



Commonwealth of Massachusetts
Office of the State Auditor
Suzanne M. Bump

Making government work better

Official Audit Report – Issued October 30, 2014

Massachusetts State Lottery Commission

For the period July 1, 2010 through September 30, 2012





Commonwealth of Massachusetts
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Making government work better

October 30, 2014

Ms. Beth Bresnahan, Executive Director
Massachusetts State Lottery Commission
60 Columbian Street
Braintree, MA 02184

Dear Ms. Bresnahan:

I am pleased to provide this performance audit of the Massachusetts State Lottery Commission. This report details the audit objectives, scope, methodology, findings, and recommendations for the audit period, July 1, 2010 through September 30, 2012. My audit staff discussed the contents of this report with management of the agency, and their comments are reflected in this report.

I would also like to express my appreciation to the Massachusetts State Lottery Commission for the cooperation and assistance provided to my staff during the audit.

Sincerely,

A handwritten signature in blue ink, appearing to read 'SMBump'.

Suzanne M. Bump
Auditor of the Commonwealth

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EXECUTIVE SUMMARY

This audit examined certain activities of the Massachusetts State Lottery Commission (MSLC) for the period July 1, 2010 through September 30, 2012. The objectives of our audit were to examine certain activities of MSLC to ensure that (1) MSLC had established and implemented adequate internal controls to ensure game integrity; (2) lottery games were discontinued in accordance with MSLC regulations and policy; (3) unsold, activated instant-game lottery tickets (instant tickets) were accurately accounted for and properly safeguarded, and sold instant tickets were accurately billed to sales agents in compliance with MSLC regulations and policy; (4) MSLC had appropriate controls in place for the monitoring and oversight of its licensed sales agents; (5) MSLC's internal audit unit complied with MSLC's established policies and procedures (this included determining whether corrective actions were taken on identified internal audit findings and recommendations); (6) accounts receivable from sales agents were administered in compliance with the Office of the State Comptroller's regulations and MSLC's policy; and (7) MSLC had taken corrective actions to address any findings from our prior audit (No. 2008-0089-3S) that were related to our current audit objectives.

Summary of Findings

- For the initial license applications and license renewal updates of some sales agents, MSLC did not conduct criminal background reviews required by its own policies. As a result, there is inadequate assurance that all of these applicants and agents met MSLC's requirements for licensure in this area; some may have criminal records that MSLC would not be aware of, which would place their operation of lottery ticket sales at a higher risk of abuse or misuse.
- MSLC did not completely fill out forms required to show that it had properly accounted for, and safeguarded, the return of instant-game lottery tickets that had been in the custody of terminated sales agents. As a result, there is no assurance that all activated instant tickets returned from terminated sales agents were accurately accounted for, properly safeguarded, and ultimately destroyed as required. Since activated instant tickets can be cashed up until the point of destruction, there is also a potential financial risk to the Commonwealth that prizes from unsold but activated instant tickets could be claimed.
- Our prior audit raised questions regarding internal controls, policies, and procedures related to sales agents' ability to illicitly scan unsold instant tickets to determine which ones were winning tickets, a practice commonly known as peeking. We recommended that MSLC ensure that its compliance unit more closely monitored its sales agents for unusual, irregular, and questionable activities and patterns and take appropriate action as warranted. During our current audit, we determined that after our prior audit period, MSLC updated its policies and procedures to include procedures to detect illicit scanning. However, contrary to its established policies,

MSLC's practice to detect peeking activities was limited to a review of sales agents who committed two or more "clear errors" (potential indicators of peeking) for four or more days of the previous week rather than the three or more days stipulated by policy.

- MSLC policy prohibits employees, or their immediate family members residing in their households, from receiving prize payments. However, our prior audit report stated that MSLC did not have adequate controls in this area and recommended that, to prevent MSLC employees and their household family members from playing MSLC games, MSLC collect the names, ages, and Social Security numbers of employees' immediate family members and conduct random checks of employee activity, including cross-checking employee name and Social Security data against payment lists of MSLC game prizewinners. Our current audit determined that MSLC still considered the issue closed and that no effort had been undertaken to institute a policy establishing random checks of employee activity, including the cross-checking of employee name and Social Security data against payment lists of MSLC game prizewinners, as a condition of employment.

Recommendations

MSLC should take the following actions:

- Comply with its established policies and procedures by conducting background reviews for all corporate officers listed either on corporate key account license applications or on license renewal update forms.
- Implement controls to ensure that its existing policies and procedures for the return of instant-game tickets in the custody of terminated agents are followed. Specifically, these controls should ensure that all Final Settlement Forms have been properly completed and contain all the necessary signatures to ensure that all activated tickets returned per the Final Settlement Form were accurately accounted for, properly safeguarded, and ultimately destroyed.
- Review sales agents who make "two or more clear errors, three or more days of the previous week," as stated in its current policies.
- Establish effective policies and procedures to determine whether any prizes are claimed by MSLC employees or their immediate household family members.

Post-Audit Action

After we completed our audit, MSLC informed us that it had implemented a new policy to ensure that all activated instant tickets collected from terminated sales agents were accurately accounted for, properly safeguarded, and ultimately destroyed and that related supporting documentation was checked for accuracy, completeness, and necessary signatures.

In addition, during our audit, MSLC indicated that a more stringent interpretation of its existing policy regarding the scanning of unsold tickets by sales agents had resulted in a significant increase in the number of disciplinary hearings of sales agents for violation of the policy.

OVERVIEW OF AUDITED AGENCY

Background

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

The commission is hereby authorized to conduct a state lottery and shall determine the types of lottery or lotteries, to be conducted . . . 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 independently audited financial 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. . . .

MSLC's executive director is appointed by the State Treasurer, subject to the approval of the Governor, and is responsible for MSLC's day-to-day operations according to Chapter 10, Section 26, of the General Laws.

