIVABLE FROM TERMINATED AND SUSPENDED SALES AGENTS 27

As of August 15, 2001 MSLC was owed over $10 million from 1,232 terminated or suspended agents (over 16.2% of the 7,600 sales agents) and $8.9 million from 1,051 sales agents that was outstanding for over 90 days. Because MSLC is not exercising due diligence and complying with its own policies and procedures relative to the collection of receivables, there is inadequate assurance that millions in receivables owed MSLC and the Commonwealth will ultimately be collected and instead will be written off as bad debt (see Audit Result No. 6). MSLC should implement timely and diligent collection practices so that the Commonwealth's cash position and revenue is maximized.

a. Inadequate Collection Efforts Relative to Millions in State Funds 28

MSLC's policies and procedures require it to disable the ticket terminals of sales agents who do not remit funds owed MSLC in the time frame established by MSLC. Further, the State Comptroller's regulations and MSLC's own internal policies and procedures require state agencies such as MSLC to make prompt and diligent efforts to collect outstanding debts, including by referring receivables that have been outstanding for periods ranging from 60 to 90 days to a debt collection agency. During our audit, we selected a sample of 88 of MSLC's accounts receivables (over $10,000 each) totaling $3,602,702 and found that 29 of these receivables totaling $1,188,296 (33%) as of December 4, 2001 had been outstanding significantly longer than 90 days. When we bought this matter to the attention of MSLC officials, they stated that the agency has subsequently submitted 15 of these 29 accounts, which represented $666,221 (56%) in receivables, for debt collection. The amount of time between the date of the last payment received by MSLC on these receivables and the date these 15 accounts were ultimately referred for debt collection by MSLC ranged from 108 days to 5 years, with the average being 2.5 years. The average number of days between the last payment received by MSLC and March 31, 2002, on the remaining 14 accounts receivables had not been referred by MSLC for debt collection was over 3 years.

b. Agency Procedures Not Followed Relative to the Collection of Revenues from Sales Agents 33

We also found many other instances in which MSLC was not exercising due diligence in collecting its receivables. For example, for six of the 15 accounts totaling $666,221 in our sample that MSLC ultimately referred for collection, agency staff did not document any collection efforts that may have been made by MSLC staff as required by MSLC's policies and procedures. However, in those instances where telephone logs were used to document collection efforts, they indicated that some sales agents

that owed MSLC hundreds of thousands of dollars had not been contacted by the agency for periods of up to five years. Also, our test revealed that a franchise corporation during fiscal year 2001 had five of its 85 stores on 13 separate occasions take an average of 73 days to pay open receivable amounts totaling $157,883 to MSLC as opposed to the five days specified in the sales agent agreements. Moreover, the five agents did not have their terminals disconnected as required by MSLC's policy. MSLC indicated that the corporation was granted a waiver for each franchise to have funds deposited by each franchise and that, in turn, the corporation would guarantee and pay the sales agents' debt.

c. Inadequate Documentation Relative to $15,000 in Accounts Receivables 37

We found one instance in which MSLC could not provide any documentation relative to a $15,000 accounts receivable. Based on our audit, we found that the company owing this amount had in fact filed for Chapter 11 bankruptcy protection during our audit period, a fact that MSLC was unaware of.

6. INSUFFICIENT SELF-INSURANCE PROGRAM FOR SALES AGENTS RESULTS IN NET LOST REVENUE OF OVER $9 MILLION OVER FOUR YEARS AS A RESULT OF BAD DEBT WRITE OFFS 38

We found that MSLC has not effectively managed the process it uses to bond its sales agents. Specifically, MSLC charges each agent an amount equal to 35 cents per day per location for each day an agent operates as a bond premium to cover the costs of any sales agents who do not meet any of the conditions contained in their sales agent agreements with MSLC. However, MSLC does not routinely assess the reasonableness of this premium to ensure that premiums collected are sufficient to cover any costs or losses incurred by MSLC as a result of non-performance by sales agents. In fact, MSLC officials could not explain how the current premium of 35 cents per day was established. The MSLC generated an average of $968,000 per year in fees over the last four years and only $941,573 in fiscal 2002. We determined that between fiscal year 1999 through 2002, MSLC wrote off $13 million in bad debt expenses that could have been covered by bond premiums had MSLC periodically reviewed and established reasonably adequate premiums. Instead, because premiums collected were inadequate (only $3.9 million over four years), the Commonwealth suffered a net loss of $9.1 million in bad debts during the last four years.

7. CONTROLS OVER MSLC'S ADMINISTRATION OF SALES AGENTS' TICKET SCANNING ACTIVITIES NEED TO BE IMPROVED 41

We found that improvements are needed with MSLC's own internal policies and procedures relative to the administration of sales agents' Instant Game ticket scanning activities. Specifically, although MSLC's policies and procedures require that MSLC terminate an agent's ability to cash tickets after the agent has committed a certain number of procedural errors, MSLC is not following this policy. We also found that MSLC has not developed adequate formal written policies and procedures on how to deal with habitual offenders who abuse the controls MSLC has established over this process. During our audit period MSLC indicated that it sent out 120

letters to sales agents who were not in compliance with MSLC policies and procedures for scanning Instant Game tickets. As a result, there is inadequate assurance that MSLC sales agents are not abusing the lottery system. Without adequate policies, procedures, and controls there is inadequate assurance that the state's lottery system will not be abused by certain sales agents or that MSLC will be able to effectively identify abusers of the system and deal with them in a consistent and equitable manner. As disclosed in our report, we found instances in which agents or members of their family or residents in the same household have won $1 million dollar prizes. The MSLC needs to review the controls over sales agents in order to maintain the public's confidence in the fairness and odds that they have a fair chance of winning.

8. IMPROVEMENTS NEEDED IN THE CONTROLS OF THE QUALITY OF INSTANT GAME TICKETS 45

During a five-month period the Deuces Are Wild, Jubilee 25, and Set for Life Instant Game tickets had a defective coating on the ticket that covers the numbers, and when the coating was rubbed off by a player the number would not appear. MSLC recalled the tickets and had new tickets reprinted, which included the appropriate prizes. The contract with the vendor that printed the tickets states that the vendor is responsible for replacing any defective tickets at no cost to MSLC. MSLC indicated that all cost associated with reprinting the tickets and delivery cost to MSLC were assumed by the vendor. However, costs associated with delivery of the new tickets to sales agents were not billed to the vendor because MSLC felt this was done by MSLC staff during their regular scheduled visit at sales agents and therefore no additional cost was incurred. Nevertheless, given the fact that during a five-month period there were three significant instances where Instant Game tickets needed to be reprinted, MSLC should reassess the adequacy of the controls it has established and contractor performance to ensure the quality of its Instant Game tickets. In addition, if similar problems are encountered in the future, MSLC should recover even its incidental, staff, administration, and overhead costs from the vendor.

9. NONCOMPLIANCE WITH STATE LAWS RELATIVE TO REPORTING SHORTAGES, LOSSES, OR THEFTS OF FUNDS OR PROPERTY TO THE OSA AND THE INCLUSION OF A STATUTORILY REQUIRED CLAUSE THAT ALLOWS THE OSA TO AUDIT THE BOOKS AND RECORDS OF ALL CONTRACTORS DOING BUSINESS WITH THE AGENCIES OF THE COMMONWEALTH 47

a. Noncompliance with the Requirements of Chapter 647 of the Acts of 1989 Regarding the Reporting of Shortages, Losses, or Thefts of Funds or Property to the OSA 48

In accordance with Chapter 647 of the Acts of 1987, an act to improve internal controls within state agencies, MSLC is required to immediately report all unaccounted-for variances, losses, shortages, or thefts of funds or property to the Office of the State Auditor (OSA). We determined that during calendar years 1999 through June 30, 2002, MSLC's records indicate that the agency had at least 2,895

incidents of lost, stolen, or misplaced Instant Game tickets in excess of $2 million that were not reported as required by this statute for the OSA to determine the cause of the conditions, make recommendations to correct the conditions found, identify the internal control policies and procedures that need modification, and report the matter to appropriate management and law enforcement officials. As a result, MSLC cannot be assured that it has adequate corrective action plans and controls in place to minimize these continuing losses.

b. OSA's Authority to Audit Contractor Books and Records Clause Not Included in Lottery Sales Agents Agreements as Required by Chapter 11, Section 12, of the General Laws **52**

According to state law, state agencies such as MSLC must include a clause in every contract or agreement awarded that provides the OSA with the right to examine the records, books, accounts, and activities of the contractors doing business with the agency. The Commonwealth's standard contract for goods and services includes this clause. We found, however, that the standard sales agent agreement that MSLC enters into with its approximately 7,600 sales agents who handle over $4 billion in revenue annually does not contain this clause. As a result, MSLC's sales agents are not being properly informed of their statutory obligation to allow the OSA to review their lottery operations and ensure contract compliance and that state funds are being properly safeguarded against loss, thefts, or misuse.

10. POTENTIAL COST SAVINGS LOST AS A RESULT OF AN INEFFICIENT CONTRACTING PRACTICE **54**

MSLC may not have utilized efficient contracting practices when it awarded its most recent contracts for the production of Instant Game lottery tickets and related marketing services. Specifically, previous contracts awarded by MSLC for these goods and services contained a "Most Favored Customer" clause that guaranteed that MSLC would get the best price available from the contractor for these items and resulted in MSLC getting reimbursements of at least $279,851 in the past. MSLC awarded its most recent contracts for printing tickets and the "Most Favored Customer" clause was not included in the contract. The Commonwealth's Operational Services Division (OSD) revised its regulations in the mid-1990s and eliminated the "Most Favored Customer" clause. However, OSD's Procurement Policies and Procedures Handbook recognizes that there are opportunities for maximizing the value of procurement through collective purchasing. Since there is a limited number of companies that produce lottery tickets and therefore limited competition, MSLC could "team" with other states to collectively purchase tickets that would result in cost savings.

11. UNALLOWABLE NON-BUSINESS-RELATED EXPENSES TOTALING $3,417 INCURRED BY MSLC EMPLOYEES WHILE REGISTERED AT A CONFERENCE **56**

During fiscal year 2001, eight members of MSLC's administrative staff registered to attend a conference in Dallas, Texas. MSLC employees who registered for this conference allegedly pursued leisure activities while they should have been attending

the conference business meetings. The Office of the State Treasurer's First Deputy Treasurer conducted an internal investigation, which resulted in certain MSLC staff members being required to reimburse the MSLC a total of $117 of the $13,345 in conference costs for what he determined were inappropriate expenses. Also, each traveler was charged one vacation day. However, we determined that these individuals under-reimbursed MSLC as much as $3,300 for the non-business-related vacation portion of the trip during which they did not attend the conference. The reimbursement should have included a portion of the airfare, conference fee, hotel, other expenses incurred and interest for time not spent at the conference. To settle this matter, the Executive Director charged each traveler, including himself, one vacation day.

12. NONCOMPLIANCE WITH CERTAIN PROVISIONS OF THE STATE'S OPEN MEETING LAW 62

Chapter 39, Section 23B, of the General Laws requires public entities such as MSLC to hold meetings which are open to the public to ensure that citizens of the Commonwealth have the opportunity to be aware of the activities that are being conducted by these agencies that are being paid for with public funds. We found that despite these statutory requirements, in at least five instances during our audit period the MSLC's Commission did not fully comply with the requirements of this statute relative to convening meetings into an executive session. Specifically, contrary to state law the Commission did not (1) maintain minutes of the matters discussed in the executive sessions of any of these five meetings, (2) state the reasons for convening into executive session in five instances or state whether MSLC would reconvene in all five sessions, and (3) take a roll call vote prior to going into executive session in one instance, and in four instances record on a roll call and enter into the minutes each member's vote to convene into executive session. As a result, the citizens of the Commonwealth cannot be assured that MSLC did not circumvent the requirements of this statute and convene into executive sessions for reasons other than those allowed by Chapter 39 and inappropriately deny the public access to agency information.

13. ACCOUNTS PAYABLE OF $2,271,847 OUTSTANDING OVER EIGHT YEARS 65

During our audit, we reviewed the telephone bills received by MSLC during fiscal years 2001 and 2002 (through March 31, 2002) and found that MSLC had an outstanding balance payable to Verizon in the amount of $2,271,847 as of March 31, 2002. According to policies established by the State Comptroller, state agencies are required to take the measures necessary to ensure that disputed bills are resolved in a timely manner. According to MSLC officials, this outstanding balance has not been resolved in over eight years. As a result of our review MSLC has worked with senior officials at Verizon, and they have agreed that $1.7 million was an overstatement. MSLC has performed a further analysis whose results indicate that it may owe Verizon approximately $350,000 or that Verizon may owe MSLC $150,000.

14. PRIOR AUDIT RESULTS UNRESOLVED OR PARTIALLY RESOLVED 68

During our follow-up audit, we determined that MSLC officials had not taken measure to adequately address issues identified during our prior audit with regard to winner identification security and internal controls, certain payroll practices, internal control procedures and system descriptions, internal controls, security, oversight and monitoring practices over sales offices, and collection of cash revenue held by sales agents.

a. Improvements Needed Regarding Winner Identification Security and Internal Controls 68

During our prior audit, we determined that MSLC did not have an adequate internal control system to properly verify names, Social Security numbers, and other pertinent data for prizewinners cashing tickets at MSLC offices. Prize claimants gave false or incomplete information to MSLC to potentially avoid state and federal tax liabilities and child support payment obligations, hide the fact that prizewinners may be receiving public assistance, or a number of other reasons. As a result, MSLC prizewinners were able to use false identification documents, names, addresses, and Social Security numbers and to file incomplete and erroneous claim forms, which resulted in numerous questionable conditions and situations that a reasonable person would believe are indicative of control and security problems that should be pursued further and eliminated, especially in an environment such as MSLC, where security and controls are critical.

In addition, we found many instances of claimants having names that appeared unusual or suspicious. Further examination revealed that many of these claimants used Social Security numbers that were not found by a commercial person identification service, had their Internal Revenue Service (IRS) Forms W2-G income information forms returned to the MSLC as undeliverable by the United States Postal Service, gave telephone numbers that were not listed, and listed nonexistent post office boxes as mailing addresses.

During our follow-up audit, we determined that MSLC had made improvement in its controls by:

- Implementing a number of controls over its claimant identification process for all claimant prizes over $600 (MSLC requires a signed photo identification, proof of Social Security number, and proof of address) and implementing policies and procedures regarding claimant identification.

- Using a commercially available people identification information service to assist in verifying claimant identification information (however, this service is only used when a claimant presents an unacceptable form of identification, does not have complete information or has conflicting information).

- Implementing a procedure that compiles a list of multiple prizewinners who have claimed 20 or more prizes totaling $20,000 or more in a calendar year and reporting this information to the IRS and Department of Revenue (DOR). Also, all claimants who redeem their winning tickets at a claim center receive a form W2-G at the time of a claim.

- Providing training to its staff regarding the implementation and compliance with MSLC policies and procedures and applicable laws, rules, and regulations regarding winner identification, security, and internal controls over these matters.

While MSLC has taken measures to improve the controls over winners identification, we determined that there are still several internal control issues and improvements needed in this area, as follows:

1. Inadequate Controls to Ensure That Sales Agents Who Owe Collectively Millions to MSLC Cannot Cash Prizes Without First Repaying Their Debt: As of the end of calendar year 2001, 1,232 current, suspended, or terminated sales agents owed MSLC a total of $10,020,517 (see Audit Result No. 5). However, MSLC has no controls in place to ensure that these delinquent agents are unable to cash winning prize tickets without first repaying their debt to the Commonwealth.

2. Inadequate Controls Relative to Ensuring Compliance with Chapter 10 of the General Laws Regarding Employees' Family Members Purchasing a Ticket or Claiming or Sharing a Prize: According to Chapter 10, Section 31, of the General Laws, no member or employee of MSLC or any spouse, child, brother, sister or parent residing in their same household can either purchase a ticket or share or claim a prize. Although MSLC requires its employees to sign a form acknowledging that they are aware of this policy, it has not established adequate controls to ensure that its staff and applicable household members are adhering to this statute.

3. Inadequate Controls to Ensure That Claimants Pay Outstanding Tax Liens: MSLC has not established controls to ensure that claimants who owe taxes to DOR and the IRS satisfy these obligations prior to being paid their claims. We selected the names of 11 individuals who had submitted multiple claims in excess of $50,000 to one of MSLC's sales agents during calendar year 2001 and found that two of these individuals were paid claims totaling $443,335 by this sales agent during this calendar year despite the fact that they had outstanding state and federal tax liens totaling $143,665 against them.

4. Inadequate Segregation of Duties Regarding Claims Processing: MSLC has not segregated the duties of those individuals who are responsible for

verifying the information provided by claimants with those processing a claim payment for a prize.

5. Controls Relative to Claimant Identification Could Be Improved: MSLC has not entered into an arrangement with the state's Registry of Motor Vehicles (RMV) for on-line access to driver's license and other identification data. Rather, MSLC stated that it only uses RMV information when it is seeking to locate current or former sales agents who have moved and owe MSLC money. Access to online information can be valuable regarding the proper identification of individuals claiming prizes.

b. Improvements Needed Regarding Certain Payroll Policies and Procedures 74

During our prior audit, we reviewed MSLC's payroll and personnel records and found that (a) certain favored employees were allowed to carry over vacation time in a manner contrary to their contract while other employees forfeited vacation days; (b) one employee took approximately four months of vacation immediately before resigning and as a result was paid for an additional six holidays, four more accrued vacation days and two skeleton days, totaling $4,569 in additional pay; and (c) there was no personnel policy and procedures manual for non-union and union employees.

During our follow-up audit, we selected a sample of 29 personnel files to review of individuals who were employed by MSLC during fiscal years 2001 and 2002. Based on our review, we determined that two of the files did not contain a required document acknowledging that neither they nor family members living in their households are allowed to claim prizes or purchase tickets on lottery games. Also, MSLC's Personnel Handbook did not include certain union contract provisions and non-union employee provisions with regard to certain vacation policies.

c. Written Internal Control Procedures and System Descriptions Need Improvement 76

Our prior audit noted that MSLC had not fully and adequately documented its internal administrative and accounting control system as required by Chapter 647 of the Acts of 1989. Chapter 647 of the Acts of 1989 defines the minimum level of quality acceptable for internal controls to be in operation throughout the various state agencies and constitutes the criteria against which such internal controls will be evaluated. We determined that inadequate internal controls continued to exist. Specifically, MSLC's internal control plan lacked required critical elements, such as the identification and clear communication of all operating cycles; identification of duties and responsibilities of staff and management at key internal control points; identification of management directives, policies, and procedures; description of continuous supervision; identification of individuals who have access to records; full documentation; and practices consistent with the documented plan.

Our prior audit recommended that MSLC continue to strengthen and improve its internal control system by implementing additional policy plans, practices, and

enhanced control and security procedures listed above to provide an appropriate environment of adequate safeguards in compliance with statutes including Chapter 647 and the State Comptroller's prescribed guidelines and the mission, roles, and responsibilities of MSLC.

During our follow-up audit, we found that MSLC has developed and implemented written policies and procedures relative to most of its operations and improved its security procedures. However, as detailed throughout this report, internal controls in certain areas still need to be improved.

d. Improvements Needed to Internal Controls, Security, Oversight, and Monitoring Practices over MSLC's Sales Offices Revenue Collection and Processing **77**

Our prior audit disclosed that MSLC reported a theft of sales revenue of $597 in accordance with Chapter 647 of the Acts of 1989. The theft occurred because an employee was allowed to have control over cash receipts in MSLC's Braintree Headquarters without proper monitoring and checks and balances in place to prevent the likelihood of thefts and shortages. Moreover, a subsequent review revealed that there were numerous other variances exceeding $129,000 at the Braintree office between the daily transaction sheets, primary deposit slips, and the actual deposits prepared by MSLC employees and made at the Braintree office. Because MSLC did not institute proper control and security, it remained vulnerable and experienced another theft of $24,061 in Boston.

Our prior audit recommended that MSLC management should refer to Chapter 647 to clearly and fully understand their statutory responsibilities and implement all requirements of the law as well as the State Comptroller's guidelines to establish and effectuate all critical revenue control objectives and activities in order to establish internal control procedures and practices that would provide for appropriate controls over the total flow of cash.

During our follow-up audit, we found that MSLC had taken measures to implement most of our recommendations made during our prior audit; however, certain issues still exist. Specifically, (1) MSLC has not taken measures to ensure that there is adequate segregation of duties and responsibilities to ensure checks and balances in its regional offices, including the Boston Game Room, (2) deposit logs for the Boston Game Room should be faxed on a daily basis rather than monthly in order to improve controls over deposits, and (3) MSLC has not developed written policies and procedures that require two signatures on handwritten checks from its Prize Account.

e. Procedures for the Collection of Cash Revenues Held By MSLC Sales Agents Need Further Strengthening **82**

MSLC has taken correction action and implemented most of our prior audit recommendations. Specifically, MSLC established a dedicated sales agent account for lottery revenue, deposits are made on a more timely basis, sales agents or regional supervisors visit all defaulted sales agents within one working day of notification that

funds cannot be swept, controls are in place to prohibit agents from selling tickets after authority has been revoked, inventory ticket procedures have been developed including on line weekly inventory, full payment of amounts owed by sales agents is required before reinstatement, a central sales agent file has been established, personnel have been trained on the importance of proper controls and security, agents notify MSLC when there is a change in ownership, and fines are imposed regarding the shut-down of terminals and revocation of licenses. MSLC indicated that it could not revise the settlement process to allow the MSLC's central bank to sweep all sales agents bank accounts for partial and full payment of amounts because of bank regulations requiring a specific dollar amount to be swept in order to process the transaction. Also, MSLC did not shorten the number of days between sweeps based on its study and determined that by reducing the collection period it would increase the number of rejected transfers, which would increase MSLC's costs of operation. Furthermore, MSLC did not discontinue the policy that allows sales agents to take commissions prior to depositing funds because of their accounting system. During our audit we contacted officials from New Hampshire who indicated that the New Hampshire state lottery uses a similar system as Massachusetts to collect revenues from its sales agents, except that New Hampshire charges a fine of $25 or 5% of the amount due from the sales agent, whichever is greater, for any agent who does not have the specified amount in their account to be swept. Although MSLC levies a fine of $75 to some of its sales agents who are delinquent and have had their terminals shut off, it should consider instituting stricter penalties such as New Hampshire does when agents are delinquent in remitting revenues owned to MSLC. Such a measure should serve as a deterrent for sales agents to not remit funds owed in a timely manner and could generate additional revenues for the Commonwealth.

15. PRIOR AUDIT RESULTS RESOLVED – IMPROVEMENTS MADE TO THE MANAGEMENT OF INSTANT GAME TICKETS **87**

During our prior audit, we found that book numbers for over 29,000 winning Instant Game tickets with a value of $600 or greater were not listed, and therefore the winning tickets could not be traced to the authorized agent who sold the ticket or the book from which it came. This represented 76% of the winning Instant Game tickets cashed during 1998. We also determined that there were inadequate inventory controls over unsold portions of books returned to MSLC (i.e., live activated tickets). We observed partial and full ticket books being returned to MSLC in plastic grocery bags or simply wrapped with elastic bands. Also, we observed that these tickets were processed in unsecured areas. Since these tickets have been activated, they could be submitted for a cash prize without detection.

During our follow up audit, we found that MSLC had taken measures to adequately address the management of millions of dollars of Instant Game tickets. MSLC has taken corrective action where it has (a) developed inventory controls, including surprise counts of sales agent tickets through all points of the ticket cycle; (b) developed written policies and procedures for the Instant Game life cycle and

communicated the policies of MSLC staff; (c) tracked and analyzed sales patterns to identify potential issues; (d) developed policies and procedures to ensure that Instant Game tickets are controlled, placed with a secure area, and deactivated; and (e) improved controls and security operations by developing tests for its system.

APPENDIX I 93

Chapter 647, Acts of 1989, An Act Relative to Improving the Internal Controls within State Agencies

APPENDIX II 96

Chapter 647 Awareness Letter from the State Auditor and the State Comptroller

EXHIBIT 1 98

Analysis of Claims/Tax Withholdings for Certain Top Claimants for Calendar Year 2001

EXHIBIT 2 101

Significant Prizes Not Claimed

EXHIBIT 3 103

Comparison of Lottery Sales to Local Aid Disbursements and to Per Capita Income

EXHIBIT 4 104

Selected Instant Game Odds and Large Prize Winners Per Game

INTRODUCTION

Background

The Massachusetts State Lottery Commission (MSLC) is authorized by Chapter 10, Sections 22 through 35, of the Massachusetts General Laws to raise revenues for cities and towns by conducting various lottery games. MSLC may establish, and from time to time revise, such rules and regulations for these activities, as it deems necessary or desirable.