According to its website, MSLC's mission is "to operate in a manner that secures the integrity of the Lottery's games and protects the well-being of its customers while maximizing revenues returned to the Commonwealth for the benefit of its cities and towns." According to its internal control plan, MSLC's goals are as follows:

- *Generate a (steady) flow of revenues for the cities and towns of MA*
- *Maintain the Lottery's reputation for game integrity: honest & fair games*
- *Maintain the Lottery's reputation for safeguarding sensitive data*
- *Support efficient lottery operations*
- *Contribute to responsible gaming*

MSLC's excess revenue over its expenses is distributed by the Commonwealth in the form of indirect and direct local aid. The indirect local aid consists of distributions to the Arts Lottery Local Aid fund; the Massachusetts Cultural Council; and the Department of Public Health, which receives MSLC funds that are used to fund the Massachusetts Council on Compulsive Gambling. Direct local aid is appropriated and distributed by the Commonwealth to its 351 cities and towns according to a formula established by the State Legislature. Lottery funds are unrestricted for the cities and towns, which means they can be spent on public safety, education, and other important local services.

MSLC has the authority to collect revenue incidental to operating various games and the authority to disburse prizes, pay commissions to agents, and cover certain expenses. During fiscal year 2011, MSLC generated \$4.418 billion in sales revenue and \$9 million in other revenue, and it paid prizes totaling \$3.199 billion, or 72% of sales. In addition, MSLC paid \$252 million for commissions and bonuses to its sales agents and had administrative and operating expenses totaling \$89 million, for a net profit of \$887 million. Of this amount, \$802 million was distributed as local aid to cities and towns, \$79 million to Arts Lottery Local Aid, \$6 million to the Massachusetts Cultural Council, and \$1 million to the Massachusetts Council on Compulsive Gambling. (These numbers are approximate; see Appendix A for specific totals.)

During fiscal year 2012, MSLC generated \$4.735 billion in sales revenue and \$9 million in other revenue, such as fees from lottery agents and investment income, and it paid prizes totaling \$3.399 billion, or 72% of sales. In addition, MSLC paid \$270 million for commissions and bonuses to its sales agents and had administrative and operating expenses totaling \$91 million, for a net profit of \$984 million. Of this amount, \$898 million was distributed as local aid to cities and towns, \$79 million to Arts Lottery Local Aid, \$6 million to the Massachusetts Cultural Council, and \$1 million to the Massachusetts Council on Compulsive Gambling. (See Appendix A for specific totals.)

For the quarter ended September 30, 2012, MSLC generated \$1.14 billion in sales revenue and \$2 million in other revenue, and it paid prizes totaling \$844 million, or 74% of sales. In addition, MSLC paid \$65 million for commissions and bonuses to its sales agents and had administrative and operating expenses totaling \$14 million, resulting in a net profit of \$219 million. Governmental revenue is also generated for the state and federal governments as a result of income taxes paid on

prize money winnings by the purchasers of MSLC tickets, further enhancing funding for government services, programs, operations, and activities. (See Appendix A for specific totals.)

MSLC receives annual appropriations to fund its own operations and that of the arts lottery. For the two-fiscal-year period ended June 30, 2012, MSLC received a total of \$164,571,734 in funding from the Commonwealth as follows:

Funding Sources	2012	2011
0640-0000—Appropriations for Operation	\$ 77,721,702	\$ 76,707,174
0640-0005—Appropriations to Monitor Games	2,715,484	2,715,484
0640-0010—Appropriations for Advertising	2,000,000	2,000,000
0640-0096—Appropriations for Health and Welfare Benefits	<u>355,945</u>	<u>355,945</u>
	<u>\$82,793,131</u>	<u>\$ 81,778,603</u>

MSLC's administrative office is located at 60 Columbian Street in Braintree. MSLC also has five regional offices, which are located in New Bedford, Springfield, Woburn, Worcester, and Boston. In addition, MSLC maintains a warehouse facility in Canton that houses instant-game lottery tickets and other supplies, as well as a computer facility in Norwell. During our audit period, MSLC operated the following 11 departments: Finance, Human Resources, Legal, Information Technology, Communications, Marketing, Operations, Security, Compliance and Investigations, Internal Audit, and Sales/Regional Operations. (See Appendix B for descriptions of all 11 departments.)

Licensed Sales Agents

All sales agents who sell lottery products must be licensed by MSLC. MSLC classifies sales agents into two general categories: key accounts¹ and non-key accounts.² A key account entity is required to execute a Continuing Corporate Guaranty³ unless the MSLC director of Credit and Collections determines that a Continuing Individual Guaranty⁴ is required. All approved non-key-account applicants must sign a Sales Agent Agreement and are required to provide a Continuing Individual Guaranty. These Guaranties are executed to mitigate the potential financial risk if an agent defaults on payments due MSLC.

¹ Key accounts are for fraternal nonprofit organizations (e.g., Veterans of Foreign Wars, the Elks) and business entities with either a single location or multiple locations pursuant to one contract between MSLC and the business (e.g., corporate chain stores).

² Non-key accounts are for all applicants not specifically identified and classified as key accounts.

³ Under this type of agreement, the corporation is liable for any debts incurred by the sales agent.

⁴ Under this type of agreement, guarantors are personally liable for any debts owed to MSLC.

According to MSLC’s licensing policies and procedures, when it receives an initial license application, MSLC initiates a three-part review. This consists of a credit review, a criminal background review, and a site assessment (not completed for corporate chain stores). These reviews are conducted to ensure that only qualified, eligible agents are licensed to sell lottery products.

License renewal updates are completed in order to obtain updated information for all sales agents. The renewal update process occurs every two years for non-key accounts and every four years for key accounts. A criminal background update review is completed every four years for all agents.