On September 27, 1971, legislation was enacted to create a state lottery that would provide a source of revenue for the 351 cities and towns of the Commonwealth. This legislation created a State Lottery Commission (Commission), whose membership is composed of the State Treasurer and Receiver General (Treasurer), who serves as Chairman; the Secretary of the Executive Office of Public Safety; the State Comptroller; and two members appointed by the Governor for terms coterminous with the Governor. These Commission members have the responsibility of approving rules and regulations, contracts, and overall policy decisions for MSLC. Specifically, Chapter 10, Section 24, of the General Laws states that MSLC shall have the following powers and duties:

> *The commission is hereby authorized to conduct a state lottery and shall determine the types of lottery or lotteries . . . and such other matters necessary or desirable for the efficient and economical operation and administration of the lottery and for the convenience of the purchasers of tickets or shares and the holders of winning tickets or shares . . . . The commission shall advise and make recommendations to the director regarding the operation and administration of the lottery. The commission shall report monthly to the governor, the attorney general and the general court, the total lottery revenues, prize disbursements and other expenses for the preceding month, and shall make an annual report to the same which shall include a full and complete statement of lottery revenues, prize disbursements and other expenses, including such recommendations as it may deem necessary or advisable . . . .*
>
> *The commission is authorized to carry on a continuous study and investigation of said lottery throughout the commonwealth in order . . . to ascertain any defects in the state lottery law or in the rules and regulations issued there under whereby any abuse in the administration and operation of the lottery or any evasion of said law or said rules and regulations may arise or be practiced . . . .*
>
> *The commission shall make a continuous study and investigation of the operation and administration of similar laws in other states or countries, of any literature on the subject which from time to time may be published or available of any federal laws which may affect the operation of the lottery, and of the reaction of citizens of the commonwealth to existing*

> *and potential features of the lottery with a view to recommending or effecting changes that will tend to better serve and implement the purposes of the state lottery law.*
>
> *The commission shall have the power to issue subpoenas to compel the attendance of witnesses and the production of documents, papers, books, records and other evidence before it in any matter over which it has jurisdiction, control or supervision. The commission shall have the power to administer oaths and affirmations to persons whose testimony is required.*

The Executive Director is appointed by the Treasurer, subject to the approval of the Governor, and is responsible for the day-to-day operation of MSLC. The following highlights specific powers and duties of the Executive Director as authorized by Chapter 10, Section 26, of the General Laws:

> *He shall act as secretary and executive officer of the commission and shall license agents to sell lottery tickets such persons as in his opinion will best serve the public convenience and promote the sale of tickets or shares, provided, however, that no person shall be assigned more than one license to sell lottery tickets or shares . . . .The director shall confer regularly as necessary or desirable and not less than once every month with the commission on the operation and administration of the lottery, shall make available for inspection by the commission, upon request, all books, records, files, and other information and documents of the commission, shall advise the commission and recommend such matters as he deems necessary and advisable to improve the operation and administration of the lottery. He shall suspend or revoke any license for violation of the state lottery law or of the rules and regulations made there under. He shall, subject to the approval of the commission and the applicable laws relating to public contracts, enter into contracts for the operation of the lottery, or any part thereof, and into contracts for the promotion of the lottery. No contract awarded or entered into by the director shall be assigned by the holder thereof except with the specific approval of the commission. He shall certify monthly to the state treasurer and the commission a full and complete statement of lottery revenues, prize disbursements and other expenses for the preceding month.*

The administrative office of MSLC is located at 60 Columbian Street, Braintree, Massachusetts. MSLC also has five regional offices, which are located in Fairhaven, West Springfield, Woburn, Worcester, and Boston. In addition, there is a Canton warehouse facility that houses Instant Game tickets and other supplies, and a computer facility in Norwell. MSLC has the authority to collect revenues incidental to running various games. It also has the authority to disburse prizes, pay commissions to agents, and to cover certain expenses. Operating expenses, such as salaries and administrative expenses, must be appropriated by the state Legislature. In addition, MSLC's Charitable Gaming Division may grant "beano" licenses to fraternal, religious, veterans, nonprofit, and charitable organizations. The division may also license beano organizations to sell charitable gaming tickets in conjunction with the game of beano.

MSLC's game revenue increased from $3.2 billion in fiscal year 1998 to in excess of $4.1 billion for fiscal year 2002, as indicated in the table below:

Massachusetts State Lottery Commission

Summary of Game Revenue by Source

Fiscal Years 1998 through 2002 (through June 30, 2002)

(000 omitted)

Revenue	Fiscal Year				
Category:	1998	1999	2000	2001	2002*
Raffle and Bazaar	$1,039,375	$988,616	$926,180	$887,433	$840,520
Beano	5,972,602	5,478,699	5,267,690	5,035,102	4,870301
Instant Game*	2,085,354,493	2,160,633,561	2,472,922,268	2,728,538,920	2,869,948,916
Big Game	55,232,867	96,040,748	110,505,464	69,501,612	112,153,522
Pull Tabs	3,341,585	3,909,867	3,562,969	3,117,275	2,738,111
Numbers	385,018,243	377,983,128	376,952,530	374,332,188	367,104,757
Mass Cash	59,758,395	53,687,421	50,709,711	48,227,563	46,178,991
Charitable Game/Collections	0	0	8,527,903	37,032,623	48,017
Keno	470,212,983	538,345,774	572,442,382	593,252,266	626,635,701
Megabucks	74,752,320	64,646,312	55,315,219	54,341,651	48,190,136
Mass Millions	65,694,294	63,539,018	52,874,115	44,591,102	40,899,183
Total Revenue	$3,206,377,157	$3,365,253,144	$3,710,006,431	$3,958,857,735	$4,119,608,155

*This information was extracted from the Massachusetts Management Accounting and Reporting System as of July 9, 2002.

Lottery sales are generated by approximately 7,600 sales agents located throughout the Commonwealth. According to MSLC sales records, 39% of annual sales, $1.6 billion, are generated by 20 municipalities, as listed in Exhibit 3. This data indicates that sales are generated from the most populated, urban areas, some of which are also main employment centers. The Exhibit also includes the latest available per capita income for these municipalities and also local aid distributions.

Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, of the General Laws, the Office of the State Auditor (OSA) conducted an audit of MSLC. The scope of our audit was to examine various activities of MSLC during the period January 20, 1999 (the last day covered by our prior audit) through June 30, 2002.

Our audit was conducted in accordance with applicable generally accepted government auditing standards and, accordingly, included such audit procedures and tests as we considered necessary under the circumstances.

The objectives of our audit were to:

- Determine the extent to which MSLC had taken measures to address the issues that were identified in the OSA's last audit of the agency (Audit No. 99-0089-3).
- Conduct an assessment of the adequacy of controls MSLC had established relative to measuring, reporting, and monitoring its effectiveness and its compliance with applicable state and federal laws, regulations, and other pronouncements as well as its own policies and procedures.

In order to achieve these objectives we reviewed applicable state and federal laws, rules, and regulations as well as MSLC's own internal policies and procedures; interviewed selected MSLC personnel; tested and reviewed MSLC accounting records and transactions; and analyzed various administrative, personnel, budgetary and other agency documents, including sales agent and consultant contracts, various MSLC reports and tax records, and the minutes of the meetings of the Commission. In addition, we conducted various analysis of claims information being maintained by MSLC using a commercially available service. The purpose of our testing in this area was to obtain, on a test basis, an idea of the accuracy of the information being provided by claimants to MSLC and to identify any unusual patterns or instances involving claims, which we believe, warrant further investigation.

In order to provide audit results and information in a timely manner and to afford the MSLC the opportunity to initiate corrective action, during the conduct of our audit fieldwork we regularly discussed in full detail issues that came to our attention, with appropriate MSLC officials

including the agency's Chief Financial Officer, Chief Operating Officer, Director of Revenue, Chief Legal Counsel, and others to obtain their views and responses. Additionally, on August 15, 2002 we had a conference with the MSLC's Executive Director, Chief Financial Officer, Chief Operating Officer, and Director of Revenue to discuss the results of our audit. The information and comments provided by these officials were considered and incorporated into our report, where appropriate.

The recommendations in this report are made to assist MSLC in developing and implementing its internal control structure and financial and administrative operations to ensure they are adequate to minimize the occurrence of errors, mistakes, or illegal acts and that the agency is operating in an economical, efficient, and effective manner in which assets and revenues are maximized and safeguarded and in compliance with all applicable rules, regulations, and laws.

AUDIT RESULTS

1. ABUSE OF SYSTEM BY PROFESSIONAL GAMBLERS, CASHERS, AND OTHER MULTI-PRIZE CLAIMANTS RESULTED IN FAVORABLE TAX WITHHOLDINGS VERSUS THE ORDINARY WINNER OR WAGE EARNER AND THE POTENTIAL LOSS OF MILLIONS OF DOLLARS IN FEDERAL AND STATE TAX REVENUES

The Massachusetts State Lottery Commission's (MSLC) current tax withholding practice is to withhold state and federal taxes only when individual prizes exceed $5,000. Prize claims are not accumulated, because each claim is treated as a separate occurrence, so that many professional cashers, possible money launderers, gamblers, and others are able to cash hundreds of tickets a year with no or minimal and inequitable taxes being withheld. This practice creates tax withholding inequities, advantages, and loopholes that are not available to the average lottery player or wage earner. For example, one person from January 1999 through April 2002 claimed 679 prizes for $1,168,378 in winnings and had only $8,400 (.72%) and $1,300 (.11%) withheld in federal and state taxes, respectively, instead of $327,146 (28%) and $58,419 (5%), respectively for an ordinary wage earner. Another person from calendar year 1999 through 2001 claimed 543 prizes for $805,746 in winnings and had only $2,883 (.36%) and $524 (.065%) in federal and state taxes withheld, respectively instead of $224,769 (28%) and $41,373 (5%), respectively. There are many other instances of "multi-winning" individuals who received between $200,000 and $500,000 over a 16-month or 28-month period that also had minimal or no taxes withheld. The following are four other examples of individuals who received significant prize claims but had minimal or no taxes withheld:

Initials of the Individual	Number of Claims	Period (months)	Gross Winnings	Federal Tax Withheld	State Tax Withheld
DM	321	24	$520,650	$8,375	$1,500
RG	248	16	$500,416	$7,778	$1,373
GG	204	16	$401,962	$15,037	$2,653
MG	173	16	$200,314	0	0

Exhibit 1 lists the large multi-claimant information for calendar year 2001 provided by MSLC.

In addition to the individuals above, other individuals had many claims at one time on the same day without any taxes being withheld. For example:

- 20 Numbers Game claims for $67,040 on March 14, 2002.
- 17 Numbers Game claims for $35,906 on January 13, 2001.
- 6 Numbers Game, Keno, or Instant Game claims for $21,276 on March 29, 2002.
- 5 Numbers Game claims for $20,845 on March 28, 2002.
- 11 Numbers Game or Instant Game claims for $36,498.50 on March 28, 2002.
- 8 Numbers Game or Instant Game claims for $8,239 on March 25, 2002.
- 33 Numbers Game claims at one time on the same day on March 19, 2002 for $84,942.

In all of these instances, claims were paid with separate checks and W-2G Income Reporting Forms were issued with no federal or state taxes withheld. In the last case, 33 separate checks and 33 separate W2-G's were issued for $2,574 each, totaling $84,942, on March 19, 2002.

Some other examples of large one-day claims at the same time without taxes being withheld are as follows:

- On February 5, 2001, 19 Keno Claims at $5,000 each, totaling $95,000.
- On July 24, 2001, 20 Numbers Game claims at $3,606 each, totaling $72,120.
- On October 9, 2001, 40 Numbers Game claims at $1,071.50 each, totaling $42,860.
- On December 12, 2001, 20 Numbers Game claims at $1,734.50 each, totaling $34,690.
- On March 28, 2002, 140 Numbers Game claims at $318.50 each, for a total of $44,590.

All of the above claimants received separate checks and, except for the March 28, 2002 payment, separate W2-G's.

Not only does this practice create an unnecessary additional administrative expense and burden, but it is also more prone to error, since thousands of additional unnecessary checks and W2-G's are printed, which burdens and frustrates the tax collection agencies with extra duplicate data and increases the potential that the names, addresses, and Social Security numbers may be erroneously recorded. MSLC officials stated that the current system is designed to operate transaction by transaction and not to aggregate winning tickets cashed at the same time. We were also told that the printing of separate checks and W2-G's is a function of the computer system design. Interestingly, the unfairness of this is demonstrated by the example of one individual who claimed a prize of $5,047 on the Numbers Game on December 29, 2001 and had $1,640.27 withheld in state and federal taxes. This inequity is further demonstrated by those lucky million dollar winners, who will collect $50,000 per year, and from whom the standard, automatic 28% ($14,000) in federal taxes and 5% ($2,500) in state tax is withheld each year.

Although MSLC officials believe the current practice is consistent with tax guidelines, tax officials stated that when individuals cash multiple tickets for prizes won on the same date, those claims should be aggregated and taxes withheld. Moreover, they indicated that there is no prohibition on withholding taxes when claims are less then $5,000. Tax officials also stated that the key to withholdings is in IRS regulations and the instructions for Form W2-G. These officials stated that box "4" of IRS Form W2-G must indicate the date on which the prize was won. For games like Megabucks and the Numbers Game, this would not be the date when the tickets were cashed, but when the actual drawing was held and the ticket holder became a winner. IRS officials stated that the intent of IRS regulations is that all lottery prizes that are won on the same date and were cashed at the same time by the same individual should be aggregated on one Form W2-G and, according to the W2-G instructions, appropriate taxes should be withheld. This is not being done now under the current MSLC practices. MSLC's Director of Revenue stated that MSLC in all cases simply puts the date the prize was claimed as the date won instead of the date the prize was actually won. In our opinion, this is not fair and equitable to the ordinary, everyday, player of lottery games or wage earner who has taxes withheld, and is not the intent of our tax system. This

practice favors and protects questionable, suspicious multicashers and punishes the honest winners/taxpayers.

As is evident, this practice is grossly unfair as compared to the ordinary player who, for example, wins and has taxes withheld instead of finding a way to circumvent the system. The ordinary wage earner, such as a waiter or bartender, is subject to tax withholdings, estimated tax payments, and interest and penalties for under-withholding. As a result, the current system has only back-end controls, when it does not need to, as compared to the ordinary taxpayer, because the government has to chase these individuals to collect taxes in a "catch me if you can" system. The ordinary person pays on an ongoing accumulating basis and settles up once a year to either receive a refund or pay the balance of what is owed in a "pay as you earn" system. This proactive control becomes even more significant when claimant information is incorrect as indicated elsewhere in this report when IRS Form W2-G's produced by the MSLC are erroneous thus providing even less assurance that claimants properly report income and pay the proper amount of taxes associated with these claims.

We believe that in order to have a more equitable system, MSLC should aggregate and accumulate claimant information so that when an individual claimant reaches the taxable threshold amount, it begins to withhold taxes on a continuing, ongoing basis. To ensure proper reporting even financial institutions are required to issue Form 1099's for interest and dividends for as little as $10. The MSLC has the ability to accumulate claims as demonstrated in the cases described in this audit report, even though it does not withhold taxes or issue Form W2-G's. MSLC also provides space on the back of all tickets for claimant identification information, (i.e., name, address, phone number). Such a measure would ensure that claimants pay the appropriate amount of state and federal income taxes, provide the Commonwealth and the federal government with appropriate tax revenue, reduce government operating costs, and be fair to all the other law abiding taxpayers.

Further, we noted one particular instance where a multiple winner had minimal withholdings and found that the individual had an outstanding state tax lien of $133,417 made 104 claims totaling $167,760 over a 12-month period during 2001, had only $1,000 in state taxes

withheld, and the winning claims were not used to satisfy the lien. If he were a "deadbeat" parent, this lien would have been satisfied automatically by withholding, intercepting, and transferring this amount to the Massachusetts Department of Revenue for proper distribution.

Exhibit 1 shows that for 2001, certain top 58 claimants received a total of $4,759,550, and MSLC withheld only $248,140 (5.2%) in federal and state taxes, as opposed to $1,570,652 (33%) that would ordinarily be withheld from any other ordinary wage earner. The negative effect of this favorable tax treatment on federal and state tax revenues is over $5.3 million for calendar years 1999 through 2002. If all lotteries across the country operate similarly, then the loss to the federal government would be approximately $45 million, since Massachusetts lottery sales is approximately one-tenth of all lotteries across the nation.

Currently, MSLC pays out approximately $2.8 billion annually in prizes, of which taxes are withheld on only approximately $400 million, leaving $2.4 billion on which no taxes are withheld by MSLC. Taken on a national level, approximately $24 billion in prizes is not subject to tax withholding.

If Massachusetts were to tax only an additional $200 million per year it could generate approximately $64 million a year in additional federal and state tax revenue, ($54 million federal and $10 million state). This of course would still leave $2.2 billion in prizes not subject to withholding. Again on a national level, the federal government would yield approximately $540 million in tax revenue.

Further, some of these individuals, some of whom are disclosed further in Audit Result No. 1, may be considered as operating a business as professional gamblers or cashers on an ongoing basis and thus would be subject to the applicable federal self-employment/Social Security tax of 15.3%.

MSLC officials indicated that they would seek an opinion from the IRS regarding aggregating claims on the date won and withholding taxes based on the aggregate amount. Also, MSLC officials indicated that, if the IRS ruling requires aggregating claims and

withholding taxes on the aggregated amount, it would make the appropriate changes to its computer system to accommodate the ruling. They did not address the possibility of withholding taxes for claims less than $5,000.

Recommendation

MSLC should take the initiative to establish policies and procedures to issue W2-G forms and to withhold a reasonable amount of taxes on an accumulating basis in an equitable manner that is fair to all the taxpayers and citizens of the Commonwealth.

Should there be any dispute or question regarding the ability to withhold federal and state taxes, MSLC should take a leadership role working with its National Association of State Lotteries and Massachusetts state and federal legislators to sponsor changes in federal and state tax withholding practices that would result in a fair amount being withheld from lottery winnings. The purpose of lotteries is to generate income for cities, towns, various state and local special projects or programs throughout the country and generate additional tax revenues. Closing these loopholes that foster tax evasion and avoidance will generate much-needed revenues and eliminate or significantly curtail any fraudulent activities, such as money laundering, cashing schemes, fraud, identity theft, and concealment.

2. NONCOMPLIANCE WITH STATE REGULATIONS AND INADEQUATE CONTROLS OVER THE PAYMENT OF CLAIMS AT ONE SALES AGENT LOCATION

MSLC is allowing one of its sales agents to pay claims of up to $49,999.99 in cash or by check, even though its agreement with MSLC only allows it to pay claims of up to $600, as is the case with all other sales agents. Further, contrary to state regulations (961 Code of Massachusetts Regulation 2.15), MSLC allowed this sales agent to sell lottery tickets at another location without providing this sales agent with a formal written authorization or license to conduct this activity. By not entering into formal written agreements with this sales agent, MSLC has not effected adequate internal controls over the activities of this sales agent and has unnecessarily exposed itself and the Commonwealth to potential risks. Additionally, this arrangement is an unfair, inequitable, and inconsistent practice in relation

to other sales agents whose business interests may be improved by having a similar ability to pay higher claims.

The MSLC has entered into contracts, entitled Lottery Sales Agent Agreements, with approximately 7,600 sales agents. These contracts establish, among other things, the duties and responsibilities of both MSLC and the sales agent under the agreement, rates of compensation, and the assumption of liabilities. During our audit, we reviewed a sample of 75 Lottery Sales Agent Agreements that were in effect during fiscal year 2002. Based on our review, in addition to the problem noted with these agreements discussed in Audit Result No. 9, we identified several concerns relative to the sales agent agreement that MSLC entered into with the Massasoit Greyhound Association Inc., (MGA), as follows:

1. The fully executed Lottery Sales Agent Agreement with MGA that was in effect during our audit period only authorized MGA to cash winning tickets for amounts of less than $600. According to MSLC officials, there are no other written agreements with MGA other than this sales agent agreement. However, we found that during calendar years 2000, 2001, and 2002, MSLC allowed MGA to exceed the authority granted to it under this agreement and cash winning prize tickets of up to $49,999.99. For example, during calendar year 2001, MGA cashed a total of 1,364 claims totaling $2,473,649 over the $600 prize limitation specified in its contract. By allowing MGA to exceed the authority granted to it under this agreement, MSLC is unnecessarily exposing itself to potential legal actions and/or liability claims or other potential problems and issues that may result. For example, MSLC's standard Lottery Sales Agent Agreement provides for sales agents, including MGA, to be compensated at a rate of 1% of the value of all prizes that are paid by the agent regardless of where the winning tickets were purchased. Since sales agents can only cash prizes of up to $600 this commission is limited to a maximum of $6 per claim. During our audit, we determined that MSLC was paying commissions to MGA in this amount for tickets it cashed up to $600 but was not paying this commission on claim amounts higher than this. However, because MGA is being allowed to cash prizes up to $49,999.99 it could decide to seek additional compensation from MSLC for the 1% of the claims it cashes over $600. Further, allowing MGA to operate in this manner is not in compliance with Section 15 of MSLC's standard Lottery Sales Agent Agreement, which states:

   This Agreement constitutes the entire agreement between the Principal and the Agent and there are no promises, terms,

conditions, or obligations other than those contained herein. This Agreement supersedes all prior contracts, understandings, communications, representations, or agreements, either oral written, between the Principal and the Agent. No modification of this Agreement shall be binding upon the Principal until such modifications shall have been approved by the Principal in writing.

2. Allowing MGA to provide services not formally agreed to in a written contract could be perceived as being discriminatory in nature. Specifically, although MSLC has the authority to allow racetracks to function as MSLC regional offices and pay claims of up to $49,999.99, MSLC has not established a formal written process that allows interested sales agents to obtain this authority. During calendar year 2002, four racetracks, including MGA, were also licensed sales agents of MSLC. However, none of the other 7,600 sales agents, including the other racetracks, have this authority. Also, MSLC's unique arrangement with MGA could provide MGA with the opportunity to generate more MSLC sales commissions than other racetracks. Specifically, although MSLC only pays commissions to MGA in the same manner as it does all other sales agents, more claimants may decide to cash winning prize tickets at MGA since it is the only sales agent that can cash claims in excess of $600. During our audit, we analyzed the amount of commissions paid by MSLC to each of the racetracks within the Commonwealth who are also MSLC sales agents during calendar year 2001. The results of our analysis are detailed below:

Summary of Commissions Paid to MSLC Sales Agent Racetracks

Calendar Year 2001

Race Track	Type of Races	MSLC Commissions
(MGA) Raynham	Greyhounds	$512,257
Wonderland	Greyhounds	$153,357
Suffolk Downs	Thoroughbred Horses	$128,027
Plainridge	Harness Racing	$49,667

As can be seen from the table above, during calendar year 2001, MGA received significantly higher commissions than other racetrack agents and in particular the other greyhound racetrack. MSLC officials stated that in order to equitably compare commissions between racetracks, one must consider the number of days a racetrack operates. However, based on our analysis, we found that both greyhound tracks operate approximately the same amount of days. The other greyhound track operates 363 days per year while MGA similarly operates 365 days per year but also runs evening races (142 during calendar year 2001). While we recognize that there may

be other contributing factors to the amount of MSLC commissions that these tracks receive, this unique arrangement can be one of the factors that allows MGA to generate significantly higher commission revenues from MSLC.

3. Based on documentation we reviewed, during fiscal years 2001 and 2002, MSLC allowed the sale of lottery numbers game tickets at the Brockton Fair. MSLC officials stated that MGA and the Brockton Agricultural Society, the company that operates the Brockton Fair, were related parties (having a common Board of Directors) and as such, the tickets sold at the Brockton Fair were done so under the authority granted to MGA by MSLC in its sales agent agreement. The 961 CMR 2.15 prohibits sales agents from selling lottery tickets at other locations unless MSLC's Director specifically authorizes this sale:

   (5) The sale of lottery tickets may be made only pursuant to a Sales Agent's license, and, except as provided in 961 CMR 2.15(6), in the specified locations listed therein. Any violation of this provision is subject to the penalties provided by law, the General Laws of the Commonwealth of Massachusetts, and any pertinent Federal Laws as the facts and 961 CMR 2.00 may warrant.

   (6) The Director may permit any Sales Agent to sell Lottery tickets or shares in locations other than those specified in his/her license and:

   (a) The Director shall specify the geographical area in which such sales may be made, and the types of locations in which such sales may be made . . . .

   (c) Any person making such sales shall be individually approved by the Director or his/her designee, and shall prominently wear and display identification in such form and manner as may be prescribed by the Director.

   However, MSLC officials were unable to provide us documentation to substantiate that it had formally authorized in writing the sale of Instant Game tickets at the Brockton Fair. On March 26, 2002 MSLC's Manager of Licensing sent a memorandum to MSLC's Director of Revenue which stated:

   After a careful review of all the 2001 Brockton Fair documents, I have concluded that the permission to allow [MGA] to be issued an off-site license was done so verbally by the Chief Operating Officer.

Regarding this matter, MSLC officials stated that they would examine these issues and consider taking measures to address them.

Recommendation

In order to address this matter, we recommend that MSLC take the following measures:

- Develop a formal written process consistent with its established policies and procedures that are not discriminatory and would allow all other organizations to apply for the authority to effectively function as an MSLC regional office with authority to redeem claims for higher limits.

- If MSLC wants MGA to continue to be able to redeem claims from $600 to $49,999.99, it should amend its contract with this sales agent to formally and legally grant this authority.

- If MSLC wants to allow sales agents to sell game tickets at locations other than their legal place of business, it should adhere to its own policies and procedures and make sure such authority is communicated in writing.

3. UNUSUAL AND EXCEPTIONALLY HIGH VOLUME OF CASH CLAIMS ACTIVITY AT ONE AGENT, WHICH HAS A UNIQUE ARRANGEMENT WITH MSLC, FOSTERS POTENTIAL ABUSE AND ILLEGAL ACTIVITY

During our audit, we reviewed the claims paid by MGA during the calendar year 2001, and the following unusual pattern became apparent. MGA has the authority to pay, in cash, up to $49,999.99 for any single Massachusetts State Lottery claim, or may issue an MGA check at the option of the claimant (See Audit Result No. 2). MGA is the only retail agent statewide that has the authority to pay out $49,999.99 in cash or check. These winning claims can include all MSLC games such as instant tickets, Keno, Daily Numbers, MassMillions, and Megabucks. The MSLC Braintree Headquarters and its five Regional Offices do not pay out cash over $25 and no other agent can pay out claims in excess of $600. We found no written agreement on file at either MSLC or MGA for this type of cash payout arrangement (i.e., payments of up to $49,999.99 in cash for a single transaction). However, if for example a person has three individual claims of $40,000 each, that person could collect $120,000 in cash under this arrangement.

During calendar year 2001, MGA paid out $5,562,743.75 in claims, and of this amount MGA paid 1,364 in claims over $600 totaling $2,473,649. Approximately 90% of claims are paid out in cash. The 11 repeat winners or known or regular track customers listed below made 1,056 claims totaling $1,732,151, which is 70% of these over $600 prize payouts from MGA

and are over 31% of total claims. Given the number of claims submitted by these individuals, there is a possibility of some potential illegal activity or questionable scheme occurring.

The summary below lists 11 individuals that may be involved in possible questionable business practices or may be utilizing the arrangement at MGA to partially shield the rightful original winner/owner of the ticket to avoid identification of that person as a winner, conceal cash, and avoid reporting income and paying state and federal income taxes, mandatory reimbursements for negligent "deadbeat" parents, and other court-ordered liens or requirements.

In addition, these cash transactions could possibly be circumventing the $10,000 U.S. Treasury Requirement for reporting certain cash transactions. A cash transaction is defined by IRS regulations as a deposit, withdrawal, exchange of currency, or other payment or transfer by, through, or to the financial institution which involves a transaction in currency of more than $10,000. Generally, a financial institution is identified as brokers or dealers in securities, money transmitters, currency exchanges, check cashers, and issuers and sellers of money orders and travelers checks. Multiple transactions must be treated as a single transaction if the financial institution has knowledge that (1) they are by or on behalf of the same person, and (2) they result in either currency received or disbursed totaling more than $10,000 during any one business day. The question is raised as to whether the MGA is acting as such an institution and thus would be required to file the appropriate "Currency Transaction Report" with the IRS regarding these transactions. Also, only minimal or no taxes were withheld on those $1,732,151 in winnings. Only $51,474 or 2.97% of taxes were withheld as compared to $571,280 or 33% that other ordinary taxpayers would pay. The following chart illustrates the claim activity of these 11 individuals.

Summary of Highest Claimants at MGA
Calendar Year 2001

Name	Number of Claims	Total	Instant Game	Daily Numbers	Mass Millions	Keno	Megabucks	Federal and State Taxes Withheld
DT	319	$444,239.75	$304,000.00	$87,339.75		$48,400.00	$4,500.00	$3,407
RG	134	275,575.00	207,606.00	46,110.00		20,359.00	1,500.00	13,450
DM	146	251,633.50	203,000.00	29,715.50		18,918.00		9,850
GG	96	170,890.00	130,633.00	36,638.00		3,619.00		4,890
PC	104	167,760.00	134,000.00	21,395.00		10,865.00	1,500.00	6,550
JM	67	98,017.00	59,500.00	23,893.00		13,124.00	1,500.00	0
Ja T	52	89,545.75	45,000.00	27,729.75	$3,000.00	13,816.00		3,300
JT	47	88,716.00	67,000.00	20,816.00		900.00		6,727
EP	38	58,890.00	44,000.00	6,676.00		8,214.00		3,300
AM	31	50,498.50	32,000.00	15,396.50		1,602.00	1,500.00	0
JC	22	36,385.50	26,000.00	5,585.50	0	4,800.00	0	0
Total	1,056	$1,732,151.00	$1,252,739.00	$321,295.00	$3,000.00	$144,617.00	$10,500.00	$51,474

On May 2, 2001 the MSLC Compliance Unit conducted a review of the claim procedures at MGA. The report stated that, according to MGA's Manager of Lottery Operations, MGA has no ability to verify claimants Social Security Numbers if a valid acceptable form of identification is not presented (i.e., drivers license, Social Security card, health insurance card, Medicare card, or military ID) when filing a winning claim. Therefore MGA did not follow alternative secondary procedures to verify the validity of the identification of claimants. The manager explained that MGA refers these claims to Braintree for assistance.

The report by the outside private accounting firm commissioned by the MSLC dated October 2001 states in part "that the lottery management has not limited Raynham's ability to pay out prizes in excess of the $600 limit established for other Lottery Agents, a recommendation made in its prior 1999 report." Additionally, the report states "our concern is heightened by the high level of prize cashing activity that takes place there, particularly at night and on weekends when Braintree oversight functions (other than MIS

System Controls) are not operating." Neither the 1999 or 2001 report by the outside accounting firm disclosed that the excess of the $600 limit was up to $49,999.99.

We visited MGA during our audit and confirmed that they still do not have the ability to verify Social Security Numbers, contrary to the MSLC Secondary Claims Procedures, and as indicated in an April 2002 MSLC compliance report MGA continues to pay claims in excess of $600 even "for tickets that were purchased outside the park, as required by MSLC policy." The April 2002 compliance report also indicated that seven repeat claimants cashed 107 (63%) of the 170 tickets cashed with a value greater than $600 during the month of February 2002. This in spite of MSLC's outside accounting firm's admonition that it has not limited MGA's ability to pay out prizes in excess of $600.

Moreover, although the MSLC Compliance Unit review states that MGA's Manager of Lottery Operations refers claimants to Braintree when adequate identification is not presented when filing a claim, according to the private outside accountant's report the Braintree oversight functions are not operating nights and weekends. This concern is further heightened by the fact that according to its May 2, 2001 and October 15, 2001 compliance reports, MGA cashes claims of up to $50,000 for tickets not purchased at MGA for professional cashers, or as the reports refer to them as "regular," "known track customers," or "repeat winners only." The April 2002 compliance report also indicated that a winning Instant Game ticket was processed, in violation of proper procedure, with a scratched-out signature on the back of the ticket.

Our prior audit recommended that MSLC should report multiple instances to the IRS and DOR for tax reporting purposes. In response MSLC implemented a policy to report the IRS multiple instances of 20 or more wins for claims of $20,000 or more during a calendar year. However, during our audit we noted that, contrary to MSLC policy of reporting all claims of 20 or more for $20,000 or more during a calendar year, four individuals who met this criteria were left out and not reported, as follows:

Name	Number of Claims	Total Winnings
FO	23	$83,500
ED	41	50,500
FC	25	48,000
TH	22	39,000
Totals:	111	$221,000

Also, two other individuals claims and winnings were underreported, one for two claims for a total of $2,000 and another for two claims totaling $3,000. In both of these instances, the Social Security numbers may have been manipulated by the claimant or recorded in error, so that it was different from the actual numbers (same numbers but in a different position). Therefore it is evident from the above conditions that the controls are inadequate and need to be improved in order to facilitate IRS and DOR tax enforcement.

Our audit disclosed that three individuals had multiple cash payments on the same day in excess of $5,000, with no tax withholdings, thus questioning what scheme is being conducted and concealed by these "lucky" winners and the extent and effectiveness of MSLC's cooperation with tax authorities. In addition we noted that two of these individuals had outstanding state and federal tax liens of $10,248 and $133,417, which could have been recovered if there was a policy similar to the "Deadbeat Parent" agreement the Lottery has with the DOR to intercept and recoup funds prior to cashing out the ticket. The following chart summarizes the activity for these three individuals, as follows:

- DT made the following 17 claims totaling $35,906 at MGA in one day with no taxes withheld:

Date Claimed	Winnings	Taxes Withheld	Game Type
1/13/2001	$2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	618.00	0	Daily Number
	2,205.50	0	Daily Number

Date Claimed	Winnings	Taxes Withheld	Game Type
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
	2,205.50	0	Daily Number
Total	$35,906.00	0	

- PC made the following eight claims totaling $8,000 at MGA in one day with no taxes withheld:

Date Claimed	Winnings	Taxes Withheld	Game Type
4/4/2001	$1,000.00	0	Instant Game
	1,000.00	0	Instant Game
	1,000.00	0	Instant Game
	1,000.00	0	Instant Game
	1,000.00	0	Instant Game
	1,000.00	0	Instant Game
	1,000.00	0	Instant Game
	1,000.00	0	Instant Game
Total	$8,000.00	0	

PC also had outstanding federal and state judgments and liens, as follows:

Date Filed	Type	Dollar Amount	Status
8/7/1997	State Tax Lien	$26,003.00	Outstanding
4/5/2000	State Tax Lien	$107,414.00	Outstanding

During 2001, PC made 104 claims totaling $167,760.

- RG made the following six claims totaling $7,670 at MGA in one day with no taxes withheld:

Date Claimed	Winnings	Taxes Withheld	Game Type
9/19/2001	$849.00	0	Daily Number
	849.00	0	Daily Number
	1,000.00	0	Instant Game
	1,736.00	0	Daily Number
	1,736.00	0	Daily Number
	1,500.00	0	Megabucks
Total	$7,670.00	0	

RG also had outstanding federal and state judgments and liens, as follows:

Date Filed	Type	Dollar Amount	Status
12/8/1998	State Tax Lien	$8,571.00	Outstanding
2/26/1999	Federal Tax Lien	$1,677.00	Outstanding

During 2001, RG made 134 claims totaling $275,575.

IRS officials stated that the IRS regulations require that all lottery prizes that are won on the same date and were cashed at the same time by the same individual should be aggregated on one Form W2-G and, in accordance with the W2-G instructions, appropriate taxes should be withheld. Because under MSLC practices these claims transactions are considered as an individual separate occurrence, even if multiple transactions occur in one day at the same time, no federal or state income taxes were withheld.

Recommendation

MSLC should change its practices to accumulate claims and withhold taxes on an ongoing basis so that the government has already collected taxes in the event claimants do not file and report their income. MSLC should also reexamine the controls to ensure that correct identification information is obtained. Specifically, MSLC should:

- Not allow cash payments over $600 at MGA and ensure that MGA abides by the rules and regulations subject to all other Lottery retail agents.
- Evaluate its controls and strengthen its oversight to prevent professional cashers from evading the system.
- Implement the recommendations in Audit Result No. 1.

4. FIVE TICKETS TOTALING $5 MILLION NOT CLAIMED, FIVE TICKETS TOTALING $5 MILLION WITH UNUSUAL PATTERN OF CLAIMS IN THE MONTE CARLO GAME, AND OTHER UNUSUAL CLAIM PATTERNS INVOLVING OVER 400 CLAIMS TOTALING OVER $6.5 MILLION

During our prior audit we identified many instances in which claimants were abusing the state's Lottery system in that they were able to receive claim payments by submitting erroneous or false information. At that time, we recommended that MSLC collaborate with other agencies in order to minimize incidents of this type and ensure that claimants appropriately report their claims information on their tax returns. Although MSLC has taken some measures to address our concerns we believe more needs to be done in this area in order to enhance the integrity of the state's Lottery system.

During our follow-up audit we identified instances of unusual patterns of claims. For example, one Instant Game, the five-dollar Monte Carlo Game, had a total of 40 $1 million grand prizes. We found that five (12.5%) of these grand prize tickets that have been outstanding for a long period of time and therefore have not been claimed. Also, we noted three instances of $1 million Grand Prizes being claimed by two sales agents and a family member who resides with one of the sales agent's corporate officers. All tickets were purchased at the respective sales agent's locations.

Finally, another two (5%) $1 million Monte Carlo grand prize tickets were purchased at the same store by individuals having the same last name and living at the same address. Both tickets were purchased from the same Lottery sales agent. One individual cashed the winning ticket on October 29, 1998, and the other individual cashed the winning ticket on May 28, 1999. These two individuals are residing at the same address, and the claim form indicated that they had the same telephone number. According to MSLC's chart, the probability of winning a $1 million in the Monte Carlo game is 1 in 1,260,000. The statistical probability of two individuals living at the same address, and winning $1,000,000 dollars from the same store and the same game is even more improbable. This game contained 40 $1 million prizes, and these individuals won two (5%) of these prizes. Also, at this same sales agent, another $1 million ticket from the five-dollar Holiday Bonus game was purchased on January 9, 1998.

We found further that one of the $1 million winners was receiving $50,000 per year over 20 years for the Monte Carlo game. When we examined the canceled check dated May 24, 2001 made payable to this individual, we noted that someone else had signed (endorsed) the payee's name on the back of the check on June 5, 2001. The endorsement signature of the payee's name on the back of the check was obviously not the same signature as that on the original claim form and on the back of the first check issued on May 28, 1999 to the winner. We raised questions about this situation during the course of the audit, and found that as a result the May 2002 installment was outstanding and on June 5, 2002 the check was returned with legal documents indicating that the claimant had died in Florida on July 1, 2000, with instructions for MSLC to make all checks payable to the deceased's spouse. However, since the MSLC's system issued two checks to an individual who was deceased, MSLC needs to examine the controls it has established relative to making annuity payments to claimants.

As previously mentioned, on March 22, 1999, a sales agent claimed a $1 million prize in the Monte Carlo Instant Game that he had purchased at his own place of business. Also, on August 9, 1999, a family member claimed a $1 million prize in the Monte Carlo Instant Game who resides with one of the restaurant sales agent's corporate officers. Furthermore,

on July 2, 1998 another sales agent claimed a $1 million prize in the Monte Carlo Instant Game.

In another situation during the years 1999 and 2000 there was a total of 26 large prize payments for Instant Game tickets totaling $115,000 paid to seven individuals, six of whom have the same last name as the two $1 million winners of the Monte Carlo game. These seven individuals were identified as living at the same address, which is a one-family residence. Additionally, during calendar year 2001, five of the same individuals cashed a total of $55,000 in Instant Game ticket prizes. We reviewed nine claim forms and related information in excess of $4,000 and determined that their tickets were all purchased in the same city from two stores. (Both of these stores have one of the claimants (LHN) listed as its Sales Agent below.) Also, this individual (LHN) has the same home address as all six of the winners below. We also noted that five Instant Game tickets were claimed for $6,000 on the same day, May 17, 1999*. The detail of these winning claims and some of the odds (for amounts of $4,000 or greater) of the seven individual winnings are listed below.

Initials of Winner	Date Cashed	Prize Amount	Odds** of Winning This Amount
LN	1/12/1999	$1,000	
	1/12/1999	$1,000	
	5/17/1999	$2,000*	
	5/17/1999	$1,000*	
	2/24/2000	$2,000	
	4/13/2000	$4,000	1,008,000 : 1
	Total:	$11,000	
LAN	6/9/1999	$10,000	201,000 : 1
	10/12/2000	$1,000	
	Total:	$11,000	
LHN	7/2/1999	$1,000	
	1/7/2000	$20,000	1,008,000 : 1
	8/18/2000	$10,000	72,000 : 1
	Total:	$31,000	
PV	12/30/1999	$10,000	252,000 : 1
	Total:	$10,000	
PN	1/12/1999	$1,000	
	5/17/1999	$1,000*	

Initials of Winner	Date Cashed	Prize Amount	Odds** of Winning This Amount
	5/17/1999	$1,000*	
	5/17/1999	$1,000*	
	7/2/1999	$5,000	144,000 : 1
	10/25/1999	$10,000	100,800 :1
	2/24/2000	$10,000	72,000 :1
	4/13/2000	$1,000	
	5/18/2000	$4,000	72,000 :1
	10/23/2000	$4,000	72,000 :1
	Total:	$38,000	
TN	7/23/1999	$1,000	
	5/26/2000	$2,000	
	9/19/2000	$1,000	
	Total:	$4,000	
DN	7/2/1999	$10,000	252,000 : 1
	Total:	$10,000	

**Odds of winning are published by MSLC

In addition, during calendar years 1999 and 2000 individuals with the same last name, as previously mentioned above, coincidently cashed a total of 356 claims for Instant Game tickets totaling $1,401,829. The following summarizes the number of tickets cashed and the amounts involved:

Number of Claims	Individual Claim Amount	Total
1	$200,000	$200,000
4	50,000	200,000
4	20,000	80,000
44	10,000	440,000
5	5,000	25,000
25	4,000	100,000
1	2,829	2,829
4	2,500	10,000
76	2,000	152,000
192	1,000	192,000
356		$1,401,829

In addition, these individuals with the same last name won $7 million in Instant Game scratch tickets, and one individual's winning ticket was purchased from a Lottery sales agent with the same last name, as follows:

Name	Date Won	Gross Winnings
TN*	10/29/98	$1,000,000
AN*	5/28/99	$1,000,000
KN	3/7/01	$4,000,000
SN**	12/3/99	$1,000,000

* Instant Game scratch ticket purchased at same Lottery sales agent. (Previously mentioned in this audit result.)

** Instant Game scratch ticket purchased from Lottery sales agent having the same last name as the winner.

Regarding the matters above, MSLC officials stated that they would consider implementing controls for those areas identified.

Also, Exhibit 2 provides examples of all significant grand prize Instant Game tickets that remain unclaimed. The table below includes six games that are over three years old and still have 17 (13%) of the 130 grand prizes, with a total prize value of $20 million, remaining unclaimed.

Table 1

Issue Date	Game	Claimed	Total	Top Prize	Unclaimed
9/11/97	1 Million Draw	29	30	$1,000,000	$1,000,000
11/18/97	Monte Carlo	35	40	$1,000,000	$5,000,000
11/12/98	Jubilee 25	22	25	$2,000,000	$6,000,000
11/12/97	Holiday Bonus	7	10	$1,000,000	$3,000,000
6/02/99	Win $1,000,000 in Cash	8	10	$1,000,000	$2,000,000
8/11/99	Instant Millions	12	15	$1,000,000	$3,000,000
		113	130		$20,000,000

Recommendation

MSLC should

- Develop policies and procedures that require the agency's Security and Compliance Division to use information in MSLC's database to periodically conduct analytical reviews of claimant information. Based on the results of these reviews, MSLC

should refer any unusual or irregular claim activities to appropriate regulatory and law enforcement agents for further review and resolution.

- Establish appropriate policies and procedures that require increasingly stringent identification steps to be taken under such circumstances such as large prizewinners (a dollar base line should be determined by MSLC), multiple prize claims, and suspicious sounding names or addresses as well as suspicious circumstances when prize claimants present themselves.

- Work with other agencies to amend regulations and laws to collect taxes from multiple prizewinners, which would help reduce the business of professional cashers who are not only helping others evade taxes but are evading taxes themselves, since it is unlikely they perform these services for free.

5. INEFFECTIVE COLLECTION EFFORTS AND NONCOMPLIANCE WITH ITS OWN DEBT-COLLECTION PROCEDURES RELATIVE TO OVER $10 MILLION IN ACCOUNTS RECEIVABLE FROM TERMINATED AND SUSPENDED SALES AGENTS

We found that MSLC had ineffective debt collection procedures and was not adhering to its own internal policies and procedures relative to the collection of millions in outstanding receivables. Specifically, although MSLC's policies and procedures require it to disable the ticket terminals of sales agents who do not remit funds owed to MSLC in the time frame established by MSLC policies and procedures, MSLC does not always follow these policies and procedures. Further, the State Comptroller's regulations and MSLC's own internal policies and procedures require state agencies such as MSLC to make prompt and diligent efforts to collect outstanding receivables, including referring those that have been outstanding for periods ranging from 60 to 90 days to a debt collection agency. As of August 15, 2001 MSLC was owed over $10 million from 1,232 terminated or suspended agents, or over 16.2% of the 7,600 sales agents, and $8.9 million from 1,051 sales agents whose debts were outstanding over 90 days. We selected a sample of 88 of MSLC's accounts receivable (over $10,000 each) totaling $3,602,702 and found that 29 of these receivable balances totaling $1,188,296 (33%) as of December 4, 2001 had been outstanding significantly longer than 90 days. When we bought this matter to the attention of MSLC officials, they stated that the agency has subsequently submitted 15 of these 29 accounts, which represented $666,221 (56%) in receivables for debt collection. The time elapsed between the date of the last payment received by MSLC on these receivables and the date on which these 15 accounts were ultimately referred for debt collection by MSLC ranged from

108 days to over 5 years, with the average being approximately 2.5 years. The average number of days between the last payment received by MSLC and the end of our audit period (March 31, 2002) on the remaining 14 accounts receivable that had not been referred by MSLC for debt collection was 1,104 days, or over three years.

We also found many other instances in which MSLC was not exercising due diligence in collecting its receivables. For example, for many of the 15 accounts in our sample that MSLC ultimately referred for collection, agency staff did not maintain telephone logs to document any collection efforts that may have been made by MSLC staff as required by MSLC's policies and procedures. Moreover, in those instances where telephone logs were available, they indicated that some sales agents that owed MSLC hundreds of thousands of dollars had not been contacted by the agency for periods of up to five years. Finally, we found one instance in which MSLC could not provide us any documentation relative to a $15,000 receivable. Based on our research, we found that this company had filed for Chapter 11 bankruptcy protection during our audit period, a fact that MSLC was unaware of.

Because MSLC is not exercising due diligence and complying with its own policies and procedures relative to the collection of receivables, there is inadequate assurance that millions of dollars in receivables owed MSLC and the Commonwealth will ultimately be collected. The results of our audit work in this area are detailed in the following sections.

a. Inadequate Collection Efforts Relative to Millions in State Funds

According to regulations promulgated by the Massachusetts Office of the State Comptroller (OSC), state agencies including MSLC are required to follow certain procedures relative to the collection of outstanding debt. In this regard, 815 CMR 9.05 promulgated by the Comptroller entitled Department Internal Debt Collection Obligations, discusses diligent efforts for collecting, dunning notices, and collection agencies, as follows:

> *Departments are responsible for making diligent efforts to collect legislatively authorized accounts receivable and debts due the State. Departments shall maintain detailed records for all accounts receivable, debts and other legislatively authorized charges for goods or services.*

According to 815 CMR 9.05(2)(d), entitled Dunning Notices:

> *If the initial bill is not paid in full by the debtor by the payment due date, and the debt has not been disputed by the debtor, a Department must demonstrate diligent efforts to collect the debt. Diligent efforts shall include at a minimum, but shall not be limited to, three written billing and dunning notices in addition to the initial billing, and a final notice as follows . . . .*
>
> > *(f) Final Notice. The final 90 days past due notice outlined in 815 CMR 9.05(2)(d) 4 shall contain language notifying the debtor that the debt has been referred for either intercept or to a Collection Agency for collection, or both.*

The standard Dunning Notice developed by OSC for outstanding debts for more than 90 days is as follows:

> *Please be advised that your account has been deemed delinquent for failure to pay and has been referred for assessment of late charges, intercept of state payments, including state tax refunds under MGL C62D, and referral to a collection agency under MGL C7A and 815 CMR 9.00 Multiple Notices of your right to dispute this debt or submit a written request for a GL C30A hearing have previously been provided. Please call the contact person for further information.*

We reviewed the policies and procedures MSLC had established relative to the collection of debt and compared this to the requirements established and promulgated by the State Comptroller. Based on this review, we found that MSLC's collection procedures, like the OSC's, require that outstanding debts be referred for collection after they have been past due for 60 days or sooner. Specifically, MSLC's collection procedures state, in part:

> *Generally, after the 60-day collection notice has been issued, the Lottery may turn the receivables over to a collection agency. However, unusual circumstances may exist which may require a "fast tracking" of the receivable to a collection agency before the 60-day collection notice has been issued. . . .*

Our prior audit disclosed that there was $15.1 million of undeposited cash sales held and owed by sales agents, of which $12.8 million may be uncollectible because of inadequate collection policies and practices that allowed shortages or thefts by MSLC sales agents.

Given our prior audit, we reviewed the accounts receivable records being maintained by MSLC and found that as of August 15, 2001, there was $10,020,517 in receivables due from 1,232 terminated or suspended agents, or over 16.2% of 7,600 sales agents, of which $8,857,813 from 1,051 was outstanding for more than 90 days. We selected a sample of 88 of these accounts receivables that were over $10,000 each and which totaled $3,602,702 and

found that 29 of these receivables totaling $1,188,296 (33%) had still not been submitted for debt collection as of December 4, 2001.

We brought this matter to the attention of MSLC officials, who stated that the agency has subsequently (March 2002) submitted 15 of these 29 accounts, which totaled $666,221, for debt collection. The number of days these debts were outstanding before being referred by MSLC for collection averaged 935 days, or over 2.5 years, and they ranged from being outstanding for between 108 days to over five years.

When asked why these 15 accounts were not referred for debt collection in a more timely manner, MSLC officials indicated that they were "working the accounts" to determine whether any of these outstanding debts could be collected. However, since these 15 receivables had been outstanding for an average of over 2.5 years, MSLC's decision to not exercise more diligence in collecting these receivables and to not refer them for debt collection in a more timely manner was not prudent and reasonable, and leads to lost revenue to the Commonwealth.

According to MSLC officials, the remaining 14 accounts were not placed in debt collection for the following reasons:

- For four accounts, sales agents who owed MSLC $159,046 for an average of 1,973 days, or over five years, had filed for bankruptcy.

- For three accounts, where sales agents owed MSLC a total of $111,856, MSLC staff were still in the process of collection because they believed they could still recover some funds owed. However, based on the documentation we reviewed, these three accounts have not had any payments made against them for on average 589 days, or approximately 1.7 years.

- Two accounts totaling $64,606 which were deliquent on average 1,353 days or approximately 3.7 years, involved pending criminal investigations and therefore collection efforts would be fruitless and were suspended.

- For two accounts that totaled $82,537 and had been delinquent for on average 343 days, MSLC officals stated that there was a change of ownership and that MSLC has not pursued collection. However, MSLC officials were unable to provide us any documentation to substantiate this claim.

- For one account totaling $56,023, the sales agent was still disputing the outstanding balance. The 815 CMR 9.06(4) promulgated by the State Comptroller requires state agencies to immediately suspend the debt collection process for any disputed debt as long as it is in dispute. The number of days since this sales agent owed this potential liability to MSLC through the end of our test period was 1,281 days, or 3.5 years.

- One account totaling $32,111 which was delinquent by 185 days, was a chain store and as noted in Section (b) below. MSLC does not always follow its collection policies and procedures for chain store operations.

- One account which was delinquent for 934 days or 2.6 years had paid MSLC $15,800.88 of the $15,985.88 it owed MSLC after the date our test was conducted.

Additionally, MSLC's Internal Control Procedures for its Accounts Receivable/Collection Department states the following regarding monitoring telephone logs, date of last payment reports, and other internal controls relative to the collection of accounts receivables:

> *The Revenue Recovery unit (RRU) is the MSLC in-house Collection Department. Its staff includes a Supervisor (who is also a collector), and between three and five full-time collectors and depending on the volume of receivables a few part-time collectors. This Unit reports to the DOR [Department of Revenue]. In addition there is one Senior Field Investigator assigned to aid the Unit by making contact in the field. The Senior Field Investigator reports directly to the DOR. This unit has been trained to adhere to applicable laws and procedures in the collection of both consumer and commercial debt. Training is on-going with seminars and testing provided for by outside vendors. All collectors are responsible for keeping daily telephone logs on the contacts made and attempted. Both RRU Supervisor and the DOR review these logs. In addition the collectors must turn in a daily (RR001a) summary. The supervisor will complete a weekly summary (RR001) and attach a combined daily summary (RR001b) for each day of the week. This report is forwarded to the DOR for review. The RRU is charged with responsibility to recover as much money as possible from Agents with a receivable balance. They will attend and participate in Agent hearings. They will attempt to structure Payment Plans within the stated guidelines (all Payment Plans are subject to review by the DOR, Controller, and Assistant Director Finance). Also there is a weekly review for all accounts assigned to each collector of > $10K. This is called the Date of Last Payment Report (DOLP). This is done to calculate the collectability of large balance accounts. The RRU is responsible for recommending Agents to be turned over to outside Collection Agencies.*

As our sample included accounts receivables with outstanding balances of over $10,000 each, we asked MSLC officials to provide us with documentation to substantiate that weekly reviews of these accounts were conducted as required by MSLC's policies and procedures and also requested copies of all the Date of Last Payment Report (DOLPs) generated during

our audit period. In response, MSLC's Director of Revenue stated that the agency does not keep records or notes from these weekly meetings because they are not required to do so and that MSLC does not keep copies of DOLPs. Consequently, MSLC's compliance to its own internal policies and procedures in this area could not be demonstrated by MSLC.