As of September 30, 2012, there were 7,453 sales agent locations throughout the Commonwealth:

Key Accounts—Corporate Chain Locations	1,693
Key Accounts—Fraternal/Nonprofit Organizations	337
Non-Key-Account Locations	5,423
Total	<u>7,453</u>

AUDIT OBJECTIVES, SCOPE, AND METHODOLOGY

In accordance with Chapter 11, Section 12, of the Massachusetts General Laws, the Office of the State Auditor (OSA) has conducted a performance audit of certain activities of the Massachusetts State Lottery Commission (MSLC) for the period July 1, 2010 through September 30, 2012. The objectives of our audit were to examine certain activities of MSLC to ensure that (1) MSLC had established and implemented adequate internal controls to ensure game integrity; (2) lottery games were discontinued in accordance with MSLC regulations and policy; (3) unsold, activated instant-game lottery tickets (instant tickets) were accurately accounted for and properly safeguarded, and sold instant tickets were accurately billed to sales agents in compliance with MSLC regulations and policy; (4) MSLC had appropriate controls in place for the monitoring and oversight of its licensed sales agents; (5) MSLC's internal audit unit complied with MSLC's established policies and procedures (this included determining whether corrective actions were taken on identified internal audit findings and recommendations); (6) accounts receivable from sales agents were administered in compliance with the Office of the State Comptroller's (OSC's) regulations and MSLC's policy; and (7) MSLC had taken corrective actions to address any findings from our prior audit (No. 2008-0089-3S) that were related to our current audit objectives.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. In order to achieve our objectives, we performed the following audit procedures:

- We reviewed the prior OSA audit report and various MSLC internal documents, including internal audit reports, the internal control plan, organizational charts, the sales agent handbook, the employee handbook, management letters, and Chapter 647 reports filed with OSA, as well as miscellaneous bulletins issued by MSLC.
- We assessed MSLC's controls regarding oversight of sales agents. Specifically, we performed the following activities:
 - We reviewed MSLC's policies and procedures for the licensing of sales agents and applicable criteria such as 961 Code of Massachusetts Regulations 2.00 and Chapter 10, Sections 23 through 35, of the General Laws. We interviewed the licensing managers who are

responsible for oversight of the issuance and renewal of sales agents' licenses to obtain an understanding of the process used by MSLC for license issuances and renewals. We requested, received, and reviewed 83 license applications, consisting of a judgmental sample of 71 non-key-account license applications from a population of 1,337 applications obtained from MSLC's Retailer Management System (RMS),⁵ as well as a judgmental sample of 12 key account license applications from a population of 43 applications submitted during our audit period. We also requested, received, and reviewed required documentation such as criminal background reviews, credit reviews, and site assessments conducted by MSLC for individuals and entities that have applied for sales agent licenses to determine whether only qualified/eligible applicants are issued licenses. We reviewed license renewal updates filed by sales agents by selecting a random non-statistical sample of 35 non-key-account renewal updates from a population of 879 updates completed in two randomly selected months during our audit period and by selecting 100% of MSLC's 37 key account renewal updates with Continuing Individual Guaranties to determine whether only qualified/eligible sales agents are allowed to retain their licenses.

- We reviewed controls MSLC had established over consumer complaints filed against sales agents by interviewing the assistant executive director of Compliance and Internal Audit. We requested, received, and reviewed complaints received by MSLC to assess whether the investigations of the complaints were promptly and properly documented in accordance with MSLC policy. For the purposes of this audit, we tested a non-statistical sample of 20 randomly selected complaints from the MSLC database file of 216 complaint cases closed during our audit period.
- We reviewed controls MSLC had established over on-site audits of sales agents by interviewing the regional manager of Asset Protection, who is responsible for oversight of on-site audits. We requested, received, and reviewed documentation for completed audits to assess whether they were conducted in accordance with MSLC policy. For the purposes of this audit, we tested a non-statistical random sample of 35 agents from the RMS list of 7,453 licensed sales agents who would have been subject to two on-site audits each for calendar year 2011.
- We reviewed controls MSLC had established over sales-to-minor stings⁶ by interviewing the senior investigator responsible for those stings. We requested, received, and reviewed documentation for completed stings to assess whether they were conducted in accordance with MSLC policy. For the purposes of this audit, we tested all three sales-to-minor stings classified as failed from the RMS list of 201 stings conducted during our audit period.
- We reviewed controls over Americans with Disabilities Act (ADA) compliance assessments conducted by MSLC at agent locations. We interviewed the deputy general counsel and the ADA coordinator to gain an understanding of the internal controls over this process. We selected a judgmental sample of 17 of the 83 applications we had chosen for initial licensing testing to determine whether required inspections were completed and whether, if applicable, implementation compliance plans were signed by the sales agent for sites that had

⁵ A database used by MSLC to maintain sales agent information, e.g., licensing data, contact information.

⁶ Procedures wherein MSLC hires minors (under 18 years old) to enter sales agent locations and attempt to purchase lottery tickets. By law, only individuals over the age of 18 can purchase lottery tickets.

failed the ADA compliance assessment in accordance with MSLC's litigation settlement agreement.⁷