We requested daily telephone logs on the 15 accounts receivable in our sample that MSLC referred for collection. MSLC officials could not provide us with any telephone logs for six of the 15 accounts receivables, which totaled $278,970, to document that any collection efforts relative to these accounts had been made. Our analysis of the remaining nine accounts revealed that for three accounts that had combined outstanding balances of $117,936, MSLC staff did not maintain formal telephone logs as required by MSLC's policies and procedures but rather made informal notes on Dunning Notices that may have been sent to the sales agents that owed money to MSLC. For the remaining six accounts that had combined outstanding balances of $269,315, MSLC staff maintained a telephone log but the information contained in these logs indicated that MSLC staff did not always exercise due diligence in collecting amounts owed to MSLC. For example, for one account in which a sales agent owed MSLC $33,912, the last time an MSLC staff member contacted this sales agent was almost five years earlier in 1997. On another account, which totaled $49,280, the last telephone call made by an MSLC staff person was in 1998, and on two other accounts which totaled $86,802, the last time an MSLC staff member attempted to contact the sales agents was in 1999.

Since these accounts were not referred for collection by MSLC until March 2002, MSLC staff should have contacted these sales agents. In some instances, agents had not been contacted by MSLC for periods of up to five years before the agency decided to take definitive measures to collect these outstanding debts. MSLC officials stated that as a result of our inquiries into this matter, on January 2, 2002 the agency began generating a report entitled Potential Uncollectable Receivables Amounts. This report identifies various information regarding amounts owed MSLC by sales agents, including the date on which the payment was due and whether the receivables had been referred for debt collection.

Further, regarding this matter, on June 27, 2002 MSLC's Chief Financial Officer provided the audit team with a memorandum, which stated in part:

> *In January of 1999, the Massachusetts State Lottery Commission was carrying receivables valued at $15.1 million on its books. There was little or no attention paid to the collection of this outstanding debt before 1999. Over the past two years, the Lottery has initiated collection policies and procedures, which has reduced the outstanding debt to $8.35 million as of June 21, 2002. The major new initiative, which addressed this matter, was the establishment of a Revenue Recovery Unit. This group is charged with monitoring Lottery Agent EFT accounts and any rejects (bounced sweeps). They also work with Lottery Agents to manage any financial difficulties and collect outstanding receivables. In Fiscal Year 1999, agent rejects were approximately .38% of sales. In fiscal year 2001 they were only .23% of sales. Collection success continues to remain strong. Almost 70% of all Agent bad debt is now collected in the same fiscal year as it accrues.*
>
> *While there has been much improvement in the collection and reduction of receivables and bad debt, much remains to be done. We initiated new agent contracts, which contain an individual continuing guarantee provision, which gives the Lottery access to all assets of individuals of the corporation. There has been some discussion for acquiring/developing collections monitoring software that is comparable to the applications used in the private collection industry. Finally, we turn over all bad debt accounts to collection agencies after the Lottery has exhausted all of our efforts.*
>
> *Over the past few months, we have begun an analysis and evaluation of our overall collection efforts. For example, we are looking at involving private collection agencies earlier in the process. We are currently conducting a cost analysis to help us in the decision making process.*

We note that as of June 30, 2002, MSLC reports indicated that sales agents owed a total of $8,964,427, of which $1,919,411 (21.4%) was outstanding for over 90 days. However, our audit work shows that improvements are still needed in MSLC's accounts receivable collection process.

b. Agency Procedures Not Followed Relative to the Collection of Revenues from Sales Agents

According to 961 CMR, promulgated by MSLC, contracted sales agents are required to pay all sums due the agency on the date established for payment. Specifically, 961 CMR (2.16)(1) states, in part:

> *Sales Agents are required to deposit into such trust account, on such terms as may be required by the Director, proceeds received by such Sales Agent from the sale of Lottery tickets.*

In order to ensure that revenues due from sales agents are collected in a timely manner, MSLC has established in its standard Lottery Sales Agent Agreement, a specific time frame for the remittance of revenues by sales agents to MSLC. In this regard, section four of this agreement states that sales agents are required:

> *To deposit into the Trust Account, no later than the first business day of each week during which banks in Massachusetts are open, all Lottery Ticket Proceeds from the sale of all Lottery Tickets by the Agent during the previous week and all Rent payments for the previous week . . . .*

Finally, MSLC has established formal written policies and procedures relative to the collection of revenues from sales agents, including measures to terminate the agent's ability to continue to sell lottery tickets if the agent does not remit revenues due MSLC within this established timeframe. Specifically, MSLC's Internal Controls On-line Accounting Unit's policies and procedures states that in the event a sales agent does not remit revenues owed MSLC within the specified time frame, MSLC staff should take the following measures:

- Electronically transmit a disconnect message to the agent.
- Act to collect the reject (amounts owed MSLC) by the end of the day. If successful, the reject is 'resolved.'

If unsuccessful, the following steps are additionally undertaken:

- Electronically transmit a disconnect message to the agent.
- Disable the agent terminal.
- Enter the reject amount and agent data into the Commonwealth's Billing and Accounts Receivable System (BARS).

During our audit, we spoke with MSLC officials, including MSLC's Director of Revenue, Manager of Revenue and Collections, and Supervisor of Collections regarding the timely deposit of MSLC revenues. We then conducted an initial test of transactions to determine compliance with applicable rules and regulations regarding the collection of these revenues. Specifically, we selected a sample of 26 sales agents who did not remit revenues totaling $142,810 owed to MSLC in the manner prescribed by the agency during the month of June 2001. Based on our review, we found that for one sales agent, MSLC did not enforce the

terms and conditions of its contract with this agent or its own policies and procedures in that it did not require this agent to remit funds owed in the prescribed timeframe, nor did MSLC disable the sales agent's terminal for non-payment.

Regarding this matter, MSLC's Director of Revenue stated that MSLC does not disable "chain store" accounts (i.e., businesses with three or more locations) because MSLC has historically had no problems collecting revenues from these entities. MSLC officials stated that the businesses MSLC deals with essentially use two business models: some businesses operate each location and do not sell franchises while others sell franchises. We determined that MSLC licenses 67 different chain store operations, of which four sell franchises. MSLC officials added that, for the most part, MSLC does not have any problems with chain stores that do not sell franchises because the corporation that owns the chain stores, ensures that the money owed MSLC is paid in a timely manner. In order to test this assertion, we reviewed the reimbursements made by two non-franchise chain stores during calendar year 2001 and found that, as MSLC's Director of Revenue contended, neither was delinquent in remitting funds owed MSLC during this fiscal year.

Although there is no formal written agency policy or procedure that provides for chain stores to be given this special consideration, MSLC's Director of Revenue provided us with a memorandum dated August 17, 2000 from him to his staff which stated:

> *Please do not Disable any Chain Store Account. The procedure to follow is to first contact…[the] Finance Coordinator for Chain Stores, before any action is taken against (including sending a EFT problem message) a Chain or Franchise sales agent location. All Sales Interruption of Chain and/or Franchise stores must come from [the Finance Coordinator for Chain Stores] or myself.*

Given the fact that MSLC's management has directed staff to not comply with MSLC's own policies, we conducted additional testing in this area. Specifically, we selected one of the 67 franchise chain store accounts for fiscal year 2001 to determine the number of days that elapsed between the date on which the account became delinquent and the date of payment of the accounts. During fiscal year 2001, a franchise corporation had 85 stores that were licensed sales agents of MSLC. Our test revealed that, during this fiscal year, five of these 85 stores on 13 separate occasions took an average of 73 days to pay open receivable amounts

totaling $157,883 to MSLC as opposed to the five days specified in the sales agent agreements. Moreover, none of these five sales agents' locations ever had their terminals disconnected as required by MSLC's own policies and procedures.

MSLC's Director of Revenue stated that one of the reasons for the significant delays in collecting revenues from franchise chains stores is that franchises often change ownership and the new owners are unaware of the revenue the former owners may have owed MSLC. However, MSLC's own regulations state that a change in ownerships is not an acceptable reason for not paying revenues owed MSLC. Specifically, 961 CMR 2.15 promulgated by MSLC entitled "Transfer of Location of License, Substantial Change of Ownership, or Complete Change of Ownership" indicates that the prospective new sales agent license may be suspended due to a prior owner's debt obligations to MSLC, as follows:

> *The Director retains the right to deny the application of any prospective licensed sales agent if there is an unpaid obligation to the Lottery at the time of change of said business. It is incumbent upon the persons who are/were in control of said business at the time of license last issue to make all prospective sales agents aware of any and all obligations due to the Lottery. The prospective sales agent should be made aware that if there is a delay in the final accounting to the Lottery his/her/its newly granted license may be suspended until the obligation due the Lottery is satisfied.*

Because MSLC is not applying its policies consistently to all sales agents, sales agents are being allowed to delay payments due MSLC. This effectively results in MSLC providing interest-free loans to these entities for the outstanding receivables and the Commonwealth's being deprived of the use of these funds and the opportunity to generate interest earnings.

It should be noted that the corporation in question requested MSLC to grant it a waiver of the requirement contained in Section Four (A), Trust Account (A) of the Lottery Sales Agent Agreement, which requires sales agents to establish a trust bank account with MSLC as the sole beneficiary. In return, the corporation agreed to guarantee the sales agent debt of its franchise if MSLC agrees to grant them a waiver regarding each franchise to have a separate trust bank account. MSLC officials stated that they approved this waiver request, but currently no waivers to this requirement have been granted. However, these officials added that as franchisees of the corporation renew their lottery sales agent agreement or new

franchisees apply for a license, MSLC will consider including this waiver in their agreement. Clearly, since chain stores generated significant revenue (approximately $1 billion out of approximately $4 billion in MSLC's revenue during fiscal year 2002), MSLC should maintain adequate internal controls over the collection of this major source of revenue.

c. Inadequate Documentation Relative to $15,000 in Accounts Receivable

Based on our review of accounts receivable, we found that for one receivable, totaling $15,000, MSLC could not provide us with any documentation to substantiate the nature of this receivable. According to MSLC officials, this receivable happened several years ago but MSLC staff was not familiar with how the receivable developed. We researched this company and found that on November 19, 2001, the company had filed for Chapter 11 bankruptcy protection in Tampa, Florida. We brought this matter to MSLC officials, who stated that they have not attempted to contact the company since 1997 but, based on these circumstances, would consider removing this receivable from the agency's accounts. However, this is another indication that MSLC's collection efforts are inadequate. Further, by not maintaining detailed records of its accounts receivable, MSLC is not in compliance with the aforementioned 815 CMR promulgated by the Office of the State Comptroller.

MSLC officials indicated that they have made significant improvements regarding collecting accounts receivable and that the receivables are a small percentage of sales and would meet or exceed any private sector standard for receivables as a percentage of sales. Although this may be true, outstanding receivables of public funds need to be collected and used to fund programs, especially in difficult economic times.

Recommendation

MSLC should improve its collection efforts and consider whether it should continue to operate its own internal collection activity versus contracting with an external collection agency. However, until such time as MSLC makes a determination on this matter, MSLC should take measures to ensure that its staff fully complies with state regulations and its own internal policies and procedures relative to exercising due diligence in a timely manner in the collection of receivables. Further, all collection efforts should be documented and routinely

evaluated by MSLC's management to ensure that diligent efforts to collect these debts are being utilized. The MSLC should take measures to ensure that it maintains adequate documentation to substantiate the existence of all receivables being recorded in its financial records. Finally, MSLC should file liens against agents who are 90 days delinquent in transmitting amounts owed as well as follow through so that it is not left out of the proceedings, and should also increase the bond fee to be sufficient to cover these terminated and suspended agents and its bad debt write-offs. (See Audit Result No. 6).

6. INSUFFICIENT SELF-INSURANCE PROGRAM FOR SALES AGENTS RESULTS IN NET LOST REVENUE OF OVER $9 MILLION OVER FOUR YEARS AS A RESULT OF BAD DEBT WRITE OFFS

We found that MSLC has not effectively managed the process it uses to bond its sales agents. Specifically, MSLC charges each agent an amount equal to 35 cents per day per location for each day an agent operates as a bond premium to cover the costs of any sales agents who may fail to meet any of the conditions contained in their sales agent agreements with MSLC. However, MSLC does not routinely assess the reasonableness of this premium to ensure that premiums collected are sufficient to cover any costs or losses incurred by MSLC as a result of nonperformance by sales agents. Moreover, MSLC officials could not even tell us how the current premium of 35 cents per day was established. MSLC generated only about an average of $968,000 per year in fees over the last four years and only $941,573 in fiscal 2002. Because MSLC has not effectively managed this process, we determined that from fiscal year 1999 through fiscal year 2002, the agency wrote off $13 million in bad debt expenses that could have been covered by bond premiums had MSLC effectively managed this process and periodically established reasonably adequate premiums. Instead, because premiums collected were inadequate (only $3.9 million over four years), the Commonwealth suffered a net loss of $9.1 million in bad debts not covered through premiums over the last four years.

According to 961 CMR 2.11 promulgated by MSLC, each sales agent who enters into an agreement with the agency must give a bond to the agency to guarantee their performance. Specifically, this regulation states in part:

> *Each licensed person shall give a Bond for his/her faithful performance of his/her duties as a licensed sales agent in accordance with provisions of law....*

Moreover, the CMR 2.00 promulgated by MSLC cites the following as a penalty for any sales agent who does not pay this bond:

> *Failure to pay a bond may be cause for non-issuance, non-renewal, or relocation of a sales agents license. The bond shall be in a form approved by the Director in such sums as shall be fixed by the Director....*

In order to ensure that each sales agent is properly bonded, MSLC has incorporated into Section 7(F) of its standard Lottery Sales Agent Agreement the following language:

> *The agent agrees "to pay an annual bonding fee to the principal in such amount as the principal shall determine"....*

MSLC's Director of Revenue stated that during the 1980's, MSLC used the fees it collected from sales agents to purchase a performance bond from Fireman's Insurance Company. This bond would pay up to $10,000 per sales agent for each agent who failed to perform (e.g., remit monies owed to MSLC), in accordance with their sales agent agreements. MSLC officials stated, however, that during the 1980's Fireman's Insurance Company discontinued providing these bonding services in the Commonwealth. Consequently, this official stated that at this time, MSLC decided to become self-bonding.

According to Chapter 26, Section 10, of the General Laws MSLC's Director is required to collect a bond from every licensed agent in such amount as may be established by the rules and regulations of MSLC. During our audit period, we determined that MSLC was assessing a bonding fee equal to 35 cents per day for each day per location a sales agent was open for business. This amount is included in the weekly bills MSLC submits to each sales agent.

We reviewed MSLC's management of its sales agent bonding process and noted several issues. First, MSLC officials could not provide us with any documentation on how this 35 cents per day bonding premium was established. MSLC officials stated that this premium was established during a prior administration and that there is no documentation that details why the bond premium was set at this level. Second, MSLC officials stated that the reasonableness of this bonding premium is not routinely reviewed by management.

Specifically, according to MSLC's Director of Revenue, the last time agency officials decided to review the reasonableness of this premium was approximately five years ago. The Director stated that at that time, MSLC management decided not to change the bonding fee because game sales and revenues were increasing and sales agent default rates were decreasing. The Director of Revenue further stated that MSLC's management has recently been reviewing this matter but no decision has been made as to whether or not to change this bond premium.

Because MSLC has not effectively managed this bonding process, the amount of premiums it has collected has been substantially lower than the losses the agency has had to realize due to nonperformance by some of its sales agents. As noted in Audit Result No. 5, during our audit period, delinquent sales agents owed MSLC over $10 million which has remained unpaid from terminated or suspended agents, in some instances for over three years, and has resulted in MSLC having to write off millions in bad debt each year.

MSLC should be actively managing this bonding process to ensure that the bonding fees it collects are sufficient to cover any nonperformance by its sales agents. However, because MSLC officials have not been actively managing this process, MSLC and the Commonwealth have unnecessarily incurred approximately $9.1 million in net lost revenue, for fiscal years 1999 through 2002 as indicated in the table below:

Fiscal Year	Bad Debt Expensed	Bond Fees Collected	Lost Revenue from Under Bonding
1999	$ 4,202,089	$980,089*	$3,222,000
2000	3,183,166	978,498	2,204,668
2001	2,645,325	971,957	1,673,368
2002	2,934,421	941,573	1,992,848
Total	$12,965,001	$3,872,117	$9,092,884

*Estimate: Prior to 2000, MSLC did not keep a separate accounting of these fees.

Regarding this matter, MSLC officials stated that in their opinion, it does not matter how much bond fees are collected because MSLC cannot retain this bonding fee revenue unless the agency gets approval from the state Legislature to establish a retained revenue account. In our opinion, the fact that the MSLC cannot keep these fees through a retained revenue

account is irrelevant. Regardless of how these funds are accounted for or whether they are deposited into a retained revenue account or the General Fund, the Commonwealth would get the benefit of recovering lost funds through these bonding fees. It is a legislative decision as to how these added revenues should be distributed and not an agency decision. MSLC receives an appropriation for its budget and all other revenues go the cities and towns and prizes. MSLC has a fiduciary responsibility to ensure that it maximizes the amount of revenues it collects to cover such losses and does not unnecessarily pass on bad debt losses to the taxpayers. MSLC officials further stated that they would look into this matter.

Recommendation

MSLC should actively manage its sales agent bonding process and take the measures necessary to ensure that the bond fee structure adequately covers all the bad debt write offs caused by nonperformance of sales agents. MSLC should immediately increase its fee structure in a fair and equitable manner to cover these lost revenues.

7. CONTROLS OVER MSLC'S ADMINISTRATION OF SALES AGENTS' TICKET SCANNING ACTIVITIES NEED TO BE IMPROVED

We found that improvements are needed with MSLC's internal policies and procedures relative to the administration of sales agents' Instant Game ticket scanning activities. Specifically, although MSLC's policies and procedures require that the MSLC shut off an agent's ability to cash tickets after the agent has committed a certain number of procedural errors, MSLC is not following this policy. We also found that the MSLC has not developed adequate formal written policies and procedures on how to deal with habitual offenders who abuse the controls MSLC has established over this process. As a result, there is inadequate assurance that MSLC sales agents are not committing abuses to the Lottery system.

The MSLC has established policies and procedures that its sales agents must follow in order to be able to cash Instant Game tickets. The purpose of these policies and procedures is to ensure that sales agents are not able to commit abuses to the Lottery system by improperly scanning unsold Instant Game tickets to identify winning tickets and claim prizes. In this regard, MSLC's policies and procedures identify specific errors that if committed by sales

agents, could limit their ability to cash Instant Game tickets. These errors, which MSLC classifies as type "A" and type "B", are described as follows:

- Type "A" Error: If an agent scans an Instant Game ticket, whether it is a winning ticket or not, the terminal will ask the agent to input the unique three-digit control number which is found under the "void if removed portion" of the ticket. If the agent does not enter this number (e.g., clears the transactions or attempts to process another transaction) or enters it incorrectly, this would constitute one Type "A" error.

- Type "B" Error: If an agent scans a ticket, correctly enters the unique three digit control number, but the ticket is not a winning ticket, this would constitute a type "B" error.

According to MSLC policies and procedures, "Any combination of 3 instances "A" and "B" errors will shut off an agent's ability to auto-cash." MSLC's auto-cash system allows agents to scan winning tickets that have up to a $10 prize without having to enter the 15-digit identification number that appears under the "void if removed" portion of the ticket. If agents lose their auto cash ability, they must manually enter the 15-digit identification number on all winning tickets. According to MSLC's policies and procedures, "Any combination of 11 instances of "A" and "B" errors will shut off instant ticket cashing altogether."

During our audit, we met with MSLC's Director of Revenue and the MSLC Compliance Analyst who is responsible for monitoring sales agent activities relative to scanning Instant Game tickets. We also reviewed various documents produced by MSLC's Compliance Unit relative to the scanning of Instant Game tickets. Based on our audit work in this area, we noted the following internal control issues:

a. Noncompliance with Agency Policies and Procedures: Although MSLC's policies and procedures state that a sales agent's ability to cash Instant Game tickets will be shut off when any combination of 11 total instances of "A" and "B" errors occur, this policy is not being followed. In fact, the Compliance Analyst stated that to his knowledge, no sales agent has ever had their ability to cash Instant Game tickets shut off. The analyst stated that the only thing that MSLC shuts off is the sales agent's auto cash system. However, each evening MSLC's computer system is programmed to automatically reactivate each sales agent's auto cash system so that it is operable the very next morning. The Compliance Analyst stated

that the controls over this process are that MSLC's computer system tracks on a daily basis those sales agents who need to have their auto cash systems reactivated. MSLC officials stated that the agency's MIS department generates a daily exception report for all auto cash errors as well as a weekly report. Each week, the Compliance Analyst obtains a computer printout of all agents who had their auto cash systems reactivated during the prior week. He reviews this printout and identifies approximately 20 of the most egregious violators. During the period covered by our audit, MSLC said that it sent out a total of 120 letters to sales agents who were not in compliance with MSLC's policies and procedures for scanning Instant Game tickets. MSLC's Compliance Analyst also stated that he has occasionally called or actually gone to a sales agents place of business to discuss this matter with a sales agent. He further stated that in his opinion, this process has been effective because rarely does a sales agent continue to violate MSLC's procedures for cashing Instant Game tickets once they have been sent a letter of notification by MSLC. However, he did not give us documentation to substantiate this claim.

b. Inadequate Policies and Procedures: We found that there are no formal written policies and procedures as to how to MSLC staff should deal with habitual offenders. The Compliance Analyst stated that he would permanently disable the auto-cash system of all agents who have their auto cash system shut down more than three times and that he believes there are currently approximately 10 to 12 sales agents who have had their auto cash system permanently suspended. At this point, the Compliance Unit opens a case file that would include information such as identification of the individual who is responsible for the operation of the machine and a detail of the transactions that caused the errors. The Compliance Analyst would then send a letter to each sales agent which would instruct the sales agent to call the Compliance unit to discuss the problem. MSLC officials also stated that sales agents who are second offenders will have their ability to auto cash disabled until they are visited by a member of the Compliance Unit and that habitual offenders are referred to the Assistant Director for Compliance/Security for appropriate action. However, there are no formal written policies and procedures that describe when disciplinary measures other than the shutting down of a sales agent's auto cash system should be taken or what types of measures should be taken to control habitual abusers of the system. Further, the

Compliance Analyst stated that sales agents who have their auto cash system deactivated can simply call into MSLC's headquarters in Braintree during the same day and have a member of the Security Unit reactivate their auto cash system. The Compliance Analyst stated that he has provided the Security Unit with a memorandum that lists criteria (e.g., the sales agent states that one of his or her employees erroneously kept scanning losing tickets and did not know how to correct this problem), which as stated by the sales agent, is an acceptable reason for the Security Unit to reactivate the sales agent's auto cash system. The Compliance Analyst pointed out that there are only a few departments, including the Compliance and Security Units, that have the ability to reactivate a sales agent's auto cash system. The auto cash reactivation mechanism is a password-protected process contained within MSLC's G-Tech system within the agency's main computer system. This system contains a grid of all sales agents and shows the number and time of the violations if any, they have committed in a given day. Before a member of MSLC's Security staff will reactivate the system, he or she will listen to the explanation provided by the sales agent and will review the grid to determine when the violations occurred. If the security person determines that the explanation provided by the sales agent is reasonable and supported by the information in the grid, he or she can reactivate the auto cash system. The security person will then manually record the time and name of the sales agent that has had their auto cash system reactivated in a log that is maintained at the security desk. MSLC's computer system will also make an electronic record of this event. However, although this process has been established, it has not been documented with formal written policies and procedures that have been adopted and promulgated by MSLC relative to reinstating the auto cash system of sales agents during a work day. Further, MSLC staff do not have formal procedures that require staff to regularly generate and review reports that accumulate information over longer periods of time (e.g., annually) so that habitual abusers can be identified and dealt with in a more timely and decisive manner.

Regarding this matter, the Compliance Analyst and MSLC's Director of Revenue stated that they do not want to shut down a sales agent's ability to cash tickets because this would result in lost revenues and would therefore not be in the best interests of the Commonwealth. These officials further stated that in many instances, there is a reasonable explanation (e.g.,

an improperly trained employee) for a particular sales agent's auto cash system being shut down. However, it is MSLC's responsibility to have controls in place to ensure that abusers of the Lottery system are effectively identified and appropriately disciplined. Without such formal controls there is inadequate assurance that the state's Lottery system will not be abused by certain sales agents or that MSLC will be able to effectively identify and deal with abusers of the system in a consistent and equitable manner. As disclosed elsewhere in this report, we found instances where agents or members of their family in the same household have won $1 million dollar prizes. MSLC needs to review the controls over sales agents in order to maintain the public's confidence in the fairness and odds that they have a fair chance of winning.

Recommendation

In order to address this matter, we recommend that MSLC should establish and implement formal written policies and procedures relative to the measures that should be taken to address abusers of the MSLC's Instant Game ticket scanning system. At a minimum, such policies and procedures should detail specific levels of abuse and the types of actions that need to be taken relative to each level. All disciplinary measures taken should be documented. MSLC should then provide training to its staff on these policies and procedures. In addition, MSLC should consider prohibiting sales agents (principals/owners only, not employees) and families (See Audit Result No. 4) from purchasing tickets from their own stores, similar to the prohibition against MSLC employees from playing the Lottery.

8. IMPROVEMENTS NEEDED IN THE CONTROLS OF THE QUALITY OF INSTANT GAME TICKETS

In its Request for Proposals for the production of Instant Game lottery tickets as well as its contract with vendors that provide these services, MSLC specifies a certain level of ticket quality that needs to be maintained. According to these contract documents, certain ticket defects are considered by MSLC to be potentially harmful to both the realization of its maximum net revenue potential and the credibility of MSLC in the eyes of the consumers. Examples of such issues include:

- Play numbers lifting off and becoming unrecognizable when latex covering is scratched off under normal conditions.
- Foil or card stock that rips away when the latex covering is scratched off under normal conditions.
- Latex coverings that fail to come off when rubbed.
- Play symbols that are partially exposed rather than completely covered by latex.
- Latex coverings that have holes which expose portions of hidden play symbols or may cause the player believe that the ticket has been tampered with, even if no portion of the play symbols have been exposed.