- We reviewed the controls MSLC had established to ensure game integrity. Specifically, we performed the following activities:
 - We reviewed data analytic reviews conducted by MSLC that compared the game's intended percentage of prize payouts to sales (revenue) to the actual percentage to determine whether MSLC researched significant differences to identify the reason for them. We interviewed the chief financial officer to gain an understanding of the internal controls over this process.
 - We reviewed controls MSLC had established over new games. Using the MSLC Marketing Department's list of new games put into operation during our audit period, we selected all 3 online games; additionally selected a random non-statistical sample of 10 instant games from a population of 68 games created; and reviewed documentation to determine whether the games' specifications, including the percentage of payouts, were approved by the MSLC executive director. We interviewed the chief financial officer to gain an understanding of the internal controls over this process.
- We reviewed the controls MSLC had established over discontinued games. From MSLC's website, we obtained the list of all games discontinued during our audit period. We selected the 1 online game discontinued by MSLC; additionally selected a random non-statistical sample of 10 instant games from a population of 89 discontinued games; and reviewed documentation to determine whether games were discontinued in accordance with established MSLC policy and regulations. We interviewed the internal auditor and the director of Asset Control and Ticket Return to gain an understanding of the internal controls over this process.
- We reviewed the controls MSLC had established over unsold, activated instant tickets and billing of sold instant tickets. Specifically, we performed the following activities:
 - We requested, received, and reviewed unsold, activated instant tickets returned to MSLC by terminated sales agents. We interviewed the MSLC internal control officer and the director of Asset Control and Ticket Return to gain an understanding of the internal controls established over this process. We selected a random non-statistical sample of 35 sales agents from a population of 1,403 sales agents terminated during our audit period (obtained from RMS) to determine whether tickets were accurately accounted for and properly safeguarded and whether sold tickets were accurately billed to agents in accordance with MSLC policy.
 - We requested, received, and reviewed reports of investigations of stolen instant tickets from sales agent locations. We interviewed the assistant executive director of Compliance and Internal Audit and the assistant director of Security to gain an understanding of the internal controls established over this process. We selected a judgmental sample of 25 investigations from the MSLC Security Department's Microsoft Access database of 471 investigations conducted during our audit period to determine whether unsold tickets were accurately

⁷ This settlement agreement is between MSLC and a plaintiff who alleged that many licensed MSLC sales agent locations were not accessible to persons with mobility impairments. It required that all new MSLC license applicants submit to on-site accessibility audits of their retail locations. It was executed on December 7, 2011.

accounted for and sold tickets were accurately billed to agents in accordance with MSLC policy.

- We reviewed MSLC's controls over its internal audit function. We interviewed the MSLC internal auditor to gain an understanding of this function and reviewed MSLC policies and procedures established for conducting audits. Additionally, we determined whether MSLC was maintaining a database of the audits started, completed, and in progress; whether it was using risk assessments in developing audit plans; whether it had implemented a process to communicate the status of the annual audit plan and the issuance of audit reports; and whether it had taken follow-up actions on reported recommendations.
- We reviewed MSLC's controls over individual accounts receivable balances due from MSLC sales agents. We interviewed the director of Credit and Collections to understand the controls associated with the collection of accounts receivable from sales agents. We selected a judgmental sample of 20 agent accounts from a report, generated from the Commonwealth's Billing and Accounts Receivable System, of 110 agent accounts created before our audit period, as well as a random non-statistical sample of 20 agent accounts from a population of 172 created between July 1, 2010 and June 30, 2012. We used this sample to determine whether stated balances were documented, accurate, and approved as well as whether overdue balances were referred to a collection agency, payment plans established where applicable, and balances written off if determined to be uncollectible in accordance with OSC regulations and MSLC policy. Additionally, we reviewed 100% of the sales agent accounts receivable balance write-offs submitted to OSC in fiscal year 2012.
- We used judgmental, non-statistical random sampling approaches, as discussed above, to achieve our audit objectives. When a non-statistical judgmental or random approach is used, the results cannot be projected to the entire population, but only apply to the items selected.

Our assessment of internal controls over financial and management activities at MSLC was based on the above interviews and document reviews. We obtained and reviewed sales agent applications and renewals and traced and compared them to RMS for consistency and completeness. We also interviewed agency officials who were knowledgeable about RMS data-input activities. Since the license application is the source document used to update RMS and the principal document that determines whether a sales agent should be licensed, we did not rely on RMS for the purposes of our audit. We believe the information we obtained directly from the sales agent applications for initial and renewal licensing was sufficient for the purposes of our analysis and findings. In addition, we obtained and reviewed reports of investigations, conducted by MSLC, of instant tickets stolen from sales agent locations, and we traced and compared the reports to the MSLC Security Department's Access database to assess consistency and completeness. We also interviewed agency officials who were knowledgeable about database-input activities. Since the reports are the source documents used to update the Access database and the principal documents that determine the

actions taken by MSLC, we did not rely on the database for the purposes of our audit. We believe the information we obtained directly from the reports of investigations of instant tickets stolen from sales agent locations was sufficient for the purposes of our analysis and findings. We also analyzed MSLC payment information and state accounting records in the Commonwealth's Massachusetts Management Accounting and Reporting System to identify payments made by the Commonwealth to fund MSLC's operations. The electronic data sources used for this analysis constitute the official procurement and accounting records of the Commonwealth, are widely accepted as accurate, and form the basis for the Commonwealth's audited annual financial statements. Accordingly, our audit did not involve a comprehensive assessment of the reliability of source Commonwealth data.

Based on our audit, we have determined that for the period July 1, 2010 through September 30, 2012, excluding the issues addressed in the Detailed Audit Results and Findings section of this report, MSLC maintained adequate internal controls over its financial operations and program activities for the areas tested.

DETAILED AUDIT RESULTS AND FINDINGS WITH AUDITEE'S RESPONSE

1. The Massachusetts State Lottery Commission did not complete criminal background reviews for all sales agents.

For the initial license applications and license renewal updates of some sales agents,⁸ the Massachusetts State Lottery Commission (MSLC) did not conduct criminal background reviews required by its own policies. As a result, there is inadequate assurance that all of these applicants and agents met MSLC's requirements for licensure in this area; some may have criminal records that MSLC would not be aware of, which would place their operation of lottery ticket sales at a higher risk of abuse or misuse.

MSLC had 11 key account⁹ sales agent applications submitted during our audit period with Continuing Corporate Guaranties. MSLC performs background reviews on all individuals associated with key accounts who sign Continuing Individual Guaranties and all individuals associated with non-key accounts. However, contrary to its own policies, MSLC did not conduct criminal background reviews on any of the corporate officers identified on key account license applications or renewal update forms for sales agents who executed Continuing Corporate Guaranties.

Authoritative Guidance

MSLC's Key Accounts policy/procedure document states, in part,

It shall be the policy of the MSLC, in compliance with Massachusetts General Law Chapter 10 et seq. and 961 [Code of Massachusetts Regulations, or CMR] 2:00 et seq, to verify the criminal background information of all applicants and existing agents.

Chapter 10, Section 27, of the Massachusetts General Laws states, in part,

Said director may refuse to issue a license to any person who has been convicted of a felony by a court of competent jurisdiction in the commonwealth or of any other state or of the United States and who, in the opinion of said director, is not of good moral character to act as a licensed agent to sell lottery tickets.

The regulation 961 CMR 2.08(2)(b) states, in part,

No applicant shall be granted a license as a Sales Agent if the applicant or any employee of the applicant who holds a position of substantial authority in the applicant's business has at any time been convicted of a felony or any violations of M.G.L. c. 271 [Crimes against Public Policy] or of

⁸ Any person or group of persons that has been issued a license to sell lottery products.

⁹ A category of sales agents consisting of fraternal and nonprofit organizations, as well as business entities operating either a single location or multiple locations under one corporate license.

any other anti-gambling statute or law relating to the taxation of gambling or the proceeds thereof unless the Director in his/her discretion decides otherwise.

Current Practices

MSLC policies and procedures require that a review be conducted to determine whether a key account applicant satisfies MSLC's eligibility requirements to become a licensed sales agent. The review includes the following:

- A credit review is conducted to determine whether the applicant has sufficient corporate assets to adequately protect and preserve the assets of the Commonwealth. If the assets are deemed adequate, a Continuing Corporate Guaranty is executed. The corporate business entity is the actual licensee; its officers may change, but the contractually binding obligation and associated risk remain with the corporate entity.
- If the entity is determined to have insufficient corporate assets, MSLC obtains credit scores for officers named on the application who hold positions of substantial authority. If any of the officers receives a passing grade, a Continuing Individual Guaranty is executed.
- When a Continuing Individual Guaranty is to be executed, a criminal background review is conducted on the officer who will sign the Continuing Individual Guaranty. If a Continuing Corporate Guaranty is to be executed, no criminal background review is conducted on any officer named on the application.
- No criminal background reviews are conducted for existing agents during the license renewal update process.

There are approximately 357 sales agents with Continuing Corporate Guaranties.

Reasons for Not Conducting Criminal Background Reviews

MSLC officials told us that during the audit period, MSLC's practice was not to conduct criminal background reviews for all corporate officers listed on key accounts with Continuing Corporate Guaranties because a corporation, as opposed to a person, was being licensed, making the corporation liable.

Recommendations

MSLC should comply with its established policies and procedures by conducting background reviews for all corporate officers listed either on corporate key account license applications or on license renewal update forms.

Auditee's Response

The Lottery will begin to administer criminal background checks on all licensees/agents including existing and new national chain accounts as of January 1, 2015.

2. MSLC did not complete documentation to show that it had properly accounted for, and safeguarded, tickets that had been in the custody of terminated sales agents.

MSLC did not completely fill out forms required to show that it had properly accounted for, and safeguarded, the return of instant-game lottery tickets (instant tickets) that had been in the custody of terminated sales agents. As a result, there is no assurance that all activated¹⁰ instant tickets returned from terminated sales agents were accurately accounted for, properly safeguarded, and ultimately destroyed as required. Since activated instant tickets can be cashed up until the point of destruction, there is also a potential financial risk to the Commonwealth that prizes from unsold but activated instant tickets could be claimed.

During our audit, we selected a random non-statistical sample of 35 sales agents from a population of 1,403 terminated sales agents (obtained from MSLC's Retailer Management System) to determine whether tickets were accurately accounted for and properly safeguarded and whether sold tickets were accurately billed to agents in accordance with MSLC policy.

MSLC developed the Final Settlement Form to document that all activated tickets returned by terminated agents are invalidated, and eventually destroyed, as required. Eight of the forms in our sample did not have the Security / Asset Protection staff member's signature documenting that the form was rechecked and verified to confirm that the actual number of tickets placed into bins for destruction agreed with what was recorded on the form.

Authoritative Guidance

According to MSLC's Asset Protection Policy, when a sales agent is terminating his or her relationship with MSLC, the MSLC Asset Protection Department is required to conduct a final instant-ticket settlement at the agent location. Under this process, all unsold and partially sold books of instant tickets are collected and returned. In order to calculate the amount due MSLC, the Asset Protection personnel record the number of instant tickets, both sold and returned, on a Final Settlement Form. This form is then verified by signature by both the sales agent and the Asset Protection staff member who picks up the tickets. All instant tickets being returned from partially

¹⁰ Activated tickets are tickets that can be cashed up until the time they are destroyed.

sold books remain “live,” and prizes on winning tickets can be claimed up until the time they are destroyed. All instant tickets are placed in locked bags and returned to the MSLC inventory control officers (ICOs) at the appropriate MSLC regional office. Upon receipt, ICOs are responsible for verifying that the Final Settlement Form is complete and accurate. To do so, an ICO signs the form, confirming that the number of tickets returned agrees with what has been recorded on the Final Settlement Form.