The contract states that the vendor is responsible for replacing any defective tickets at no cost to MSLC and for paying for the cost of retrieving the defective tickets and redistributing the newly printed tickets.

In order to deter the distribution of defective tickets, MSLC has established a process whereby members of its staff routinely test the quality of tickets prior to distribution.

According to information provided to us by MSLC officials, during our audit period there were three significant instances in which Instant Game tickets were determined to have a defective coating that covers the numbers on the tickets and needed to be recalled and reprinted, as indicated in the following table:

Date of Recall	Game Name	Number of Tickets Recalled/Reprinted
January 2002	Deuces Are Wild*	12,960,000
April 2002	Jubilee 25	10,080,000
December 2001 through January 2002	Set for Life	3,986,700

*According to MSLC officials, these defective tickets were never distributed to sales agents. MSLC staff identified the defect and SGI reprinted the tickets before distribution.

Further, we were provided with documents that indicated that the reprinted tickets contained the same prizes as the original tickets, thereby maintaining the stated odds of winning prizes within the game. MSLC officials stated that they did not recover any costs associated with the retrieving and redistribution of these tickets because this was done by

MSLC staff during their regularly scheduled visits at sales agents and therefore no additional costs were incurred. However, during a five-month period there were three significant instances where Instant Game tickets needed to be reprinted. Therefore, MSLC should reassess the adequacy of the controls it has established and contractor performance to ensure the quality of its Instant Game tickets and if similar problems are encountered in the future, recover even its incidental staff, administration, and overhead costs from the vendor.

MSLC officials indicated that the problem with Instant Game tickets is that the older the ticket gets, the more likely a problem will exist because the latex hardens and when a player attempts to rub off the latex coating the number or symbol will not appear. MSLC is looking into this issue regarding the "shelf life" of an Instant Game ticket and is planning to come up with a solution (e.g., order less tickets, pull tickets back when they become old).

Recommendation

MSLC should reassess its policy regarding the recovery of incidental costs from its vendors regarding defective tickets and continue to evaluate the "shelf life" of Instant Game tickets, particularly in the event of repeated occurrences.

9. NONCOMPLIANCE WITH STATE LAWS RELATIVE TO REPORTING SHORTAGES, LOSSES OR THEFTS OF FUNDS OR PROPERTY TO THE OSA AND INCLUDING A STATUTORILY REQUIRED CLAUSE THAT ALLOWS THE OSA TO AUDIT THE BOOKS AND RECORDS OF ALL CONTRACTORS DOING BUSINESS WITH THE AGENCIES OF THE COMMONWEALTH

In accordance with Chapter 647 of the Acts of 1987, an act to improve internal controls within state agencies, MSLC is required like all other agencies to immediately report all unaccounted-for variances, losses, shortages or thefts of funds or property to the Office of the State Auditor (OSA). We determined that during calendar years 1999 through June 30, 2002, MSLC's records indicate that the agency had at least 2,895 incidents involving millions of dollars in lost or stolen Instant Game tickets that were not reported to the OSA so that the OSA can determine the cause, the breakdown in internal controls, and extent of the loss as required by this statute. As a result, MSLC cannot be assured that it has adequate corrective action plans and controls in place to minimize continued losses of this type. Additionally, according to state law, state agencies such as MSLC must include a clause in

every contract awarded that provides the OSA with the right to examine the records, books, accounts, and activities of the contractors doing business with the agency. We found, however, that the standard sales agent agreement that MSLC enters into with its approximately 7,600 sales agents does not contain this clause. As a result, MSLC's sales agents are not being properly informed of their statutorial obligation to allow the OSA to review their operations and ensure contract compliance and that state funds are being properly safeguarded against loss, theft, or misuse.

The specific problems we found relative to these issues are discussed in the following sections:

a. Noncompliance with the Requirements of Chapter 647 of the Acts of 1989 Regarding the Reporting of Shortages, Losses, or Thefts of Funds or Property to the OSA

The state Legislature, recognizing the inherent problem of agencies policing themselves, enacted Chapter 647 of the Acts of 1989. This statute directed and empowered the OSA to review the internal controls within agencies and instruct the agency about what needs to be corrected to prevent repeat occurrences, since such a review may not effectively be accomplished in an open and unbiased manner by an agency itself. The Legislature also recognized that an individual agency should not investigate thefts or shortages within its own operation and charged an independent agency, the OSA, with that additional responsibility.

Chapter 647 of the Acts of 1989 (see Appendix I), An Act Relative to Improving the Internal Controls within State Agencies, requires agencies to immediately report all unaccounted-for variances, losses, shortages, or thefts of funds or property to the OSA. This law also requires the OSA to determine the internal control weaknesses that contributed to or caused an unaccounted-for variances, loss, shortage, or theft of property; make recommendations to correct the condition found; identify the internal control policies and procedures that need modifications; and report the matter to appropriate management and law enforcement officials. Specifically, Chapter 647 states, in part:

> *All unaccounted for variances, losses, shortages or thefts of funds or property shall be immediately reported to the State Auditor's Office, who shall review the matter to determine the amount involved which shall be reported to appropriate management*

> *and law enforcement officials. Said Auditor shall also determine the internal control weaknesses that contributed to or caused the condition. Said Auditor shall then make recommendations to the agency official overseeing the internal control system and other appropriate management officials. The recommendations of said Auditor shall address the correction of the conditions found and the necessary internal control policies and procedures that must be modified. The agency oversight official and the appropriate management officials shall immediately implement policies and procedures necessary to prevent a recurrence of the problems identified.*

Our prior audit report identified that a theft of MSLC property at its Braintree headquarters was not reported to the OSA and that MSLC conducted its own internal review, contrary to Chapter 647. If the theft was reported to the OSA by MSLC it could have possibly prevented a second and subsequent theft that occurred at one of MSLC's regional offices since the OSA is charged with the responsibility of identifying the cause of such thefts, and recommending a solution. It is important that these incidents be reported immediately and investigated by the OSA as prescribed by law to ensure full and proper disclosure, resolution, and corrective action to preclude their reoccurrence. Our prior audit report recommended that MSLC management should refer to Chapter 647 and the Joint Awareness letter of the OSA and the OSC (see Appendix II) to clearly and fully understand their statutory responsibilities and implement all requirements of the law.

During our follow-up audit, we found that the Preface as well as Chapter II of MSLC's Internal Control Manual Policies and Procedures Volume 1 describes how MSLC staff should report all unaccounted-for variances, losses, shortages, or theft of funds or property to the OSA. Included in this manual are the applicable forms for reporting such incidents to the OSA. However, we found that MSLC was not following its own internal policies and procedures in this area. Specifically, we conducted a review of the lost/stolen ticket incident reports at MSLC sales agent locations and regional offices for the period January 1, 1999 through June 30, 2002. These incident reports are maintained by MSLC's Security and Compliance Department, which is responsible for investigating lost/stolen ticket incidents. During this period of time, there were no losses/thefts reported at MSLC's regional offices, as was the case during our prior audit. However, we determined that there were 2,895 reported incidents of lost/stolen lottery tickets at MSLC sales agent locations.

The following schedule summarizes these reported incidents using MSLC's incident categories for calendar years 1999 to June 30, 2002.

Summary of Incidents of Unaccounted for Variances of Instant Game Tickets Calendar Years 1999 through June 2002

Category of Incident	1999	2000	2001	2002	Total
Lost/Stolen Misplaced During Delivery	135	418	202	81	836
Unknown (1)	461	55	123	9	648
Larceny	127	140	108	47	422
Breaking and Entering	104	121	120	52	397
Inventory (2)	-	54	179	126	359
Theft at Sales Agent	-	7	54	23	84
Production (3)	-	27	36	6	69
Sales (4)	-	7	25	6	38
Armed Robbery	7	14	8	3	32
Fire	-	1	7	2	10
	834	844	862	355	2,895*
Dollar Amounts**	$1,150,526	$1,151,129	-	-	$2,301,655

*The number of tickets involved in these incidents could represent many thousands of individual tickets, but are not accounted for by MSLC.

**MSLC's does not record dollar values for all lost/stolen tickets because, according to MSLC officials, sales agents do not always provide this information. Consequently, the dollar values indicated are in all instances understated. According to MSLC records, the percentage of lost/stolen items that are included in these dollar amounts are as follows: 1999 (78%), 2000 (72%). MSLC officials were unable to provide dollar values for calendar years 2001 and 2002.

Explanation of Certain Lost/Stolen Categories:

(1) Unknown: Sales agents report missing tickets but have no explanation (e.g., theft) for the shortage.

(2) Inventory: These are the result of MSLC's Security and Compliance Division taking inventories of Instant Game tickets at sales agent locations and identifying missing tickets.

(3) Production: This category is used by MSLC to identify incidents in which a sales agents claim they received fewer books of tickets than they ordered.

(4) Sales: Incidents where sales agents report thefts to MSLC Sales Representatives instead of directly to MSLC's Security and Compliance Division.

Our review of the internal controls MSLC has established relative to this process indicated that MSLC has established written policies and procedures on how agency staff should

administer all reported incidents of lost/stolen tickets, including those stolen or misplaced during delivery. However, our review of the lost/stolen ticket incident summary reports revealed that MSLC did not report any of the aforementioned 2,895 incidents to the OSA and was therefore not in compliance with Chapter 647 of the Acts of 1989.

Regarding this matter, MSLC's Director of Revenue stated that it is MSLC's opinion that thefts/losses of property at sales agent locations are not subject to the requirements of Chapter 647. The Director added that although these tickets are technically the property of the Commonwealth, when a theft occurs, sales agents are required to report this matter to MSLC's Security and Compliance Division, which is open 24 hours per day. Once the incident is reported, MSLC immediately deactivates all the stolen tickets so they cannot be redeemed. If a sales agent does not immediately report the theft, according to MSLC's standard Lottery Sales Agent Agreement, the sales agent is responsible to the MSLC for all claims made against the stolen tickets until such time as they are deactivated. According to MSLC officials, because sales agents are liable for these cashed tickets, the Commonwealth's exposure to any type of loss is minimal. MSLC officials also pointed out that some of the incidents in the 2,895 number were the result of such things as delivery or production errors which are often corrected and do not result in actual lost or stolen tickets.

The Director of Revenue's assertion that Instant Game tickets are not subject to the provisions of Chapter 647 because the agent is responsible for all claims made against the stolen tickets until deactivated is contradictory to the terms and conditions of Section 3 of MSLC's standard Lottery Sales Agent Agreement, which states, in part:

> *All Lottery tickets, ticket stock, bet slips, advertising material, etc. (the "Lottery Merchandise") provided to the agent by the principal, and the proceeds from the sale of such lottery tickets (the "Lottery Tickets Proceeds"), shall at all times remain the exclusive property of the principal [MSLC], and the agent shall hold all the lottery tickets and lottery merchandise as property of the principal [MSLC], which property is to be under the direction and control of the principal [MSLC].*

While MSLC has limited its exposure to loss in terms of claims paid on stolen tickets, there are still lost costs associated with the production, distribution, and marketing of these tickets which represents a loss to the Commonwealth, however minimal MSLC believes it to be.

Given the fact that MSLC acknowledges in its standard Lottery Sales Agent Agreement that Instant Game tickets are the property of the Commonwealth, it is obligated to comply with all the requirements of Chapter 647 and report all lost/stolen ticket incidents to the OSA. The statute does not give discretion to agencies to decide at what point or threshold a loss is reportable. The law is clear and unequivocal; it states, "*all* unaccounted for vacancies, losses, shortages or thefts of funds or property shall be immediately reported to the State Auditors Office." While we acknowledge that some incidents such as those involving unaccounted-for tickets as a result of production or delivery problems may not result in tickets actually being lost or stolen, this fact does not mitigate the issue that the MSLC has a legal responsibility to report these and all other incidents that involve losses or unaccounted-for variances to the OSA. Moreover, MSLC officials stated that it does not reprint and redistribute any tickets that have been stolen, which limits its ability to accurately report to the public the number and amounts of outstanding winning tickets in each Instant Game, since winning tickets may be lost or stolen and deactivated and therefore not available for sale to the public. Regarding this matter, MSLC officials stated that the agency has recently implemented a policy whereby it notifies the public when the MSLC is about to close a game that a prize is not available. However, we believe that the public should be either notified of any prizes that may be unavailable in a specific game in a more timely manner or that MSLC should consider reprinting the exact tickets that were lost and stolen to maintain the amount of available prizes in each game.

b. OSA's Authority to Audit Contractors Books and Records Clause Not Included in Lottery Sales Agents Agreements as Required by Chapter 11, Section 12, of the General Laws

Chapter 11, Section 12, of the General Laws requires agencies of the Commonwealth to include a clause in every contract or agreement with its contractors that provides the OSA the right to examine the accounts, books, records, and activities of the contractors. Specifically, regarding this requirement this statute states, in part:

> *The department of the state auditor is hereby authorized to inspect, review or audit, in conformity with generally accepted government auditing standards, the accounts, books, records and activities of vendors contracting, having contracted, or agreeing to provide services or materials of any description, or any other thing of value pursuant to any and all contracts or agreements between the commonwealth, its*

> *departments, agencies, bureaus, boards, commissions, institutions, or authorities and said vendors to the extent necessary to determine compliance with the provisions and requirements of such contracts or agreements and the laws of the commonwealth. Any grant or contract entered into between an entity, including vendors, and a state agency shall include a clause providing the state auditor with access as intended by this section. [Emphasis added.]*

Moreover, the Commonwealth's new Standard Contract Form and instructions, effective January 24, 2001, contain a clause referring to the OSA's authority to access contractor records as required by Chapter 11, Section 12, of the General Laws. This standard clause formally notifies contractors of their responsibility to maintain adequate records and to make these records available for review by the OSA, thereby providing a mechanism to facilitate the proper oversight of these public contracts.

During our audit we reviewed a sample of 75 MSLC contracts that were in effect during fiscal year 2002. Based on this review, we determined that, in most instances, MSLC uses standard contract forms to award contracts to its vendors. During fiscal year 2001, MSLC had 110 contracts totaling $105,647,752 with vendors for various goods and services. Further, based on information we were able to obtain from the Massachusetts Management Accounting and Reporting System (MMARS), as of January 25, 2002 MSLC had 77 contracts with vendors and had expended $62,494,765. However, we found that the standard contract forms that MSLC uses for its Lottery Sales Agent Agreements do not contain a clause providing the OSA with access to these vendors' records as required by Chapter 11, Section 12 of the General Laws. MSLC officials stated that, in their opinion, it is not necessary to have this clause in its Sales Agent Agreements. However, the language of Chapter 11, Section 12, clearly indicates that inclusion of this clause in all contracts with vendors who do business with state agencies is mandatory, not discretionary.

Given the billions of dollars in revenue being generated by the approximately 7,600 sales agents that are awarded these contracts (see Section a) and the fact that these agents are experiencing losses, shortages, thefts, and variances, failure by MSLC to include this language in its contracts and agreements to make agents aware they are subject to audit and its failure to properly report such losses to the OSA for review clearly is inappropriate and not in the best interests of the Commonwealth.

Recommendation

In order to minimize the repeated occurrences of lost, stolen, and unaccounted-for tickets, we recommend that MSLC management again refer to Chapter 647 and the Joint Awareness letter of the Office of the State Comptroller and the Office of the State Auditor, to clearly and fully understand their statutory obligations. MSLC management should then take measures to ensure that it reports all losses and thefts of funds or property, including Instant Game tickets, to the OSA as required by law. Also, MSLC should consider measures to notify the public of any changes in available game prizes that have resulted from lost/stolen tickets.

In order to ensure and maintain the public's confidence in the fairness of the game and their odds of winning, MSLC should consider restoring and replacing all such tickets. Otherwise, it is unfair for people to be chasing a chance to win a prize when prizes may not be in the game. In this regard MSLC should consider requesting the vendors to reprint tickets to duplicate the lost or stolen tickets and return them to circulation.

In addition, MSLC's Lottery Sales Agent Agreements should be immediately amended to include a clause providing the OSA access to contractors' books and records as required by Chapter 11, Section 12, of the General Laws. Further, MSLC should take measures to ensure that in the future, all contracts and agreements entered into by MSLC contain this clause. MSLC's informing all sales agents that they are subject to audit by the OSA to the extent of their Lottery operations may provide an additional deterrent to continued losses and shortages.

10. POTENTIAL COST SAVINGS LOST AS A RESULT OF AN INEFFICIENT CONTRACTING PRACTICE

The MSLC may not have utilized efficient contracting practices when it awarded its most recent contracts for the production of Instant Game lottery tickets and related marketing services. Specifically, previous contracts awarded by MSLC for these goods and services contained a "most favored customer" clause that guaranteed MSLC would get the best price available from the contractor for these items. In August 1999, MSLC awarded its most recent contracts for these goods and services but these contracts did not contain this clause,

the incluson of which has resulted in MSLC cost savings and reimbursements of at least $279,851 in the past as a result of our prior audit. The most favored customer clause stipulates that during the contract term, the supplier shall not furnish instant tickets to another Lottery, company, or organization, at prices less than those established for MSLC. Such prices would be adjusted in making such comparisons for quantity, quality, inflation and other factors. MSLC officials stated that they were not required to include this clause in these new contracts and did not do so because in their opinion, it would be to hard to administer.

Our prior audit recommended that MSLC expeditiously complete the Request for Proposals (RFP) process so that a new favorable Instant Game tickets printing contract could be awarded before MSLC's current contract expired. During our follow-up audit, we found that on May 6, 1999, MSLC issued a Request for Responses (RFR) for instant lottery tickets, game designs, and marketing services. On August 2, 1999, MSLC awarded a two-year contract[1] (with options to renew for an three additional one-year periods) to Scientific Games International, Inc., and Pollard Banknote Limited (Pollard). Under these contracts, SGI was considered the primary supplier, and as of the end of our audit period SGI had a contract maximum obligation of $28,725,591. According to MSLC officials, Pollard is considered a secondary supplier of these tickets and as of the end of our audit period Pollard had a contract with a maximum obligation of $11,674,409. Neither the RFR nor the contracts that were awarded to SGI and Pollard contained the "most favored customer" clause.

Regarding this matter, on March 4, 2002, MSLC's Assistant Executive Director/General Counsel sent a memorandum to MSLC's Director of Revenue in which he explained the reason for not including the clause in this contract, as follows:

> *The Lottery has used the Procurement Regulations outlined in 801 CMR 21.00 for many years. These regulations are quite comprehensive and are promulgated by the Operational Service Division (OSD) of the Office of Administration and Finance. Although the regulations are mandated for Executive Branch Departments, other Constitutional Offices (i.e., Treasury) are encouraged to take advantage of the bidding process outlined in said regulations. OSD revised the Regulations in the mid-*

[1] This contract was subsequently extended through August 1, 2002.

> *1990's. The regulation regarding "most favored customer" was dropped by OSD at that time. It is our understanding that it was dropped by OSD because of the difficulty of enforcement. Therefore, when the Lottery went out to bid in 1999 the provisions of "most favored customer" were not part of 801 CMR 21.00.*

MSLC officials also stated that MSLC establishes specifications (e.g., size of tickets, paper quality) that is different from other states and therefore it would be difficult for MSLC to enforce this clause even if it were part of the contract. Moreover, they stated that there are currently only a few companies in the United States that produce lottery instant tickets.

However, even though OSD revised its regulation regarding the "most favored customer" clause, OSD's Procurement Policies and Procedures Handbook recognizes that there are opportunities for maximizing the value of a procurement through "collective purchasing." This type of procurement can result in savings by "teaming" with other entities in the procurement process. Because of the limited number of companies that produce lottery tickets and the resultant limited competition, MSLC could "team" with other states to collectively purchase tickets with other states, which could result in cost savings.

Recommendation

Since there is limited competition in this industry and it is likely that most other state lotteries use these same vendors, MSLC should seek to create an arrangement to purchase as a consolidated group with those other state lotteries in all subsequent procurements and contracts for its production of the Instant Game tickets and related services. The cost savings from such multi-state collective procurements would likely result in greater costs savings.

11. UNALLOWABLE NON-BUSINESS-RELATED EXPENSES TOTALING $3,417 INCURRED BY MSLC EMPLOYEES WHILE REGISTERED AT A CONFERENCE

During fiscal year 2001, eight members of MSLC's administrative staff registered for a conference in Dallas, Texas. MSLC employees who went to Dallas for the conference allegedly pursued leisure activities such as golf and sightseeing while they should have been attending the conference business meetings. The Office of the State Treasurer's First Deputy conducted an internal investigation, which resulted in certain MSLC staff members being required to reimburse the MSLC a total of $117 of the total $13,345 in conference

costs for what determined to be inappropriate expenses, and each member forfeited one vacation day. However, we determined that these individuals should have reimbursed MSLC as much as $3,417 for expenses during this trip, including a portion of the airfare, conference fees, hotel, interest, and other expenses incurred for time not spent at the conference.

During fiscal year 2001, eight members of MSLC's administrative staff attended a conference of the North American Association of State and Provincial Lotteries (NASPL) in Dallas, Texas, hosted by the Texas Lottery Commission. This conference, which was held between September 26 and October 1, 2000, offered a variety of educational programs relating to gaming, marketing, communications, technology, and legal security issues affecting state lotteries and also included a trade show.

Subsequent to this conference, a local media organization criticized certain activities of MSLC's staff at this conference, alleging that certain individuals were sightseeing and playing golf while they should have been participating in conference sponsored activities. As a result of the concerns raised in the media, the First Deputy Treasurer conducted a review of the activities relative to the eight individuals who attended this conference. According to documents maintained by MSLC, the First Deputy Treasurer's review consisted of an examination of various documents (e.g., expense reports) relative to the conference, a review of MSLC's travel policies relative to attending conferences, and interviews with the eight MSLC employees who registered at the conference.

On December 18, 2000, the First Deputy Treasurer sent a memorandum to the State Treasurer in which he detailed his review in this matter. In this memorandum, the Office of the State Treasurer's First Deputy Treasurer stated that the media report did not recognize any MSLC employee attendance at other NASPL events, such as a meeting of all Lottery Directors or their participation at the conference trade show, and contended that in some respects, information provided in the media broadcast was incorrect. However, this memorandum went on to state:

> *A weakness in the existing policy, however, involves the lack of any guidance regarding the appropriate number of Lottery employees that the Executive Director should allow to attend the same conference. As I understand it, in the past the*

Lottery would usually send about a dozen employees to the annual NASPL conference. While it is clear that the eight employees that attended this year's conference represent a variety of the Lottery's business units (MIS, Sales, Marketing, Public Relations) without significant overlap, it is reasonable to question whether it was necessary to send eight individuals to the same conference....

During my interviews with those eight Lottery employees who attended the NASPL conference, each recounted a significant amount of detail about their participation at the NASPL conference. However, as noted above, the NASPL conference provided an opportunity for Lottery employees to attend general and breakout sessions on a variety of topics, from marketing to information technology. While the Lottery employees did attend some of these sessions, it is clear that they, and the Lottery, would have benefited from other sessions that weren't attended by any employee of the Massachusetts Lottery. In the future, Lottery employees must understand that if they attended a NASPL conference, or any other conference, they are there to gather as much information as possible, from attending the trade show and breakout sessions to participating in large meetings and informal discussions. While there is always free time built into any conference schedule, it must be made clear to everyone at the Lottery who may attend a conference, if it isn't already, that their focus must be on learning about new technologies and new approaches that will help the Lottery do its job better.

On a couple of instances Lottery employees didn't attend the conference for a period of time for recreational purposes. On Thursday, September 28, five of the employees left the conference at about 11:30 am to visit Dealy Plaza, which, as I understand it, houses the JFK Museum among other attractions. They all returned to the conference approximately two hours later. Additionally, one of the employees played golf while conference sessions were being held. Another Lottery employee also played golf upon arriving in Dallas on Tuesday morning because his first NASPL meeting wasn't until 4pm, but he appropriately used vacation time.

Based on this review, the First Deputy Treasurer made the following recommendations:

- All requests from Lottery employees to attend out-of-state seminars or conferences should require preapproval from the Treasurer or First Deputy Treasurer, in addition to the Executive Director. Employees should only be approved to attend a conference if it makes good business sense.

- As part for the preapproval process, all employees requesting to attend a seminar or conference should be required to identify what specific workshops or seminars would help them perform their jobs at the Lottery.

- In order to facilitate the spread of information to relevant employees who do not attend a conference, all employees who attend a seminar or conference should be required to submit a follow-up report highlighting what workshops and other related events they attended and what information should be shared with their co-workers.

- Employees attending the conference should reimburse the Lottery for cab rides that were not directly related to their participation at NASPL. The travel policy should be revised to provide more guidance on what are proper reimbursable expenses, particularly with regard to cab fares, and employees should be educated about these guidelines.

- Require employees who were away from the business conference or sessions to forfeit vacation time.

Based on this review, MSLC was repaid $117 for some unallowable cab fares of the $13,345 in costs incurred while sightseeing by these eight MSLC employees who registered for the conference, as indicated in the following table:

NASPL 2000 Conference Travel Cost/Reimbursement Summary

Employee Title	Conference Fee	Air Fare	Hotel	Other Expenses	Repayment of Cab Fare	Net Expenses to the State
Executive Director	$625	$877	$433	$162	$(89)	$2,008
Chief of Staff	625	862	431	96	(28)	1,986
Assistant Director, Regional Operations	625	267	576	41		1,509
Assistant Manager of Operations	625	267	576	61		1,529
Associate Product Manager	625	267	576	72		1,540
Product Manager	625	267	575	173		1,640
Public Relations Coordinator	625	267	431	33		1,356
Assistant Operation Director	625	240	720	75	0	1,660
Total	$5,000	$3,314	$4,318	$713	$(117)	$13,228

Additionally, on January 3, 2001 MSLC's Executive Director in a memorandum instructed the agency's Assistant Director of Human Resources to charge each of the eight registrants, including himself, one vacation day "for the time individuals spent away from the conference." However, the Executive Director did not determine the amount of Commonwealth funds expended while these individuals were on vacation. We confirmed that each of the eight attendees was in fact charged one vacation day on January 6, 2001.

We also reviewed all of the documentation being maintained by MSLC relative to the conference and noted that no documents (e.g., attendee summaries, attendance records) indicate how much time each attendee actually attended conference-related rather than personal activities. Consequently, the actual time spent by these eight individuals at

conference-related activities could not be demonstrated by the MSLC. Based on the determination that the travel-related costs for the eight employees for one day, amounts to least $3,417, the Commonwealth should not pay for the hotel, meals, and other related expenses while these individuals were on vacation.