After verification by the ICO, any activated instant tickets are stored in locked rooms with limited access until they are destroyed. Non-activated tickets are returned to inventory to be redistributed. The destruction process begins with an MSLC Security or Asset Protection staff member, accompanied by the ICO, entering the locked room and verifying that the number of tickets to be destroyed agrees with what was recorded as having been returned on the Final Settlement Form. Once the number is rechecked and verified, the Asset Protection staff member signs the form and then places the instant tickets into a secured bin. The bin is taken into a secured area, where it remains until a mobile shredder makes a scheduled pickup and destroys the tickets.

Reasons for Incomplete Documentation

MSLC had not implemented monitoring controls to ensure that Final Settlement Forms had been fully completed, including all necessary and required signatures. MSLC could not explain why the monitoring controls had not been implemented.

Recommendations

MSLC should implement controls to ensure that its existing policies and procedures for the return of instant-game tickets in the custody of terminated agents are followed. Specifically, these controls should ensure that all Final Settlement Forms have been properly completed and contain all the necessary signatures to ensure that all activated tickets returned per the Final Settlement Form were accurately accounted for, properly safeguarded, and ultimately destroyed.

Auditee's Response

The Lottery became aware of this issue during the Audit process and in March 2014 implemented a new policy that is also included in the Lottery's Internal Control plan. The Director of Asset Control and Ticket Return now reviews and keeps a separate folder for each region's final settlements. These forms are checked for accuracy and completion with all the necessary signatures by the Director. This new policy adds an additional step to further ensure that all activated instant tickets are accounted for, properly safeguarded and ultimately destroyed.

3. Unresolved Prior Audit Results

a. MSLC had insufficient controls over sales agent ticket peeking activities.

Our prior audit (No. 2008-0089-3S) raised questions regarding internal controls, policies, and procedures related to sales agents' ability to illicitly scan unsold instant tickets to determine which ones were winning tickets, a practice commonly known as peeking. We recommended that MSLC ensure that its compliance unit more closely monitored its sales agents for unusual, irregular, and questionable activities and patterns and take appropriate action as warranted.

During our current audit, we determined that after our prior audit period, MSLC updated its policies and procedures to include procedures to detect illicit scanning. Specifically, MSLC's Compliance Policy and Procedure Manual, in its section on "Clear Errors" Reporting, states that sales agents will be subject to review for "two or more clear errors, three or more days of the previous week." Clear errors are "intentionally or unintentionally [abusing] auto cash privileges, a potential indicator of attempted 'peeking.'"¹¹ However, contrary to its established policies, MSLC's practice to detect peeking activities was limited to a review of sales agents who committed two or more clear errors for four or more days of the previous week rather than the three or more days stipulated by policy. Specifically, there were 773 instances during our audit period, involving 469 agents, where two or more clear errors were committed three or more times in a week. However, 433 of these sales agents were not reviewed by MSLC. Further, according to the Compliance Policy and Procedure Manual, a sales agent who is cited for clear errors for a second time within 12 months will have his/her auto cash privilege suspended pending a hearing before the executive director or his or her designee. We determined that 133 out of the 469 sales agents committed a second offense within 12 months of the first offense, but that 128 out of these 133 cases were not identified as second offenses and followed with an administrative hearing.

MSLC officials told us the policy was interpreted as requiring follow-up for two or more clear errors for more than three days in the previous week, as opposed to two or more clear errors for three or more days in the previous week. During our field work, MSLC told us it would change the practice to a review of two or more errors for three or more days in the previous week to comply with its established policy.

¹¹ "Auto cash privileges" refers to a sales agent's ability to cash small prizes (up to \$20) by simply scanning the ticket on a lottery terminal.

b. MSLC had insufficient controls over prohibited game participation among employees and their household family members.

MSLC policy prohibits employees, or their immediate family members residing in their households, from receiving prize payments. However, our prior audit report stated that MSLC did not have adequate controls in this area and recommended that, to prevent MSLC employees and their household family members from playing MSLC games, MSLC take the following actions:

- Require, as a condition of employment, the names, ages, and Social Security numbers of immediate family members of all MSLC employees.
- Conduct random checks of employee activity, including cross-checking employee name and Social Security data against payment lists of MSLC game prizewinners.

Our current audit determined that MSLC still considered the issue closed and that no effort had been undertaken to institute a policy establishing random checks of employee activity, including the cross-checking of employee name and Social Security data against payment lists of MSLC game prizewinners, as a condition of employment.

Recommendations

MSLC should take the following actions:

- Review sales agents who make “two or more clear errors, three or more days of the previous week,” as stated in its current policies.
- Establish effective policies and procedures to determine whether any prizes are claimed by either MSLC employees or their immediate household family members.

Auditee's Response

- *As of March 2013, upon the Audit staff raising this issue during their work, the Lottery took a more stringent interpretation of the existing policy regarding scanning of non-winning tickets by its Sales Agents. Since that time, the number of Lottery Sales Agent disciplinary hearings has increased markedly. Agents found violating this policy immediately have their “auto cash” ability suspended, which adds manual steps to the process of cashing winning instant tickets at their store location and are scheduled for a disciplinary hearing. The “auto cash” privilege may or may not be restored following the hearing process. Since September 2013, the Lottery has held 32 Agent discipline hearings for violations of this policy. During these 32 hearings, there has never been any evidence indicating that a Lottery Sales Agent or its employees have intentionally misused the Lottery cashing system as a means to impermissibly identify instant ticket winners. The majority of violations were caused by new employees/improperly trained employees and by customer demands to have their tickets in-hand scanned. Lottery Sales Agents in question were counseled on better training its*

employees and better communicating with its customers the current terminal's inability to serve as a "ticket checker."