The following chart shows the analysis of these costs for the eight MSLC employees who took the trip to Dallas, including interest for expenses incurred by them while on vacation and not attending the conference. The chart prorates the ineligible expenses for airfare, conference fees, hotel, cab fare, meals, and calculated interest, as follows:

2000 NASPL Conference

Summary of NonReimbursable Conference Expenses

Employee Title	Air Fare (1)	Conference Fee (2)	Hotel (3)	Cab Fare (4)	Meals (5)	Interest (6)	Total
Executive Director	$219	$156	$ 144	$ 55		$ 14	$ 588
Chief of Staff	215	156	144	28	$13	14	570
Assistant Director, Regional Operations	53	125	144	41		9	372
Assistant Manager of Operations	53	125	144	41		9	372
Associate Product Manager	53	125	144	54		9	385
Product Manager	44	104	144	47	17	9	365
Public Relations Coordinator	67	156	144	15	5	9	396
Assistant Operation Director	48	125	144	43	-	9	369
Total	$752	$1,072	$1,152	$324	$35	$82	$3,417

(1) The nonreimbursable airfare amount was calculated by dividing each individual's total airfare by the number of days they attended the conference to determine the daily charge to prorate.

(2) The nonreimbursable conference fee amount was calculated by dividing the $625 conference fee by number of days each participant attended according to their documented flight schedules to determine the daily charge to prorate.

(3) This is the cost of one night's (vacation portion) stay in the hotel.

(4) MSLC recovered $117 in what it deemed to be unallowable cab fares. However, we reviewed the receipts for all cab fares reimbursed and found that, in all but one instance, the receipts did not indicate the business nature of the travel. Even allowing one cab trip from the airport to the hotel and then back to the airport, the other cab fares which totaled $324 are all unallowable as opposed to the $117.37 MSLC received in reimbursements. This fact is further supported by MSLC's current Employee Travel and Reimbursement Policy, which states "cab fare reimbursement will be from hotel to point of Lottery business or from home to airport or hotel to airport only."

(5) MSLC's travel policies and procedures in effect during this period allowed for reimbursements of $3 for breakfast, $5 for lunch, and $9 for dinner per person. The questioned amounts for the Chief of Staff and the Public Relations Coordinator are in excess of those allowed by this policy. The questioned amount for the Product Manager was one day's meal expense.

(6) The estimated reimbursements for these expenses were made from MSLC's Regional Depository Account. The average interest rate earned on this account during a sample of months during our audit period was .0012831% per month. We multiplied this .0012831% times 19 months (the last day of the conference through the end of our audit period to get a rate of return of .02438) times the additional reimbursements owed to calculate an appropriate rate of reimbursement for lost interest.

Regarding this matter, MSLC officials stated that they believed that the recommendations of the First Deputy Treasurer were necessary and that the agency has taken measures to improve the controls in this area. MSLC officials further stated that the First Deputy Treasurer provided the results of his review to a State Ethics Commission (SEC) special investigator, who indicated that no further review or presentation to the SEC was warranted at that time, and to Chief of the Public Integrity Division of the Attorney General's Office, who indicated that this was not a criminal matter. Finally, MSLC officials stated that although the agency's Executive Director charged each of the eight people, including himself, who registered for the conference one vacation day, in fact, these individuals only spent two hours away from conference-related activities. Consequently, these officials stated that they believe that these eight individuals have more than adequately reimbursed MSLC in this matter.

However, based on our audit work, although MSLC officials stated that these eight staff members only spent two hours away from conference related activities, they did not provide us documentation to substantiate this claim. To the contrary, the First Deputy Treasurer clearly states in the third paragraph, that one employee played golf while conference sessions were being held. However, overall the forfeiture of one vacation day and the return of $117 generally settles the matter.

We determined that one MSLC employees attended the 2001 NASPL conference in Albuquerque, New Mexico. Based on our review of the documentation relative to the expenses incurred by the MSLC employees attending this conference, MSLC has implemented many of the recommendations made by the First Deputy Treasurer. However, although a summary of the 2001 NASPL conference was prepared, a requirement that such summaries be prepared has not been formally incorporated by MSLC in its written policies and procedures.

Recommendation

For guidance on the proper, fair, and equitable computation to reimburse the Commonwealth for non-business-and vacation-related expenditures, MSLC should refer to OSA Audit No. 2001-5084-2 relative to our review of administrative and operating expenditures incurred by seven state retirement boards. Further, MSLC should improve its controls over the attendance of staff at training conferences and seminars (e.g., formally requiring staff members to document the time spent attending conference-related activates).

12. NONCOMPLIANCE WITH CERTAIN PROVISIONS OF THE STATE'S OPEN MEETING LAW

According to Chapter 39, Section 23B, of the General Laws, public entities such as MSLC are required to hold meetings which are open to the public to ensure that citizens of the Commonwealth have the opportunity to be aware of the activities that are being conducted by these agencies that are being paid for with public funds. We found, however, that despite these statutory requirements, at least five instances occurred during our audit period in which MSLC's Commission did not fully comply with the requirements of this statute when convening meetings in executive session. For example, contrary to state law, MSLC did not maintain minutes of any of the matters discussed in the executive sessions of these five meetings and in four instances did not state the reasons for convening into executive session. As a result, the citizens of the Commonwealth cannot be assured that MSLC did not circumvent the requirements of this statute and convene into executive sessions for reasons other than those allowed by Chapter 39 and inappropriately deny the public access to agency information.

Chapter 39, Section 23B, of the General Laws, commonly referred to as the Open Meeting Law, was enacted to ensure that meetings of governmental bodies are open to the public so that citizens can be aware of certain activities and decisions being made by public agencies that are being operated with public funds. To this end, this statute details specific criteria for the conduct of both open session and executive session (those not open to the public), meetings of governmental bodies.

As part of our audit, we reviewed the minutes of 14 meetings of the Commission that were held between the period October 26, 1998 and June 11, 2001[2]. The purpose of this review was both to gather information on MSLC's activities during the period under audit as well as to assess MSLC's compliance with the provisions of Chapter 39 of the General Laws.

During the 14 meetings that we reviewed, the Commission voted to convene into executive session five times: on March 19, 1999 (two sessions), July 19, 1999, September 13, 1999, and April 12, 2000. We found a number of instances where the Commission did not fully comply with the requirements of Chapter 39 regarding executive session meetings, as follows:

- For all five executive sessions, the presiding officer did not state whether the Commission would reconvene after the executive session. We determined that in all five instances, the Commission did in fact reconvene the regular meeting.

- For four of the five executive sessions, the presiding officer did not give a reason for convening the Commission into executive session. In one instance (the March 19, 1999 meeting) a reason for convening into executive session was stated. However, the reason was recorded as "personnel matter," which is general in nature and not specific enough to determine whether this was an allowable reason under the statute.

- For one of the five executive sessions, a roll call vote was not taken prior to the Commission's going into executive session. For the remaining four executive sessions, the minutes of the opening meeting indicate that the Commission "unanimously" voted to convene into executive sessions, but the vote of each member was not recorded on a roll call vote and entered into the minutes as required by the statute.

- On March 19, 1999, a motion to go into executive session was made by an "Acting Executive Director" who was not a member of the Commission and therefore did not have the authority to make such a motion.

- The Commission did not maintain minutes for all five of these executive session meetings.

[2] Although our audit period extended through June 30, 2002, MSLC officials were only able to provide us with the minutes of Commission meetings through this date. According to MSLC officials, this was because the minutes of any other meetings that may have been held were not yet approved by the Commission.

Because minutes of the open sessions of these Commission meetings did not in all cases adequately document the reason for the Commission's convening into executive session, MSLC did not keep minutes of executive sessions, and other procedural activities contained within the Open Meeting Law were not adhered to, MSLC was not in compliance with Chapter 39 and the citizens of the Commonwealth cannot be assured that the Commission did not circumvent the requirements of the Open Meeting Law and adjourn into executive session meetings for reasons other than those allowed by Chapter 39 and inappropriately deny the public access to agency information.

We discussed this matter with MSLC's General Counsel, who told us that, in his opinion, if no votes were taken by the Commission in executive session, then no minutes were required to be maintained. However, Chapter 39 requires that minutes of meetings be maintained for all meetings, including those held in executive session. This fact is further supported in Massachusetts Practice, Administrative Law, Chapter 18, Section 1421, entitled Maintenance of Meeting Records, which states, in part:

> *There is no way for the governmental body to avoid the statutory necessity for maintaining accurate records by going into executive session....*
>
> *The device of a governmental body going into executive session does not negate the continuing overall requirement that a governmental body must maintain accurate records of all of its meetings.*

The General Counsel added that the other issues we identified (e.g., the Commission's not taking a roll call vote prior to convening into executive session) were merely technical oversights. However, given the importance of holding fair, open public meetings and complying with the law, the MSLC should take measures to ensure that no such technical oversights occur.

Recommendation

The Commission should take measures to ensure that it fully complies with all the requirements of Chapter 39, as follows:

- Maintain minutes of executive session meetings, including all discussions regardless of whether votes are taken.

- Announce whether the Commision will reconvene after the executive session.
- Ensure that presiding officers state the reasons for convening into an executive session.
- Take a roll call vote prior to entering into an executive session.
- Ensure that only members of the Commission make motion to enter into an executive session.

13. ACCOUNTS PAYABLE OF $2,271,847 OUTSTANDING OVER EIGHT YEARS

According to policies established by the State Comptroller, state agencies are required to take the measures necessary to ensure that disputed bills are resolved in a timely manner. During our audit, we reviewed the telephone bills received by MSLC during fiscal years 2001 and 2002 (through March 31, 2002) and found that MSLC had an outstanding balance payable to Verizon in the amount of $2,271,847 as of March 31, 2002. According to MSLC officials this outstanding balance has not been resolved in over eight years. Because MSLC management did not resolve this disputed bill in a more timely manner, there is less assurance that this dispute will be resolved in the most equitable manner.

During our audit we assessed the controls MSLC established relative to the payment of bills for goods and services. According to MSLC's Budget Policies and Procedures Manual, MSLC staff are required to expedite the payment of bills. Specifically, the section of the manual entitled Invoice/Bill Payment Approval Procedure states, in part:

> *Bills should be forwarded in a timely fashion as the commonwealth must pay interest on bills that are over 30 days old. . . .*

This manual also establishes specific procedures for the payment of bills. Although MSLC has policies and procedures relative to the payments of bills, it did not during our audit period have any formal written policies and procedures on how to resolve disputed bills. Rather, the agency's Chief Financial Officer stated that MSLC merely follows the procedures established by the Office of the State Comptroller (OSC). According to Memorandum No. 289 issued on October 29, 1999 by the OSC, the following is the Commonwealth's policy relative to invoices that it receives that are deemed by agency staff to be unacceptable:

> *The department has fifteen (15) days (30 days for Medicaid providers) from the receipt of an invoice to notify the vendor with written reason(s) why an invoice has been rejected and identifying requirements to cure the deficiency. If the invoice is incorrect or cannot for good reason be accepted, it should not be held by the department and negotiated, it should be returned to the vendor immediately. . . .*

We reviewed the telephone bills paid by MSLC during our audit period and found that, as of the end of our audit period, MSLC had an outstanding balance due Verizon totaling $2,271,847. MSLC officials did not provide us with any documentation that indicated that MSLC adhered to this policy and notified the vendor with written reasons as to why the invoices relative to this payable were incorrect or what needed to be done to remedy the situation.

As a result of our audit, MSLC officials looked in to this matter. We were provided with all the documentation the agency was maintaining (e.g., the dates on which the liability was incurred, the reason for the liability, and what has been done to resolve the liability). On June 19, 2002 MSLC's Chief Financial Officer provided us with a memorandum indicating that he did not concur with the amount claimed as a receivable and said that he had not received sufficient documentation from Verizon to substantiate that MSLC owes anything:

> *In August of 2001, the Massachusetts State Lottery Commission initiated an audit of our telephone billings. This audit revealed that over the years, Verizon had over-billed the Commission. In working with Verizon, we also discovered that in five separate instances they had not correctly applied/recorded payments from the Commission. In an effort to reconcile this issue, over the past several months I have met with various service managers, corporate account managers, directors, and general managers from the Verizon Corporation. As of today, we have reduced the number in question by almost seventy four percent. It also appears to me that during the transitions from NET&T to Bell Atlantic to Verizon, etc., there may have been some billing problems. Additional meetings have been scheduled with Verizon to address this matter.*

On June 27, 2002, MSLC's Chief Financial Officer (CFO) provided us with a memorandum in which the CFO provided the following additional comments on this matter:

> *Verizon has been carrying an amount due from the Massachusetts State Lottery Commission of $2.3 million dollars for more than eight years. Over the past year, we have been working with several senior Verizon employees to reconcile this purported amount due to Verizon. We have reviewed previous charges, credits and payments going back to 1993 (the last year that payment records are available in MMARS). In early June, Verizon agreed that the billing statement was overstated by $1.7 million.*

> *This overestimate was the result of Verizon not applying five separate lottery payments. Also, Verizon has over-billed the lottery $500,000 over the years which we discovered during an audit initiated by the lottery. Verizon agreed to credit the lottery account for the five billings that were not applied and the overpayments for a total of $1.7 million. However, the invoice will not reflect the credit for approximately two months.*
>
> *After the parties agreed to the $1.7 million over-statement, we went to work doing a month by month, year by year analysis of the New England Telephone, NYNEX, Bell Atlantic, Verizon charges and credits. We then analyzed the lottery records and payments. Our analysis confirms that Verizon does not apply timely lottery payments in a timely manner. This poor business/accounting practice partially skewed the data and analysis. We therefore agreed on an amount paid by the lottery in fiscal year 2002 through April 30, 2002 and worked our way back to and including fiscal year 1993. The result for this analysis suggest that the lottery may owe Verizon approximately $350,000, or Verizon may owe the lottery approximately $150,000.*
>
> *The analysis continues. As stated in my previous memo to your staff on this matter, unless and until Verizon produces documentation that proves the lottery has not paid for service, we will not honor the bill. The lottery will not pay services that have not been delivered or received.*

MSLC's CFO stated that the agency had hired a consultant to review this matter and all telephone bills but did not provide us with any documentation (e.g., written report), indicating the results of this consultant review. MSLC's CFO stated that MSLC is currently working with Verizon to resolve this issue that MSLC is currently complying with OSC's policy for resolving disputed invoices and is paying all other bills in a timely manner as independently confirmed by the OSC. Nevertheless, this matter should have been addressed at the time the disputed charges began to occur so that the individuals involved would be aware of the circumstances relative to the charges and the matter could be resolved in an informed and equitable manner.

Recommendation

MSLC should continue to resolve this matter and take measures to ensure that it continues to comply with OSC and MSLC policies in dealing with disputed invoices. In the future, MSLC should ensure that any questionable expenses or invoices are resolved in an equitable and expeditious manner.

14. PRIOR AUDIT RESULTS UNRESOLVED OR PARTIALLY RESOLVED

During our follow-up audit we determined that MSLC officials had not taken all measures to adequately address certain issues identified during our prior audit with regard to (a) winner identification security and internal controls, (b) certain payroll practices, (c) internal control procedures and system descriptions, (d) internal controls, security, oversight, and monitoring practices over sales office revenue collection and processing, and (e) collection of cash revenue held by sales agents. The issues that have not been completely resolved are discussed below:

a. Improvements Needed Regarding Winner Identification Security and Internal Controls

During our prior audit, we determined that MSLC did not have an adequate internal control system to properly verify names, Social Security numbers, and other pertinent data for prizewinners cashing tickets at MSLC offices. We found that some prize claimants gave false and incomplete information to MSLC to avoid state and federal tax liabilities and child support payment obligations, hide the fact that prizewinners may be receiving public assistance, and make claims on behalf of others, or for a number of other reasons. Certain MSLC prizewinners used false identification documents, names, addresses, and Social Security numbers and filed incomplete and erroneous claim forms, which resulted in numerous questionable conditions and situations that a reasonable person would believe are indicative of control and security problems that should be pursued further and eliminated, especially in an environment such as MSLC, where security and controls are critical.

In addition, we found many instances of claimants having names that appeared unusual or suspicious. Further examination revealed that many of these claimants used Social Security numbers that were not found by a commercial person identification service, gave telephone numbers that were not listed, and listed nonexistent post office boxes as mailing addresses. Moreover, our prior audit revealed that almost 1,800 IRS W2-G income information forms amounting to almost $7 million were returned as undeliverable by the United States Postal Service. These returned W2-G forms indicate a very high probability that these gambling winnings were unreported and resulted in tax and other forms of evasion.

These deficiencies resulted in a number of instances in which it appeared that individuals other than the actual prizewinners where able to claim prizes for the actual prizewinners. Such conditions could cause a number of serious issues, such as evasion of state and federal tax liability, underpayment of taxes by using false identification if the prizewinner is in a tax bracket higher than MSLC's withholding rates, lessening of the amount of state and federal taxes by using a person (a professional casher) to cash a winning ticket for a fee that is less than the winner's tax liability, avoidance of paying past-due child support, avoidance of lessening public assistance payments by the amount of prize winnings (welfare fraud), and evasion of law enforcement agencies for any number of reasons.

During our follow-up we determined that MSLC had made some improvements as follows:

- We found that MSLC has implemented a number of controls over its claimant identification process in terms of identification and documentation criteria. For example, according to MSLC policies and procedures, all claimants for prizes over $600 must provide the claims desk staff member with a signed photo identification, proof of Social Security identification, and proof of address, city, state, and zip code. MSLC defines acceptable forms of this identification in its policies and procedures as follows:

Acceptable Forms of Photo ID	Acceptable Forms of Social Security Number
Drivers License	Drivers License
Mass ID	Social Security Card (signed)
Passport	Health Insurance Card
Work ID with signature	Medicare Card
Military ID	Military ID

  Additionally, MSLC has established policies and procedures that detail how agency staff are required to resolve and document instances when claimants cannot provide the requisite forms of acceptable identification.

- Effective February 2000, MSLC began using a commercially available people identification information service called T.C.I. Experian Database. However, this service is not used when processing all claims but is used in various situations such as when the prize claimant presents an unacceptable form of identification, does not have complete identification, or has conflicting identification.

- MSLC has taken some measures to report to the IRS and DOR professional cashers and others who possibly may be evading taxes. Specifically, MSLC has instituted a procedure whereby a list of multiple prizewinners who have claimed 20 or more prizes at MSLC totaling $20,000 or more in a calendar year is compiled. These lists are forwarded to both the IRS and DOR on a monthly basis. However, our tests revealed instances (See Audit Results No. 1, 2, and 3) in which certain individuals may still have been able to compromise the Lottery system. Also, certain individuals were either unreported or had their total prize claims underreported. Effective April 3, 2001 MSLC adopted a policy whereby all claimants who redeem their winning tickets to one of the claim centers receive their IRS Form W2-G attached to their checks. The only time the IRS W2-G forms are mailed at the end of the year are for those individuals who have won significant individual prizes and are receiving annual payments over a specified period of time. However, it should be noted that because MSLC did not adopt this policy until April 3, 2001, between the period covered by our last audit through April 1, 2001, a total of 4,446 IRS Form W-2Gs that reported $21,213,562 in income to claimants were returned by the US Postal Service to MSLC as being undeliverable, as indicated in the following table:

Summary of Returned Form W-2Gs

Calendar Years 1999 through 2001

Calendar Year	Form W-2Gs Mailed	Form W-2Gs Returned*	Dollar Value of Returned Forms
1999	62,627	1,717	$10,191,807
2000	76,932	2,065	$8,127,310
2001	30,181	664	$2,894,445
Totals	169,740	4,446	$21,213,562

* If more current information is made available (e.g., a more current mailing address) MSLC will resend IRS Form W-2Gs. For example, of the 3,782 IRS Form W-2Gs returned to MSLC during calendar years 1999 and 2000, the agency resent 353.

Also, MSLC does not account for total multiple winnings by a claimant on one IRS Form W2-G. According to MSLC's Director of Revenue, it is the agency's opinion that current IRS regulations require MSLC to account for each occurrence of a winning ticket as a separate transaction for income tax withholding purposes. However, we found problems MSLC's current income tax withholding practices (See Audit Result No. 1).

- MSLC provided training to its staff regarding the implementation and compliance with MSLC policies and procedures and applicable laws, rules, and regulations regarding winner identification, security and internal controls over these matters.

While MSLC has taken some measures to improve the controls over the winner identification process we determined that there are still several internal control issues and improvements that are needed in this area, as follows:

1. Inadequate Controls to Ensure That Sales Agents Who Owe Millions to MSLC Cannot Cash Prizes without First Repaying Their Debt: As of the end of fiscal year 2001, 1,232 suspended or terminated sales agents owed MSLC a total of $10,020,517 (see Audit Result No. 5). However, MSLC has no controls in place to ensure that these delinquent agents are unable to cash prize tickets without first repaying their debt to the Commonwealth. MSLC officials stated that when sales agents are issued a sales agents license it is typically done using the sales agent's Federal Identification Number (FIN) rather than the individual's Social Security number. Consequently, MSLC could not determine the extent to which delinquent sales agents may have been able to claim prizes from MSLC during our audit period. MSLC should consider placing liens or take other means to collect these funds.

2. Inadequate Controls Relative to Ensuring Prohibition against MSLC Employees' Immediate Family Members Purchasing a Ticket or Claiming or Sharing a Prize: According to Chapter 10, Section 31, of the General Laws, no member or employee of MSLC or any MSLC employee's spouse, child, brother, sister, or parent residing in their same household can either purchase a lottery ticket or share or claim a prize. Although MSLC requires its employees to sign a form acknowledging that they are aware of this policy, the agency has not established controls to ensure that its staff and applicable household members are adhering to this statute. Specifically, MSLC does not require its staff to provide the Social Security numbers of family members living in their household to MSLC. During our audit, we obtained the names and Social Security numbers of 138 of the approximately 425 MSLC employees who were employed by the agency during calendar year 2001. We compared this information with the names and Social Security numbers of individuals who claimed prizes of $600 or more during calendar year 2001 and did not identify any of the 138 MSLC employees in our sample as being prize claimants during this calendar year. However, for the reasons previously mentioned, it was not possible to determine whether any family/household members of the 138 employees had claimed prizes during this calendar

year. Regarding this matter, MSLC officials stated that they did not know whether it would be possible to require family members to provide the Social Security numbers of other family members living in their household. However, MSLC needs to take measures necessary to ensure compliance to this statute.

3. Inadequate Controls over Ensuring That Claimants Pay Outstanding Tax Liens: MSLC has not established controls to ensure that claimants who owe taxes to DOR or the IRS repay their tax obligations prior to being paid their claims. During our follow-up audit, we selected the names of 11 individuals who had submitted multiple claims, totaling in excess of $50,000, to MSLC during calendar year 2001. During our review, we found that two of these individuals who were paid claims totaling $443,335 by MSLC during this calendar year had federal and Massachusetts tax liens totaling $143,645 against them. In both cases, these individuals cashed in their winning tickets without MSLC's offsetting their tax liens (See Audit Results No. 1 and 3). MSLC officials indicated they would contact the OSC to determine whether they could use the intercept process to apply winning claims against state tax liens.

4. Inadequate Segregation of Duties Regarding Claims Processing: MSLC has not segregated the duties of those individuals who are responsible for verifying the information provided by claimants with those processing a claim payment for a prize. According to MSLC, this segregation is not possible due to the limited amount of staff at each claim center. MSLC's Director indicated that the agency's Security and Compliance Department conducts reviews at each MSLC regional office twice each year. However, this control is inadequate since it is designed to detect incidents of noncompliance after they happen rather than establish an effective front-end control such as proper segregation of duties, which is intended to prevent problems from occurring.

5. Controls Relative to Claimant Identification Could Be Improved: MSLC has not entered into an arrangement with the state's Registry of Motor Vehicles (RMV), for on-line access to driver's license and other identification data. Access to on-line information can be valuable regarding the proper identification of individuals claiming prizes. Rather, MSLC stated that

the agency only uses RMV information when it is seeking to locate current or former sales agents that have moved and owe MSLC money.

Recommendation

In order to address the issues relative to this matter, MSLC should:

- Develop and implement controls in accordance with Chapter 10, Section 31, of the General Laws to ensure that no member, employee, or immediate family members who live in the employee's residence purchase a ticket or share or claim a prize.

- Develop and implement controls to ensure that deliquent sales agents and individuals who have tax liens who attempt to cash winning lottery tickets over $600 are identified and, if possible, recover outstanding debts owed by these agents to MSLC, DOR, and the IRS.

- Establish procedures, that would require MSLC's Security and Compliance Department to periodically review claim forms to ensure that the identification being accepted by Lottery staff is in fact, consistent with MSLC policies and procedures.

- Establish procedures that require MSLC staff to properly document all instances where claimants submit identification that appears to be false and report these incidents to the appropriate law enforcement officials.

- Provide its claims department with on-line access to stored W2-G informaiton per winner in order to review multiple prizewinners for potential irregularities. If MSLC believes that it is not appropriate to provide such information to Claims Department staff, it should establish a process to provide it to its Security and Compliance staff for analysis and actions. It should then develop policies and procedures that require the agency's Security and Compliance Division to use information in MSLC's database to periodically conduct analytical reviews of claimant information. Based on the results of these reviews, MSLC should refer any unusual or irregular claim activities to appropriate regulatory and law enforcement agents for further review and resolution.

- Institute measures to preclude or minimize the circumvention of security controls systems, such as adequately segregating duties so that the individual verifying a claimant's corrected identification is different than the person processing a payment for a prize being claimed.

- Enter into an interagency cooperative agreement with the RMV for on-line access to drivers license data and any other identification data.

- Consider accumulating total of winnings on one W2-G per year for multiple winners (See Audit Result Nos. 1, 2 and 3).

b. Improvements Needed Regarding Certain Payroll Policies and Procedures

During our prior audit, we reviewed MSLC's payroll and personnel records and found that (a) certain employees were allowed to carry over vacation time in a manner contrary to their contract while other employees were made to forfeit vacation time; (b) one employee took approximately four months of vacation immediately before resigning, and as a result was paid for an additional six holidays, four more accrued vacation days, and two skeleton days totaling $4,569 in additional pay; and (c) there was no personnel policy and procedures manual for non-union and union employees.