Additional information:

Currently, the barcode used to cash MSLC instant tickets is located on the back of each ticket. If the barcode used to cash Instant Tickets were printed in the play area, under the latex covering, on the front of the ticket, Agents would need to scratch the play area of each ticket in order to cash it, thus eliminating the possibility of "auto cash" abuse. However, this type of cashing is impractical due to the damage that scratching the latex area causes to the underlying data resulting in barcode reader errors. Recent advancements in barcode printing and reading technologies have generated "PDF" barcodes that have acceptable read rates when they are printed under latex covering and then read after the latex has been scratched off. Unfortunately, the terminals currently installed at MSLC Agent locations, do not have the ability to read the new PDF barcodes. The MSLC will soon be releasing [procurement forms] to procure a new host system and agent location hardware. The resulting agent terminal will have the ability to read PDF barcodes. In anticipation of new terminal barcode readers, the MSLC started printing PDF barcodes on all new instant tickets in April 2013. Once the new technology is implemented at store locations and a significant majority of MSLC instant tickets in circulation bear the PDF barcode, we will be able to employ the new barcode and securely auto cash all instant tickets, eliminating the ability for agents to unintentionally or intentionally abuse the auto cash feature.

- Every MSLC employee must sign a form upon hire acknowledging the prohibition of playing Massachusetts Lottery games, including the purchase of games offered in Massachusetts that cross state lines (Powerball, Mega Millions and Lucky for Life). MSLC has consistently acted upon any report that a Lottery employee has purchased or was playing a Lottery game. MSLC's consistent enforcement practice is evidenced by the fact that MSLC has terminated employees who were found to have violated this prohibition.*

Auditor's Reply

Based on its response, MSLC is taking measures to detect illicit scanning by sales agents by making a more stringent interpretation of its current policy, the results of which indicate a significant increase in sales agents receiving disciplinary hearings. However, while we agree with the MSLC policy that each employee must sign a form acknowledging the prohibition of their, or their immediate household family members', playing MSLC games, in our judgment this policy alone is not sufficient to deter the practice or provide reasonable assurance that MSLC employees and immediate family household members are not playing the games. For this reason, we again recommend that MSLC establish effective policies and procedures to determine whether any prizes are claimed by either MSLC employees or their immediate household family members. Such policies and procedures could include a cross-check of MSLC employees' and their immediate family household members' Social Security numbers against those reported on prize claim forms, as recommended in prior reports from the Office of the State Auditor. Alternatively, as we discussed with MSLC during our current audit, if this option is problematic because of confidentiality concerns regarding Social

Security numbers, MSLC could cross-check employees' and their immediate family household members' addresses against the addresses reported on prize claim forms. Either cross-check would provide an additional layer of internal control that would better ensure adherence to MSLC's established policy.

APPENDIX A

Statements of Revenue, Expenditures, Transfers, and Changes in Fund Balance¹² 2011–2012 (amounts in thousands)

Revenue, Expenditures, and Changes in Fund Balance

Revenue	July 1, 2012 through September 30, 2012	2012	2011
Instant Tickets	\$ 784,591	\$ 3,251,483	\$ 3,008,070
Mega Millions	13,976	101,480	104,910
Powerball	28,332	82,913	60,833
Numbers Game	79,743	333,857	344,437
Mass Cash	17,035	71,058	47,470
Keno	192,793	790,459	768,218
Cash WinFall	0	13,528	30,037
Daily Race Game	6,146	23,319	20,800
Megabucks Doubler	6,252	33,581	30,634
Online Raffle Game	0	10,291	–
Lucky for Life	11,331	16,775	–
Other	799	5,831	2,292
Ticket sales revenue	<u>1,140,998</u>	<u>4,734,575</u>	<u>4,417,701</u>
Plus: retailer fees / other income	1,994	9,144	8,852
Total revenue	<u><u>1,142,992</u></u>	<u><u>4,743,719</u></u>	<u><u>4,426,553</u></u>
Expenditures			
Prizes	844,252	3,398,819	3,198,923
Retailers' commissions and bonuses	65,226	269,656	251,970
Administrative and general expenses	14,210	91,142	88,635
Total expenditures	<u>923,688</u>	<u>3,759,617</u>	<u>3,539,528</u>
Excess (deficiency) of revenue over (under) expenditures before transfers	<u>219,304</u>	<u>984,102</u>	<u>887,025</u>
Less: revenue transfers (see next page)	–	983,786	887,912
Net change in fund balance	<u>–</u>	<u>316</u>	<u>(887)</u>
Fund balance (deficit) at beginning of year	–	2,106	2,993
Fund balance (deficit) at end of year	<u><u>–</u></u>	<u><u>\$ 2,422</u></u>	<u><u>\$ 2,106</u></u>

¹² Our review was not intended to enable us to express, and we do not express, an opinion on the Statements of Revenue, Expenditures, Transfers, and Changes in Fund Balance. The disclosures of revenue, expenditures, transfers, and changes in fund balance represent information for the first quarter of fiscal year 2013, ended September 30, 2012, and for the fiscal years ended June 30, 2012 and June 30, 2011, and are intended solely for informational purposes.

Revenue Transfers

Transfers	2012	2011
Direct local aid to cities and towns	\$ 897,704	\$ 802,202
Arts Lottery Local Aid fund	78,614	78,614
Massachusetts Cultural Council	6,198	6,096
Massachusetts Council on Compulsive Gambling	1,270	1,000
Total transfers	<u>\$ 983,786</u>	<u>\$ 887,912</u>

APPENDIX B

Massachusetts State Lottery Commission Key Departments¹³

Finance

The Finance department consists of: Accounting, Budget & Procurement, Credit & Collections, Fixed Assets & Inventory Management, Licensing, Asset Protection, and Audit & Control.

The Accounting department performs financial control and reporting activities for the Lottery including revenues, prizes/bonuses paid, administrative expenses, bank account reconciliations, preparation of the monthly statement of operations and the year-end annual report. . . .