Our prior audit recommended that MSLC develop a comprehensive personnel policies and procedures manual that incorporates union contract provisions so that management's directives and scope of authority are communicated to all employees. We also recommended that MSLC review its vacation carryover policy to ensure that it is communicated to all employees, is fair and equitable to all employees, meets the needs of MSLC and does not hamper MSLC operations, and complies with the union contract.

During our follow-up audit, we selected a sample of 29 individuals who were employed by MSLC during fiscal years 2001 and 2002 and asked MSLC officials to provide us with a copy of their personnel files. We reviewed the contents of these files to determine MSLC compliance with its own internal personnel policies and procedures. Based on our review of these files we noted that, for the most part, these files were current and complete, with one exception. MSLC's personnel policies and procedures require staff members to sign a document in which they acknowledge the fact that neither they nor any family members living in their households are allowed to claim prizes on Lottery games. However, two of the 29 files we reviewed did not contain this form.

We reviewed the Massachusetts State Lottery Commission Employee Handbook, which was developed by MSLC in September 2000 and revised in September 2001, and determined that this document details personnel policies and procedures for union employees. We also

reviewed a memorandum dated February 15, 2000 from MSLC's Assistant Executive Director of Human Resources to the agency's Payroll Manager that details the approved vacation accrual amounts for non-union employees. MSLC officials stated that the handbook applies to both union and non-union employees and that the only difference is the vacation accruals as detailed in this February 15, 2000 memorandum. Although MSLC issued a separate memorandum on vacation day accruals for non-union employees, this policy is not formally incorporated into MSLC's handbook. Further, although the handbook and this memorandum establish accrual amounts for paid leave, neither document identifies MSLC's policy on the amount of vacation time that can be carried forward by each employee. The agreement between MSLC and the Service Employees' International Union (SEIU) Local 254 AFL-CIO effective July 1, 2000 through June 30, 2003 does establish a maximum amount of paid vacation leave accruals for union members by stating:

> *In no event shall vacation leave credit be carried over for more than one succeeding vacation year, except with the written authorization of management, in which case it could be carried forward for no more than three years.*

However, this contractual condition is not stated in MSLC's handbook. It should also be noted that this agreement does not establish the number of years of creditable service necessary to obtain the specified vacation day accrual amounts.

In addition we determined that MSLC had not implemented adequate internal controls over its payroll activities as required by Chapter 647 of the Acts 1989, an Act Relative to Improving Internal Controls within State Agencies, which requires agencies to develop an internal control plan that documents in writing the internal control procedures relative to documentation, the conduct of transactions, authority to conduct transactions, segregation of duties, supervision, and access to records and information. During our audit, we asked MSLC officials to provide us with their internal control plan in the payroll area. In response, MSLC officials provided us with a document entitled, Human Resources/Payroll Division Internal Control Plan, which states:

> *The Payroll Division of the Human Resources Department is currently establishing an Internal Control Plan in accordance with the guidelines established by the Comptroller and the Human Resources Compensation Management System.*

> *The objective of the plan is to establish agency guidelines for the department as well as minimize risks and ensure compliance with the rules and regulations of the Commonwealth.*

MSLC officials stated that the Payroll Department's Internal Control Plan is a work in progress. However, since Chapter 647 was enacted over 12 years ago, an internal control plan should have been developed by now.

Recommendation

In order to address this matter, we recommend that MSLC take measures to ensure that its employee handbook formally incorporates both non-union employee information as well as union contract provisions so that management directives and scope of authority are communicated to all employees. Further, MSLC should take measures necessary to ensure that its payroll department develops and implements an internal control plan as required by Chapter 647.

c. Written Internal Control Procedures and System Descriptions Need Improvement

Our prior audit noted that MSLC had not fully and adequately documented its internal administrative and accounting control system as required by Chapter 647 of the Acts of 1989. To achieve a strong administrative and accounting control environment and to safeguard Commonwealth assets and revenues, it is essential and a statutory requirement that all state agencies and departments, including MSLC, fulfill their responsibilities and comply with the law to document and implement such a system. Chapter 647 of the Acts of 1989 defines the minimum level of quality acceptable for internal controls to be in operation throughout the various state agencies and constitutes the criteria against which such internal controls will be evaluated. We determined that MSLC's internal control plan lacked required critical elements, such as the identification and clear communication of all operating cycles; identification of duties and responsibilities of staff and management at key internal control points; identification of management directives, policies, and procedures; description of continuous supervision; identification of individuals who have access to records; full documentation; and practices consistent with the documented plan.

Our prior audit recommended that MSLC continue to strengthen and improve its internal control system by implementing additional policy plans, practices, and enhanced control and security procedures listed above to provide an appropriate environment of adequate safeguards in compliance with Chapter 647; the OSC's prescribed guidelines; and the mission, roles, and responsibilities of MSLC.

During our follow-up audit, we reviewed the internal controls MSLC had established over various aspects of its operations, including its policies and procedures. Based on our review we determined that, in the areas we reviewed, MSLC had taken measures to strengthen its internal controls by developing and implementing written policies and procedures for most of its operations and that MSLC has improved its security procedures. However, as noted throughout this report, internal controls in certain areas of MSLC's operations still need to be improved, and MSLC should continue to strengthen and improve its internal control system by implementing additional policy plans, practices, and enhanced control and security procedures to provide an appropriate environment of adequate safeguards in compliance with Chapter 647; the OSC's prescribed guidelines; and the mission, roles, and responsibilities of MSLC.

Recommendation

MSLC should continue to develop, improve and strengthen its internal controls for all areas of its financial and operational areas.

d. Improvements Needed in Internal Controls, Security, Oversight, and Monitoring Practices over MSLC's Sales Offices Revenue Collection and Processing

Our prior audit disclosed that MSLC reported a theft of sales revenue of $597 in accordance with Chapter 647 of the Acts of 1989. The theft occurred because an employee was allowed to have control over cash receipts in MSLC's Braintree headquarters without proper monitoring and checks and balances in place to prevent the likelihood of thefts and shortages. Moreover, our review revealed that there were numerous other variances exceeding $129,000 between the daily transaction sheets, primary deposit slips, and actual deposits prepared by MSLC employees and made at the Braintree office. Moreover, we noted that control weaknesses, poor oversight, and inadequate support from Braintree

headquarters allowed for a shortage of another $24,061 in Boston. We also discovered that $39,259 of sales revenue deposits, in the form of electronic fund transfers, were not transferred to the Office of the State Treasurer in a timely manner. Further, we discovered $309,681 in outstanding checks in the MSLC Prize Account, included items that were more than one year old and should have been investigated and resolved. Additionally, we discovered that certain bank accounts upon which handwritten checks are drawn required only one authorized signature, which represented a serious cash control weakness.

Our prior audit recommended that MSLC management refer to Chapter 647 to clearly and fully understand their statutory responsibilities and implement all requirements of the law as well as OSC guidelines to effectuate all critical revenue control objectives and activities and establish internal control procedures and practices that would provide for appropriate controls over the total flow of cash. We found during our follow-up audit that MSLC has taken corrective action and implemented the following regarding our prior audit recommendations:

- Documented management directives; administrative policies; and accounting policies, procedures, and manuals, including internal control procedures and accountability systems and identification of all operating cycles.
- Provided qualified and continuous supervision, oversight, and monitoring to all staff, including clearly communicating duties, responsibilities, and accountability to each staff member and reviewing each staff member's work.
- Ensured that transactions are recorded, reported, and deposited promptly.
- Limited access to all cash resources.
- Developed and improved inventory controls over Instant Game tickets that include periodic counts of cash and tickets on hand in sales offices.
- Developed and implemented monthly (or as often as necessary) reconciliation procedures that would compare bank statements to MMARS and cash records and ensured that any variances in the reconciliation are investigated and reported to management.

- Implemented policies and procedures to ensure that old outstanding checks and funds not swept by the Treasurer's Office are handled in a proper and timely manner.

- Improved its internal audit function procedures.

During our follow-up audit, we conducted site visits at two of MSLC's regional offices: the Boston Game Room and the Woburn regional office. During these site visits we spoke with MSLC staff, assessed the control environment, and reviewed various activities and transactions being conducted by MSLC regional staff. We found that the MSLC had taken measures to implement most of our recommendations made during our prior audit. For example, the MSLC has developed and implemented monthly reconciliation procedures for reconciling its daily sales reports to its bank account statements. Also, we determined that MSLC's Boston and Woburn regional offices are following agency procedures relative to the collection, accounting, and depositing of cash. Lastly, the staff in each of MSLC's regional offices are required to send various reports including sales and inventory reports daily and armored car pick-up logs monthly to MSLC's headquarters in Braintree indicating that there have been improvements in the level of oversight and monitoring by MSLC over its regional offices.

However, we noted that three recommendations from our prior report were not fully implemented, as follows:

First, the MSLC has not taken measures to ensure that there is an adequate segregation of duties and responsibilities to ensure checks and balances in its regional offices including the Boston Game Room. However, even though currently there are only two employees assigned to the Boston Game Room and their duties are not adequately segregated, there are controls such as system-generated sales reports and security measures, video cameras, and an armored car service that would limit the ability of either individual to abuse the system.

Second, regarding the transfer of funds, we reviewed and analyzed deposits from MSLC's regional offices. We determined that deposits are being made, on average, within five or six days after receipt. The following table illustrates deposits made by all regional offices for July 10 and August 10, 2001 and February 11 and March 11, 2002. The amounts of the

deposits were taken from daily deposit slips and were traced to armed car logs and bank account statements. Although funds are not deposited daily, MSLC regional offices have procedures in place that minimize the potential of loss or theft of funds awaiting transit. Such procedures require that funds awaiting transit be sealed in a deposit bag and placed in a locked safe that allows limited access.

Deposits by Regional Offices
July 10, 2001, August 10, 2001, February 11, 2002, and March 11, 2002

Amount of Deposit	Date of Deposit Slip	Date of Pick-Up	Date of Deposit	Number of Days between Date of Deposit Slip and Date of Deposit at Bank
$1,193.00	7/10/01	7/13/2001	7/16/01	6
$1,069.00	7/10/01	7/17/2001	7/18/01	8
$1,375.00	7/10/01	7/13/2001	7/16/01	6
$1,132.00	8/10/01	8/14/2001	8/15/01	5
$734.50	8/10/01	8/14/2001	8/15/01	5
$588.00	8/10/01	8/14/2001	8/15/01	5
$810.00	8/10/01	8/17/2001	8/20/01	10
$784.00	8/10/01	8/14/2001	8/16/01	6
$202.00	8/10/01	8/17/2001	8/20/02	10
$1,273.00	2/11/02	2/12/2002	2/13/02	2
$978.50	2/11/02	2/12/2002	2/13/02	2
$1,183.00	2/11/02	2/12/2002	2/13/01	2
$543.00	2/11/01	2/15/2001	2/19/01	8
$652.00	2/11/01	2/12/2002	2/13/02	2
$594.25	2/11/02	2/15/2001	2/19/02	8
$659.00	3/11/02	3/12/2002	3/13/02	2
$1,173.00	3/11/02	3/12/2002	3/13/02	2
$924.00	3/11/02	3/12/2002	3/13/02	2
$528.00	3/11/02	3/15/2002	3/18/02	7
$750.00	3/11/02	3/12/2002	3/13/02	2
$615.00	3/11/02	3/15/2002	3/18/02	7
			Average	5.2

As noted in the table above, based on our sample, it is taking MSLC on average between five to six days from the receipt of funds to the deposit of these funds into the regional depository account. Given the nature of MSLC's operation (e.g., relatively small deposits from several different regional offices) we do not believe that the number of days to complete the depository transaction to be unreasonable. As we previously noted, funds are accounted for and prepared for deposit daily and are kept in a secured safe until picked up by the armored car service. Our review revealed that the MSLC has developed and implemented monthly reconciliation procedures consisting of comparing the Regional Account Daily Sales Report to the bank account statement.

Third, MSLC has not developed and implemented written internal control procedures that require handwritten checks from the Prize Account to have two signatures as recommended by the prior audit report. Rather, MSLC's Internal Control Manual - Policies & Procedures, Volume VIII, Finance Book II of III, Check Writing Procedure, states, in part:

> *Manual/Split Check 'System'. The Manual/Split Check System is a manual process of writing prize checks, as the name indicates. The checks are in two categories:*
>
> > *Manual Checks. Checks typed from source documents to fund a MSLC liability.*
> >
> > *Split Checks. Checks typed to replace & adjust system issued checks the main reasons that Accounting would have to reissue a MPS check is because the original is lost/misplaced, or for legal matters (i.e. splits). Regardless, Fleet must be notified either by a stop payment order or a void. A new check would then be re-issued manually by Finance. It is the responsibility of the employee from Accounting to enter the replacement check in either the "Manual" check log or "Duplicate" check log in Excel. Presently the only personnel authorized to issue generic checks are the Controller, Chief Accountant, Financial Projects Administrator and the Claims/Validation Manager.*

MSLC's check logs indicated that during the period January 1, 2002 through May 10, 2002 MSLC wrote 153 manual and split checks totaling $1.9 million. Our follow-up review revealed that these handwritten checks were prepared by the accounting department and then signed by only one individual who was authorized to do so.

Regarding these matters, MSLC officials stated that they believe that the controls in this area are adequate because these checks are issued on a limited basis and only the four individuals noted above are authorized to sign these checks. However, allowing one individual to both initiate and authorize checks is a control weakness that needs to be addressed.

Also, logs of deposits picked up from the Boston Office are faxed to the Braintree headquarters on a monthly basis instead of being faxed on the date of pick-up. If the logs are faxed on the date of pick-up, the Braintree headquarters would have more timely information to monitor deposits.

Recommendation

MSLC should consider implementing controls that require dual signatures on all manual checks. In addition, logs of deposits picked up from Boston should be faxed on the date of pick-up to MSLC headquarters instead of monthly, to facilitate monitoring and oversight. Also, MSLC should continue to review and implement additional controls regarding the lack of segregation of duties at the Boston Game Room.

e. Procedures for the Collection of Cash Revenues Held by MSLC Sales Agents Need Further Strengthening

Our prior audit disclosed that MSLC's settlement process for collecting cash receipts from sales agents was too lengthy and resulted in untimely collection of its revenues; loss of unremitted revenue; and, in certain cases, sales agents having illegally and/or improperly withheld funds. As a result, approximately $15.1 million of cash receipts were not transferred to MSLC from its sales agents as of January 26, 1999. Moreover, this had been a longstanding issue, as a previous audit issued by the OSA also reported outstanding amounts owed by sales agents representing cash sales receipts that they had not remitted through the established settlement process. We found during our follow-up audit that MSLC had taken corrective action and implemented the following regarding our prior audit recommendations:

- Established a better process to ensure that potential sales agents are viable and responsible businesses that will be able to remit revenue to MSLC in a timely basis.

- Established a dedicated account for all sales agents whereby the only transaction will be the depositing of MSLC revenues.

- Required agents to make timely deposits to the dedicated account.

- Expanded field representatives and/or regional supervisors duties or a newly formed collections group to visit all defaulted sales agents within one working day of notification by the host bank that funds cannot be swept.

- Developed controls and procedures to prohibit agents from selling tickets after their authority has been revoked.

- Developed inventory procedures and controls to confirm whether ticket books are on an agent's premises.

- Reviewed its policies with regard to fines and all other actions taken against defaulted agents and implemented finance charges on past due amounts.

- Required sales agents to prepare and file a weekly online inventory of tickets on hand.

- Required sales agents to make full payment of amounts owed before a revoked license is reinstated.

- Instituted a central filing system to access sales agent revenue information in a timely manner.

- Ensured that agents notify MSLC when there is a change in ownership status by instituting penalties and fines for noncompliance or making them individually responsible for not giving notice.

- Made periodic counts of tickets on hand at sales agents, particularly of those with delinquency problems.

- Provided training to all MSLC personnel to reeducate them on the importance of proper controls and security.

- Ensured that its internal audit function improves its procedures.

As part of our follow-up review, we spoke with MSLC officials and reviewed all policies and procedures the agency has implemented relative to the collection of revenues from sales agents for both instant and on-line games. We also verified the flow of transactions through MSLC's cash receipts cycle and conducted several tests of transactions on this system. The

settlement process involves collecting (sweeping) funds from sales agent accounts and depositing them into a Commonwealth of Massachusetts account. This process includes on-line and Keno transactions from the prior week for all sales agents and Instant Game ticket transactions for the prior week for half of the sales agents. Instant Game tickets for the other half of sales agents are processed the following week.

MSLC officials provided us with explanations for their decision not to implement the suggested recommendations to (1) revise the settlement process to allow MSLC's central bank to sweep all sales agent bank accounts for partial and full payments of amounts owed, (2) shorten the collection process by the host bank, and (3) discontinue the policy that allows sales agents to take their sales commissions prior to depositing funds with MSLC, as follows:

1. According to MSLC officials they did not revise the settlement process to allow MSLC's central bank to sweep all sales agent bank accounts for partial and full payment of amounts owed.

   MSLC indicated that given the regulations that pertain to this process, it was not possible at this time to revise the settlement process, Specifically, MSLC regulations 961 CMR 2.16(1), Deposits of Lottery Revenues, states:

   > *Each Sales Agent shall be required to establish a trust account at a bank that is a member of the New England Automated Clearing House Association [NEACH] . . . .*

   NEACH is a nonprofit association that helps members originate and receive automated clearing house (ACH), transactions and provides products, services, education and marketing to increase the acceptance, use and quality of electronic transactions.

   The ACH network offers an assortment of technical formats that can be used for a variety of payment applications, products, and services. The ACH network is governed by operating rules and guidelines, which are developed by the actual users of the system, and is administered through a series of agreements among financial institutions, customer, trading partners, and ACH Operators.

   The ACH system is a batch processing, store-and-forward system. Transactions by financial institutions during the day are stored and processed later in a batch mode. This means that rather than sending each payment separately, ACH transactions are accumulated and sorted by destination for transmission during a predetermined time period. NEACH uses this batch processing system because it claims it provides significant economies of scale and provides faster processing than paper checks,

which must be physically handled. Instead of using paper for necessary transaction information, ACH transactions are transmitted electronically between financial institutions through data transmission. According to NEACH's policies, a specific dollar amount is what is called a mandatory field and has to be entered into a field in order to process the transaction or sweep of the account.

During our audit, MSLC officials provided the audit team with documentation from NEACH which included the "2001 ACH Rules" governing the mandatory fields needed to process an ACH transaction." Section 2.3 of NEACH's operating rules, Glossary of File Format Data Elements, states:

> *Mandatory for ACH Processing. A "Mandatory' field is necessary to ensure the proper routing and/or posting of an ACH entry. Any "Mandatory" field not included in an ACH record will cause that entry, batch, or file to be rejected by the ACH Operator.*

MSLC officials stated that each week they enter the amount owed by each sales agent as the required mandatory field but if the amount in the sales agent's account at the time of the sweeps does not match the amount entered by MSLC as a mandatory field, the bank under NEACH's operating rules will not allow the transfer of any funds.

In its fiscal year 2001 audit, MSLC's private accounting firm recognized, as did the OSA, the importance of improving the effectiveness for the revenue collection process. However, they also recognized MSLC's limited ability to address this problem by stating:

> *While the Lottery has pursued the balanced checking option with Bank, it has been unable to secure a commitment from Fleet to either change the procedures or the rules that govern the EFT [Electronic Funds Transfer] sweep process. The Lottery will continue to press for this service.*

While we acknowledge that fact that under its current regulations it is difficult for MSLC to further expedite the collection of revenues from sales agents, we urge MSLC to take further measures to accomplish this purpose. Further, we suggested that MSLC may want to consider amending its regulations to establish a more efficient revenue collection process, such as to shorten the collection process by the host bank, which is currently 15 days to a maximum of four days to ensure the timeliness of revenue collection to the Commonwealth.

2. MSLC officials stated that the agency did not implement our recommendation to shorten the collection process by the host bank, which was 15 days, to a maximum of four days to ensure the timeliness of revenue collection to the Commonwealth. MSLC's official stated that MSLC currently conducts two sweeps of each sales agents account. On Sunday of each week, MSLC's Special Report 61 is electronically transmitted to agents identifying the net amount the sales agent owes MSLC. The

sales agents are responsible for making sure that the net funds due to MSLC as indicated in these reports are deposited in MSLC accounts by the close of business on Monday. On Friday, the member banks sweep all sale agents accounts except those accounts that do not have the specific dollar amount as indicated in Special Report 61. The following Tuesday, MSLC again tries to sweep those accounts that were rejected. In order to shorten the process, MSLC would have to reduce the number of times it sweeps sales agents accounts from twice to once per week (the Friday the sales agent's deposits are due).

Based on this fact, MSLC conducted what it called a Sweeps Study with the host bank for transferring sales agent's funds to access the feasibility of shortening the collection process to a maximum of four. The study involved taking a sample of sale agent accounts who had rejected transfers during a ten-day period and comparing the results of implementing one sweep of sales agent accounts versus two sweeps. The study concluded that MSLC would have incurred $1.4 million in uncollected sales agent funds that should have been transferred but were rejected because of incorrect balances for the 10-day period utilizing the one-sweep method, whereas MSLC would have incurred only $283,590 in rejected transfers for the same period utilizing a second sweep. As a result, MSLC officials determined that reducing the collection period and using only one sweep would cause a material increase in the number of rejected transfers, which would increase MSLC's costs of operation.

3. MSLC officials stated that the agency did not implement our recommendation to discontinue the policy that allows sales agents to take their sales commission prior to depositing MSLC funds. MSLC officials also stated that the agency is unable to change this policy because of the manner in which MSLC's accounting system operates and that they cannot withhold commissions from sales agents because the transaction stream is such that the sales agents have all the revenue and it is up to them to remit the proper amount to MSLC. The net amount owed sales agents consists of total sales minus any cancels, free bets, commissions, cashes, cash bonus, claims bonus, credit/debit for adjustments, service fees, and bonding fees. The sales agent receives Special Report 61 indicating the net due MSLC from the sales agent on Sunday for the prior Sunday to Saturday week. The sales agent payment should be deposited into the MSLC account by the close of business Monday. The sales agent is not sent a commission from the MSLC before the invoice is paid, but rather the commission owed the sales agent is deducted from the invoice when the sales agent receives the Report 61 indicating the net amount due to MSLC.

Based on our follow-up audit work in this area, MSLC has taken measures to improve the controls over this aspect of its operation. However, during our audit, we contacted a member of the state of New Hampshire's Legislative Auditor's Office, who told us that the New Hampshire state lottery uses a similar system as Massachusetts to collect revenues from its sales agents, except that New Hampshire charges a fine of $25 or 5% of the amount due

from the sales agent, whichever is greater, for any agent who does not have the specified amount in their account to be swept. Although MSLC levies a fine of $75 to some of its sales agents who are delinquent and have had their terminals shut off, it should consider instituting stricter penalties such as New Hampshire does when agents are delinquent in remitting revenues owed to MSLC. Such a measure should serve as a deterrent to prevent sales agents from not remitting funds owed in a timely manner and could generate additional revenues for the Commonwealth.

Recommendation

MSLC should continue to improve its collection of cash receipts held by sales agents in order to shorten the time funds are transferred from the sales agent. Moreover, MSLC should review its penalty and fine policies and procedures and implement stricter fines and penalties similar to those of New Hampshire for agents that are delinquent in submitting funds to MSLC in a timely manner. Such fines should increase for subsequent occurrences, depending on the frequency and length of time for nonpayment of revenue due MSLC.

15. PRIOR AUDIT RESULTS RESOLVED – IMPROVEMENTS MADE TO THE MANAGEMENT OF INSTANT GAME TICKETS

During our follow-up audit, we found that MSLC had taken measures to adequately address the management of millions of Instant Game tickets. During our prior audit, we conducted various tests of 500,000 books of Instant Game tickets having approximately 150 million tickets to determine whether systems were in place to ensure that, in all claims for prizes, the winning tickets were purchased from an authorized sales agent and was from a book that had been activated and settled by an authorized sales agent. We found that book numbers for over 29,000 winning Instant Game tickets with a value of $600 or greater were not listed, and therefore the winning tickets could not be traced to the authorized agent who sold the ticket or to the book from which it came. This represented 76% of the winning Instant Game tickets cashed during 1998. We also determined that there were inadequate inventory controls over unsold portions of books returned to MSLC (i.e., live activated tickets). We observed partial and full ticket books being returned to MSLC in plastic grocery bags or simply wrapped with elastic bands. Also, we observed these tickets processed in

unsecured areas. Since these tickets have been activated, they could be submitted for a cash prize without detection.

Our prior audit recommended that MSLC:

- Improve its controls and security operations by developing tests for its systems.
- Develop and practice improved inventory controls, including surprise counts of tickets held by sales agents, through all points of the life cycle from receipt to distribution, sales, claims for prizes, tickets returned as unsold, and ticket destruction.
- Develop written policies and procedures for the Instant Game ticket revenue cycle, incorporate them into internal control plans, and clearly communicate these controls to MSLC staff.
- Track and analyze agent sales patterns to identify potential problems and create safeguards and strategies to address and resolve them.
- Ensure that returned Instant Game tickets are controlled and placed within a secure area.
- Establish a secured process for deactivating returned Instant Game tickets.
- Ensure that its internal audit function improves its procedures for addressing the issue noted in its audit result.

During our follow-up audit, we reviewed all of MSLC's policies and procedures relative to MSLC's administration of Instant Game tickets and performed a test that involved selecting a sample 23 winning Instant Game lottery tickets that were sold during calendar year 2000. The purpose of this test was to determine the agent that sold the ticket; the book the ticket came from, whether the book was still activated, and when the ticket was settled. We also observed security and inventory control procedures relative to Instant Game lottery tickets at MSLC's Braintree headquarters and spoke with responsible officials regarding these matters. Based on our review, we determined that MSLC had developed and implemented adequate controls over this process.

Specifically, during our prior audit we found that MSLC's validation system allowed instant tickets with a prize under a certain amount that had not been activated to be cashed. We

also found that the activation process did not protect MSLC's billing process from "shelving," a term that refers to a sales agent selling tickets from multiple activated books all at the same time instead of selling a complete book before activating another book. By shelving, a sales agent delays the billing and settlement process, thereby allowing the sales agent to hold onto MSLC funds for an extended period of time.

MSLC has addressed the shelving issue by changing its method of cashing out sales agents. During the prior audit period agents were billed for individual books of Instant Game tickets when the Guaranteed Low End Prizes (GLEPs) reach 80% within a book (between 121 and 180 days of activation) or 85% within a book (between one and 120 days of activation), when the book has not reached the 80% mark but the sales agent has had the book for six months, or when a game is being terminated and taken off the market. MSLC has since adopted a Cumulative Cashing Policy, which tracks GLEPs on a cumulative basis rather than by individual books. MSLC uses pre-established criteria or flags to identify when sales agents need to pay for books of tickets based on a percentage (e.g., 85%) of the prizes claimed by a sale agent in each game to the total GLEPs in the books the sales agent received for the game. For example, if a sale agent received five books of tickets for a game that had a total GLEPs of $5,000, once the total prizes claimed by the agent for that game reached $850 ($5,000 GLEPs ÷ 5 books x 85%), the agent would have to pay for one book of tickets. Once 85% of the GLEPs dollar value of a book has been cashed, that book is considered completely cashed and no longer used in any cumulative cashing calculations. Therefore, a sales agent does not benefit by activating several books of the same game at the same time. Rather, agents are billed for them based on cumulative cashing and not by individual books.

On December 7, 1999 MSLC implemented policy No. P107 entitled, "Policy & Procedures For Handling Misdelivered Instant Ticket Packets." One of the purposes of this document is to ensure that MSLC can locate all its instant ticket packs. If a consumer attempts to cash an unactivated ticket MSLC's Retail Sales Department will receive a Non Activation Report by agents, which lists attempted cashes on tickets from unactivated books. MSLC officials

will then try to determine what agent was assigned the ticket. No unactivated tickets can be cashed regardless of their prize dollar value.

Our prior audit report outlined several weaknesses in Ticket Return Unit (TRU) policies, procedures and security. Specifically, Return Forms were not signed by both sales agents and MSLC employees; TRU employees were unable to verify their daily input of ticket quantities returned; actual ticket numbers were not entered, just quantities of tickets; TRU employees worked in unsecured, scattered areas; and returned tickets were not shredded or defaced in any way. Also, we observed returned tickets being dropped off in grocery bags.

During our follow-up audit we determined that an Edit Report is printed by MSLC's computer operations the day after TRU personnel enter return ticket data into MSLC's IBM system. This report lists all packs (partial or full) and destroyed tickets along with their final keyed status. This Edit Report function is the result of a collaboration between MSLC's Finance Department and its computer programmers. By incorporating this important edit function, TRU employees are able to verify their inputs, which are directly related to billings.

Return forms state the book numbers from which the returned tickets have come from. TRU employees enter quantities only; however, MSLC's systems, ISYS and IBM, keep track of how many tickets have been cashed, settled, and credited to the sales agent for a particular game and book. Therefore, the return tickets become invalid as soon as they are processed by the TRU. Returned tickets that are not reassigned (some full books) are destroyed regularly through shredding at MSLC's regional offices (except Springfield) and MSLC's headquarters. MSLC has contracted with Mobile Shredding Services to shred the return tickets that are not reassigned. MSLC's Woburn and Worcester regional offices are visited by this vendor twice a month, Fairhaven once a month, and Braintree every three weeks or so depending on volume. Due to the small volume of tickets sold in the area, Springfield sends its returned tickets in locked red bags to Braintree to be shredded. Each MSLC regional office (excluding Springfield) is staffed with an Inventory Control Officer, who is responsible for securing the returned tickets and completing the necessary paperwork to be sent to Braintree. On two separate occasions we witnessed returned tickets being shredded

at the Braintree headquarters and noted that the controls over this process appeared to be adequate.

During the prior audit we observed TRU employees working from a table in the hallway of the season ticket area near the second-floor elevators. They were also working in and around the return room with the door to the room left open and the room sometimes left unattended. During our follow-up audit we interviewed TRU staff present in the Return Room, including the Return Room Supervisor and MSLC's Director of Revenue. We also reviewed 35 Return Forms for completeness and traced these forms to the Edit Report for February 5, 2002 to determine whether they were properly recorded. Based on our audit work we determined that TRU employees are no longer working in unsecured, scattered areas. Moreover, MSLC has adopted Ticket Return Unit Internal Control Procedures. Currently, access to the Return Room is restricted to authorized personnel only, and it is MSLC's policy that this room is never left unattended.

In addition, tickets that have been returned and are being reassigned are locked in storage lockers with combination locks. They are reassigned the next day and are the first tickets to be shipped out of inventory. Tickets that are going to be destroyed are locked in storage bins with combination locks. These locked bins are kept in a locked cage in the mailroom/warehouse area outside of the Return Room in an area that is alarmed during non-work hours.

Regarding the physical inventory for Instant Game tickets, MSLC has established two policies, No. P102, entitled Policy and Procedure Regional Office Physical Inventory (effective November 1, 1999), and No. P110 entitled Policy for Conducting a Physical Inventory of Instant Game Tickets at Sales Agent Locations (effective January 31, 2000). These policies require all regional offices to take a weekly physical inventory of all Instant Game books assigned to their location. A separate inventory is to be conducted for each sales agent number assigned to that location.

MSLC has also established a policy that requires its field sales representatives to conduct a minimum of two complete physical inventory checks of Instant Game tickets at each sales

agent location annually. They complete Form P110, which is then stored at the corresponding regional office. Additionally, MSLC's Security and Compliance Division conducts random unscheduled checks of Instant Game tickets and the controls that sales agents use to secure MSLC products. Also, according to MSLC's Director of Revenue, each sales agent takes a final reading of instant tickets at the end of each day, recording the ticket number of the last ticket sold from each book.

Finally, based on our interviews with MSLC officials, the agency has made improvements and enhancements to its reporting and tracking capabilities. Specifically, since our prior audit, MSLC's Management Information Systems (MIS) and Finance departments have been collaborating to improve the tracking of instant ticket activities as well as ad hoc querying and reporting. The major development in these areas has been the implementation of G-Ware, purchased from G-Tech in March of 1999 and used since July 2000. G-Ware is a tracking tool whereby online transactions are recorded in its product and master journal file. Every transaction is given a serial number by the online system. The product and master journal file is loaded into G-Ware. This software product has the ability to aggregate data and link transactions to other related transactions.

APPENDIX I

Chapter 647, Acts of 1989, An Act Relative to Improving the Internal Controls within State Agencies

H 5

Chapter 647

THE COMMONWEALTH OF MASSACHUSETTS

In the Year One Thousand Nine Hundred and Eighty-nine

AN ACT RELATIVE TO IMPROVING THE INTERNAL CONTROLS WITHIN STATE AGENCIES.

Be it enacted by the Senate and House of Representatives in General Court assembled, and by the authority of the same, as follows:

Notwithstanding any general or special law to the contrary, the following internal control standards shall define the minimum level of quality acceptable for internal control systems in operation throughout the various state agencies and departments and shall constitute the criteria against which such internal control systems will be evaluated. Internal control systems for the various state agencies and departments of the commonwealth shall be developed in accordance with internal control guidelines established by the office of the comptroller.

(A) Internal control systems of the agency are to be clearly documented and readily available for examination. Objectives for each of these standards are to be identified or developed for each agency activity and are to be logical, applicable and complete. Documentation of the agency's internal control systems should include (1) internal control procedures, (2) internal control accountability systems and (3), identification of the operating cycles. Documentation of the agency's internal control systems should appear in management directives, administrative policy, and accounting policies, procedures and manuals.

(B) All transactions and other significant events are to be promptly recorded, clearly documented and properly classified. Documentation of a transaction or event should include the entire process or life cycle of the transaction or event, including (1) the initiation or authorization of the transaction or event, (2) all aspects of the transaction while in process and (3), the final classification in summary records.

(C) Transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority. Authorizations should be clearly communicated to managers and employees and should

Chapter 647, Acts of 1989, An Act Relative to Improving the Internal Controls within State Agencies

H 5

include the specific conditions and terms under which authorizations are to be made.

(D) Key duties and responsibilities including (1) authorizing, approving, and recording transactions, (2) issuing and receiving assets, (3) making payments and (4), reviewing or auditing transactions, should be assigned systematically to a number of individuals to ensure that effective checks and balances exist.

(E) Qualified and continuous supervision is to be provided to ensure that internal control objectives are achieved. The duties of the supervisor in carrying out this responsibility shall include (1) clearly communicating the duties, responsibilities and accountabilities assigned to each staff member, (2) systematically reviewing each member's work to the extent necessary and (3), approving work at critical points to ensure that work flows as intended.

(F) Access to resources and records is to be limited to authorized individuals as determined by the agency head. Restrictions on access to resources will depend upon the vulnerability of the resource and the perceived risk of loss, both of which shall be periodically assessed. The agency head shall be responsible for maintaining accountability for the custody and use of resources and shall assign qualified individuals for that purpose. Periodic comparison shall be made between the resources and the recorded accountability of the resources to reduce the risk of unauthorized use or loss and protect against waste and wrongful acts. The vulnerability and value of the agency resources shall determine the frequency of this comparison.

Within each agency there shall be an official, equivalent in title or rank to an assistant or deputy to the department head, whose responsibility, in addition to his regularly assigned duties, shall be to ensure that the agency has written documentation of its internal accounting and administrative control system on file. Said official shall, annually, or more often as conditions warrant, evaluate the effectiveness of the agency's internal control system and establish and implement changes necessary to ensure the continued integrity of the system. Said official shall in the performance of his duties ensure that: (1) the documentation of all internal control systems is readily available for examination by the comptroller, the secretary of administration and finance and the state auditor, (2) the results of audits and recommendations to improve departmental internal controls are promptly evaluated by the agency management, (3) timely and appropriate corrective actions are effected

Chapter 647, Acts of 1989, An Act Relative to Improving the Internal Controls within State Agencies

H 5

by the agency management in response to an audit and (4), all actions determined by the agency management as necessary to correct or otherwise resolve matters will be addressed by the agency in their budgetary request to the general court.

All unaccounted for variances, losses, shortages or thefts of funds or property shall be immediately reported to the state auditor's office, who shall review the matter to determine the amount involved which shall be reported to appropriate management and law enforcement officials. Said auditor shall also determine the internal control weaknesses that contributed to or caused the condition. Said auditor shall then make recommendations to the agency official overseeing the internal control system and other appropriate management officials. The recommendations of said auditor shall address the correction of the conditions found and the necessary internal control policies and procedures that must be modified. The agency oversight official and the appropriate management officials shall immediately implement policies and procedures necessary to prevent a recurrence of the problems identified.

House of Representatives, December 21, 1989.

Passed to be enacted, George Fleming, Speaker.

In Senate, December 22, 1989.

Passed to be enacted, William M. Bulger, President.

January 3, 1990.

Approved,

Michael Dukakis Governor.

APPENDIX II

Chapter 647 Awareness Letter from the State Auditor and the State Comptroller

The Commonwealth of Massachusetts

Office of the State Auditor
State House
Boston, MA 02133

Office of the Comptroller
One Ashburton Place
Boston, MA 02108

September 19, 2000

Legislative Leadership
Judicial Branch Administrators
Elected Officials
Secretariats
Department Heads

The State Auditor and the Comptroller are both committed to departmental improvements in the Internal Control structure of the Commonwealth. A good system of controls, as you know, assists management in meeting objectives while avoiding serious problems. Chapter 647 of the Acts of 1989, *An Act Relative To Improving Internal Controls Within State Agencies*, establishes acceptable Internal Control systems for state government operations and constitutes the criteria against which we will evaluate internal controls. With the passage of this law, we began a campaign to educate all department staff on the significant role of internal controls in department operations.

In the past few years, departments have made significant progress in the area of internal controls. Every department has certified that they have documented internal controls in the form of an Internal Control Plan. In Fiscal Year 2001, we are focusing our Internal Control Campaign on the review of department risk assessments, as documented within the departments' internal control plans. Internal control plans must, of course, include all aspects of a department's business, programmatic operations as well as financial.

A major requirement of Chapter 647 is that "an official, equivalent in title or rank to an assistant or deputy to the department head, shall be responsible for the evaluation of the effectiveness of the department's internal controls and establish and implement changes necessary to ensure the continued integrity of the system". This official, whom we refer to as the Internal Control Officer, is responsible for ensuring that the plan is evaluated annually or more often as conditions warrant.

During this annual Statewide Single Audit, we continue with our review of the Commonwealth's internal controls. We analyze and evaluate information obtained during the audit process in our continuing effort to educate agencies regarding both the need for internal controls and the risks of not having adequate internal controls in place.

Chapter 647 Awareness Letter from the State Auditor and the State Comptroller

To assist departments with this effort, we provide the following support activities:

- The Office of the Comptroller offers departments free monthly training on internal controls. These classes are listed in the *OSC Training Bulletin*.
- The Office of the Comptroller provided a new document entitled the *Internal Control Guide for Managers* on the Office of the Comptroller's Web page: http: www.osc.state.ma.us/. Part II of the guide will be available shortly and will replace the current *Internal Control Guide for Departments*, currently available on the Web.
- Upon request, the Office of the Comptroller provides assistance to departments in the process of redefining or reviewing their internal control plans.
- As part of the Statewide Single Audit, auditors will review and comment upon departments' internal control plans, risk assessments, and the reporting level of the Internal Control Officers.
- We have updated and automated the Internal Control Questionnaire (ICQ) for easier submission. These changes to the ICQ will enable OSA and OSC to evaluate department internal controls and monitor their progress.

Chapter 647 also requires that "all unaccounted for variances, losses, shortages, or thefts of funds or property be immediately reported to the Office of the State Auditor" (OSA). The OSA is required to determine the amount involved and the internal control weaknesses that contributed to or caused the condition, make recommendations for corrective action, and make referrals to appropriate law enforcement officials. In order to comply with this law instances must be reported on the *Report on Unaccounted for Variances, Losses, Shortages, or Thefts of Funds or Property* and be submitted to the OSA. Reporting forms can be obtained by contacting the Auditor's office, Room 1819, McCormack State Office Building, or Web Site: http://www.magnet.state.ma.us/sao/.

In conjunction with the above requirement, please note that management is responsible for financial records and systems and must inform, disclose and make representations to the auditors with regards to their management of funds, account activities, programs and systems.

The Offices of the State Comptroller and the State Auditor are committed to the goal of improving the Internal Control structure of the Commonwealth. Thank you for your cooperation and attention on this worthwhile task. Please do not hesitate to call upon the staff of either office for assistance.

A. JOSEPH DeNUCCI
Auditor of the Commonwealth

MARTIN J. BENISON
State Comptroller

EXHIBIT 1

Analysis of Claims/Tax Withholdings for Certain Top Claimants for Calendar Year 2001

Initials	Number of Claims	Period (months)	Total Winnings	Federal Tax Withheld	State Tax Withheld
CJ	290	12	$458,954.00	$5,600.00	$900.00
DT	317	12	$444,239.75	$2,883.10	$524.20
RG	134	9	$275,575.00	$7,800.00	$1,350.00
DM	146	11	$251,633.50	$8,400.00	$1,500.00
GG	96	9	$170,890.00	$4,200.00	$690.27
PC	104	12	$167,760.00	$5,600.00	$1,000.00
SC	20	11	$155,600.00	$42,000.00	$7,250.00
JO	29	8	$138,000.00	$0.00	$0.00
CC	21	7	$135,865.50	$29,225.00	$5,250.00
MG	84	12	$107,274.00	$0.00	$0.00
FO	50	11	$103,598.00	$8,400.00	$1,500.00
JM	67	9	$98,017.00	$0.00	$0.00
Ja T	52	12	$89,545.75	$2,800.00	$500.00
Jo T	47	12	$88,716.00	$5,750.00	$977.17
MC	55	11	$77,282.00	$0.00	$0.00
LC	31	12	$74,816.00	$5,600.00	$1,000.00
RC	32	10	$73,832.00	$8,400.00	$1,500.00
JN	20	1 day	$72,120.00	$0.00	$0.00
TH	28	11	$68,440.50	$2,800.00	$450.00
FC	35	11	$67,827.50	$7,000.00	$1,198.00
JM	23	10	$67,049.00	$11,200.00	$1,900.00
VG	24	11	$63,749.00	$8,400.00	$1,500.00
AR	28	5	$58,957.50	$0.00	$0.00
EP	38	9	$58,890.00	$2,800.00	$500.00
GS	22	2	$58,812.00	$0.00	$0.00
EP Jr	29	11	$58,000.00	$2,800.00	$500.00
CT	21	3	$56,380.00	$0.00	$0.00

Analysis of Claims / Tax Withholdings for Certain Top Claimants for Calendar Year 2001

Initials	Number of Claims	Period (months)	Total Winnings	Federal Tax Withheld	State Tax Withheld
AW	43	11	$56,317.00	$0.00	$0.00
DH	26	11	$55,509.00	$2,800.00	$450.00
TD	20	7	$54,000.00	$8,400.00	$1,450.00
TH	22	11	$50,000.00	$5,600.00	$1,000.00
AM	31	12	$50,498.50	$0.00	$0.00
DP	25	11	$46,527.00	$0.00	$0.00
SB	21	6	$44,213.50	$0.00	$0.00
DC	23	11	$44,000.00	$2,800.00	$450.00
PB	25	12	$43,160.00	$2,800.00	$500.00
UC	40	1 day	$42,860.00	$0.00	$0.00
FK	27	11	$42,624.50	$2,800.00	$500.00
LC	25	11	$41,985.50	$0.00	$0.00
CF	32	12	$41,499.00	$0.00	$0.00
JJ	22	11	$40,345.50	$0.00	$0.00
RG	25	11	$40,160.00	$2,800.00	$450.00
JF	28	12	$39,822.00	$2,800.00	$500.00
MM	21	11	$38,520.00	$0.00	$0.00
JC	22	2	$36,385.50	$0.00	$0.00
FM	26	5	$36,053.75	$0.00	$0.00
ED	27	11	$35,246.00	$0.00	$0.00
GL	20	1 day	$34,690.00	$0.00	$0.00
SS	20	7	$33,798.00	$2,800.00	$450.00
AG	24	7	$33,633.00	$0.00	$0.00
TC	41	9	$32,794.50	$0.00	$0.00
DD	22	5	$32,200.00	$1,450.00	$273.00
DL	24	11	$32,000.00	$0.00	$0.00
WK	20	11	$31,504.00	$0.00	$0.00

Analysis of Claims / Tax Withholdings for Certain Top Claimants for Calendar Year 2001

Initials	Number of Claims	Period (months)	Total Winnings	Federal Tax Withheld	State Tax Withheld
TC	24	10	$31,000.00	$0.00	$0.00
SL	24	9	$25,737.00	$0.00	$0.00
SJ	20	4	$25,643.00	$4,600.00	$820.00
JO	25	1	$25,000.00	$0.00	$0.00
	2638		$4,759,550.25	$211,308.10	$36,832.64

Represents those individuals who had at least 20 claims totaling $20,000 or more during this calendar year.

EXHIBIT 2

Significant Prizes Not Claimed

We noted that periodically, significant prizes were not being claimed. For example, according to MSLC records, as of July 30, 2002, the following instant ticket major prizes remained unclaimed.

Issue Date	Game	Approximate Number of Tickets Printed	Claimed	Total	Top Prize	Unclaimed	Last Date to Redeem**
09/11/97	$1 Million Draw	40,320,000	29	30	$1,000,000	$1,000,000	
11/18/97	Monte Carlo (sold out $5 ticket)	50,400,000	35	40	$1,000,000	$5,000,000	12/15/02
09/24/98	Lifetime Cash	60,480,000	16	20	Grand Prize*	-	
11/12/98	Jubilee 25	70,560,000	22	25	$2,000,000	$6,000,000	
11/12/98	Holiday Bonus	35,280,000	7	10	$1,000,000	$3,000,000	
01/21/99	Bonus for Life	40,320,000	18	20	$50,000 for Life	$100,000 for Life	
06/02/99	Win $1,000,000 in Cash	40,320,000	8	10	$1,000,000	$2,000,000	
08/11/99	Instant Millions	30,240,000	12	15	$1,000,000	$3,000,000	
09/22/99	Set for Life	40,320,000	18	20	Grand Prize*	-	
09/19/00	$1,000,000 Bankroll	30,240,000	9	10	$1,000,000	$1,000,000	
11/02/00	$400,000,000 Spectacular (sold out)	50,400,000	9	10	$4,000,000	$4,000,000	8/15/02
11/02/00	$400,000,000 Spectacular (sold out)	50,400,000	18	20	$1,000,000	$2,000,000	8/15/02
03/29/01	$1,000,000 Windfall	30,240,000	9	10	$1,000,000	$1,000,000	
09/18/01	$1,000,000 Instant Monopoly	30,240,000	9	10	$1,000,000	$1,000,000	
11/06/01	$600 Million Spectacular	75,600,000	14	15	$4,000,000	$4,000,000	
11/06/01	$600 Million Spectacular	75,600,000	27	30	$1,000,000	$3,000,000	
01/23/02	Magic $1,000,000	30,240,000	6	10	$1,000,000	$4,000,000	
03/26/02	Casino Nights	30,240,000	3	10	$1,000,000	$7,000,000	

*A winner is entitled to participate in a drawing in which they have a chance to win one of several grand prizes. For example, in the Set for Life Game, one of the grand prizes was $250,000 per year for life.

**Game was closed one year prior.

Additionally, based on information published by MSLC, during our audit period, one Megabucks prize of $4.5 million went unclaimed, and since 1984, 30 Megabucks prizes totaling approximately $17 million expired without being claimed. According to MSLC, approximately $11 million in lottery prizes each year remain unclaimed.

MSLC has established written policies and procedures No. P118, entitled, Policy and Procedures for Terminating an Instant Game, which states, in part:

> *It is the Policy of the Massachusetts State Lottery Commission to generate revenue from the sale of Instant Game tickets. It is the Policy of the Massachusetts State Lottery Commission to have sufficient quantity of Instant Game tickets, in each game offered for sale, to adequately distribute these tickets to the general public. When there is no longer sufficient quantity of Instant Game tickets available for distribution or the cashing levels have slowed to a point that the game is virtually inactive or all the Game Prizes have been claimed or all the highest level prizes for a particular game have been claimed, it is the Policy of the Massachusetts State Lottery Commission to terminate that game(s) and issue notices to establish the last day of sale and the last day to redeem prizes.*

These policies and procedures further describe how MSLC sales agents are notified that a particular game is closed as well as other procedures such as the inventory and retrieval of unsold tickets. Additionally, MSLC officials stated that when a last date to redeem is nearing, MSLC will distribute press releases to the media informing the public of an unclaimed prize. MSLC contacts the printer of the tickets to determine which sequence of books had the unclaimed winner.

Chapter 10, Section 32, of the General Laws establishes the timeframe for MSLC to hold prize funds for potential claims and how any unclaimed funds are to be used by stating:

> *Unclaimed prize money for the prize on a winning ticket or share shall be retained by the director for the person entitled thereto for one year after the drawing in which the prize was won. If no claim is made for said money within such year, the prize money shall be allocated in the same manner as lottery revenues are allocated.*

We determined that MSLC takes measures to inform the public of outstanding prizes and the termination of Instant Games.

EXHIBIT 3

Comparison of Lottery Sales to Local Aid Disbursements and to Per Capita Income

Municipality	Agent Sales	Sales Rank	Sales % to Total Sales	Local Aid Disbursements	Local Aid % to Total Aid	Per Capita Income	Per Capita Income Rank
Boston	$477,591,267	1	12.061	$63,317,673	7.325	$23,353	223
Worcester	136,149,025	2	3.438	31,173,945	3.606	18,614	327
Quincy	86,452,161	3	2.183	10,529,542	1.218	26,001	150
Springfield	83,172,060	4	2.100	33,541,618	3.880	15,232	348
Lynn	79,004,345	5	1.995	14,999,139	1.735	17,492	334
New Bedford	77,699,643	6	1.962	23,420,418	2.709	15,602	346
Brockton	66,036,207	7	1.667	18,163,976	2.101	17,163	340
Lowell	60,880,381	8	1.537	20,290,173	2.347	17,557	333
Fall River	56,648,325	9	1.430	22,377,287	2.589	16,118	344
Somerville	55,282,647	10	1.396	12,508,012	1.447	23,628	213
Waltham	50,270,939	11	1.269	5,592,244	.647	26,364	141
Malden	49,797,874	12	1.257	8,706,592	1.007	22,004	255
Cambridge	46,335,204	13	1.170	8,069,333	.933	31,156	78
Methuen	45,697,089	14	1.154	5,372,469	.622	22,305	251
Weymouth	44,250,779	15	1.117	7,491,327	.867	24,976	174
Chicopee	43,016,639	16	1.086	9,863,384	1.141	18,646	324
Revere	42,881,853	17	1.082	6,200,119	.717	19,698	311
Peabody	40,589,223	18	1.025	4,978,526	.576	24,827	179
Medford	40,015,692	19	1.010	7,490,591	.867	24,707	183
Taunton	37,031,229	20	0.935	8,807,391	1.019	19,899	306
Top 20 Total	$1,618,802,582			$322,893,759			
Total	$3,959,631,381			$864,464,920			

Source: Sales Data – Massachusetts State Lottery Commission Agent Sales Data calendar year 2001 and Local Aid Distributions for fiscal year 2001.

Per Capita Income – U.S. Census Bureau 2000 data for 1999.

EXHIBIT 4

Selected Instant Game Odds and Large Prize Winners Per Game

	Prize	Winners Per Game	Probability of Winning
Jubilee 25 ($5):			
70,560,000 Tickets	$2,000,000	25	1: 2,822,400
	$50,000	70	1: 1,008,000
	All Prizes	14,789,275	1: 4.771
Holiday Bonus ($5):			
35,280,000 Tickets	$1,000,000	10	1: 3,528,000
	$200,000	35	1: 1,008,000
	All Prizes	7,349,520	1: 4.80
$600 Million Spectacular ($10):			
75,600,000 Tickets	$4,000,000	15	1: 5,040,000
	$1,000,000	30	1: 2,520,000
	$100,000	75	1: 1,008,000
	All Prizes	20,699,970	1: 3.65
Instant Millions ($5)			
30,240,000 Tickets	$1,000,000	15	1: 2,016,000
	$20,000	60	1: 1,008,000
	All Prizes	6,342,285	1: 4.768
Monte Carlo ($5)			
50,400,000 Tickets	$1,000,000	40	1: 1,260,000
	$50,000	50	1: 1,008,000
	All Prizes	10,917,790	1: 4.933