The Budget and Procurement department works with senior management to prepare the Lottery's annual spending plan that is submitted to the Office of Administration & Finance and the state legislature. They work with Lottery department heads to prepare and monitor internal department budgets. . . .

The Credit and Collections department is charged with gathering, analyzing, and recommending prospective agents who've requested a Lottery license. They also are responsible to collect late or delinquent amounts from sales agents. The Department works with active agents to secure past due amounts owed to the Lottery and to resolve any issues that might cause a reoccurrence of a missed payment. In addition, the Department works with outside collection agencies to retrieve amounts owed by agents who have been terminated. Also, they control the (Ticket) Claims & Validation and Season Ticket processes.

The Fixed Assets & Inventory Management department is responsible for recording and monitoring Lottery non-ticket inventory status, identifying and entering all Lottery fixed assets onto [the state's Massachusetts Management Accounting and Reporting System] and managing a yearly count of all non-ticket inventory items including fixed assets. This Department is also responsible for Returned Tickets (from agents), End-of-Game Termination, Surplus Property and Records Retention.

The Licensing Department is responsible for processing new agent licensing applications, the renewal of agent licenses for existing agents and the collection of appropriate licensing fees. The Department also works with other state agencies and departments to ensure all lottery agents are authorized to conduct business and sell lottery products within the Commonwealth.

The Asset Protection department conducts semi-annual audits of ticket inventory (and other operational areas) at all Lottery agent locations. The department also performs audits for all changes of ownership, terminations or forced settlement situations. The staff provides technical assistance to agents in the areas of loss prevention, inventory management and protection of assets. In addition, the Department schedules regular audits of all charitable games and bingo and beano events.

The Audit & Control department issues charitable games licenses to qualified organizations allowing them to run bingo and sell charitable game tickets. They are responsible for collecting the 5% tax on gross proceeds from bingo games as well as raffles, bazaars, Las Vegas, and Monte Carlo nights. This group prepares an annual financial report of Massachusetts charitable game operations.

¹³ All text in this appendix is quoted from the Massachusetts State Lottery Commission's 2012 internal control plan.

Human Resources

Human Resources (HR) is responsible for administering all personnel related issues, as well as the recruitment, hiring, and retention of employees. The department develops and implements policies and procedures pertaining to the legitimate interest of the Lottery and its employees. . . .

Legal

The Legal Department functions in a capacity similar to an in-house legal counsel for a large corporation. Counsel represents the Lottery Commission in several areas including bid preparation, contract negotiation, prize claims, Administrative Hearings, Commission Hearings, and other daily routine matters. The department also works with the Attorney General's office in matters that are directly related to the operation of the Lottery.

IT

The IT department is responsible for all computer technology. . . . They support all Lottery departments with systems or data needed to accomplish their objectives; such as those established for strategic initiatives, development or procedural improvements, regulations, and/or mandates. The department is divided into four functional areas: Programming, Quality Control, Computer Operations, and Network Management.

The Programming department handles all changes and development of new software for more than five thousand programs needed to keep the Lottery's business running. . . .

The Quality Control department is responsible for the testing of products and software before installation to the Lottery's production systems or terminals. . . .

The Computer Operations department is responsible for the day-to-day operation of all the Lottery's computer systems. . . . The Computer Operations staff is also responsible for designing, testing, and producing second chance drawings, media notification of draw results, and for update of the automatic telephone voice response system and the masslottery.com web site.

The Network Management staff handles all of the administrative computing needs of the Lottery. . . .

Communications

The Communications/Public Relations department works in cooperation with the Treasurer's office and is responsible for the general oversight of all agency communication activities both internally and externally. Public Relations responds to media inquiries and manages agency information such as revenues and sales material. . . .

Marketing Department

Marketing is responsible for developing and producing the Lottery's marketing strategy. They control product management and promotions. These include Instant Tickets, Keno, on-line games, pull tabs, and second chance drawings. They track sales and work closely with the advertising vendors and media outlets.

Sales/Regional Operations

The Sales and Regional Office Operations provide fully integrated, statewide lottery activities for all customers across the state. The day-to-day functions in each region include Sales, Claims Desk, and Field/Technical Services. . . . Claims for prizes under \$50,000 can be paid out at the regional offices. Prizes of \$50,000 or greater must be claimed at the head office in Braintree. . . .

Operations

The Distribution Department is responsible for the daily distribution of Instant Game Tickets to our Lottery agents throughout the state. . . .

The Facilities Department is responsible for the premises occupied by the Lottery throughout the Commonwealth. . . .

The Telecommunications Department is responsible for the Lottery's voice and data communications systems, including desk telephones, cellular telephones and the Lottery's microwave system.

Security

The Security Unit provides and administers general protection practices for all aspects of the Lottery's operations that include the following:

- *Develops and implements the security policy*
- *Ensures Lottery facilities are secure*
- *Ensures controls for each location are sufficient and up-to-date*
- *Ensures the security, integrity, & confidentiality of information (created, received and/or maintained at the Lottery)*

Compliance and Investigations

It is the responsibility of the Compliance Unit to insure the integrity of the Lottery by monitoring policies and procedures and insure they are carried out with impartiality and fairness. . . . The Investigations Unit administers assistance to the Security Department regarding unauthorized access reports and emergency conditions occurring at the Lottery's facilities. This Unit also initiates investigations relating to claims made by Lottery consumers and Lottery sales agents throughout the Commonwealth.

Internal Audit

Internal Audit (IA) performs evaluations of the design and effectiveness of internal controls. Internal Audit is responsible for monitoring the progress of major and medium risk audit issues as reported by Internal Audit, the State Auditor, and the external auditor. The audit process includes analysis of internal controls, utilization of data analytics to track or trend events, and coordination of the MSLC's strategic policy with the annual audit plan.