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NO. 2003-0089-11S

TRANSITION ASSISTANCE ADVISORY REPORT
FOR THE
MASSACHUSETTS STATE LOTTERY
COMMISSION

OFFICIAL AUDIT
REPORT
SEPTEMBER 10, 2003

Audit No. 2003-0089-11S

September 10, 2003

Joseph C. Sullivan, Executive Director
Massachusetts State Lottery Commission
60 Columbian Street
Braintree, MA 02184-1738

Dear Mr. Sullivan:

Enclosed I am providing you with a Transition Assistance Advisory Report, No. 2003-0089-11S, in response to your request that we conduct a transition assistance review of the Massachusetts State Lottery Commission (MSLC). Our review, which was performed in accordance with Chapter 11, Section 12, of the Massachusetts General Laws and Chapter 647 of the Acts of 1989, examined the status of corrective action on recommendations from prior audits conducted by the Office of the State Auditor (OSA), outside auditors, and the incoming Treasurer's Transition Team report to advise you of any other subsequent issues that came to our attention during our review that warrant further attention and corrective action. Our mutual objective is to ensure that adequate fiscal, administrative, and accounting internal controls, as well as policies and procedures, are in place for the efficient and economical operation of MSLC functions in compliance with applicable laws, rules, and regulations, to provide for the complete and accurate accounting and reporting of financial resources, programs, and activities entrusted to the MSLC.

Accordingly, the enclosed report provides you with timely observations and recommendations to afford you the opportunity to initiate appropriate and meaningful corrective action to minimize the exposure of resources to loss or misuse and to improve programs and activities to fulfill your fiduciary responsibilities for the efficient and economical operation of the MSLC for the benefit of the Commonwealth.

This transition report identifies several areas and specific problems and concerns that need to be or are in the process of being addressed, as summarized below:

- We noted the continued practice previously reported of many professional cashers each repeatedly claiming hundreds of prizes for hundreds of thousands of dollars a year. Many claims that occurred on the same day were purchased from numerous agents around the state for which no taxes were withheld because each claim was considered a separate item for tax reporting requirements which creates tax withholding inequities compared to the average taxpayer. Multiple claims also burden MSLC by necessitating the issuance of hundreds of separate tax reporting W-2G forms for professional cashers. Many of these cashers bypassed lottery offices by redeeming tickets for cash, at the Massasoit Greyhound Association, Inc. (MGA) (Page 7).
- One MSLC sales agent out of 7,300 is allowed to pay claims of up to \$25,000 in cash, while all other agents are limited to paying claims up to \$600, yielding an unfair advantage and additional commissions as compared to other agents. This agent, which was previously allowed to pay claims up to \$50,000, had its maximum payout reduced to \$25,000 as a result of our prior disclosures. The agent does not have the controls that are in place at MSLC offices to verify the identity and Social Security information of claimants. Further, MSLC control and oversight of this sales agent needs to be improved, considering the volume of activity that takes place there (Page 13).
- As of February 28, 2003, agents owe MSLC \$6.8 million after write-offs of \$880,000. This is a reduction from \$9 million previously reported, of which \$2 million was outstanding over 90 days. MSLC has instituted procedures to bill more regularly, and for certain situations shut agents down and turn accounts over to collection agencies. The prior report demonstrated that the \$.35 daily charge for each agent was outdated and insufficient to cover losses attributable to delinquent or terminated agents. Consistent with our prior recommendation, the MSLC is now developing a fair, sliding-scale-type fee structure for delinquent agents sufficient to cover agent losses. Further, MSLC needs to utilize the Massachusetts Management Accounting and Reporting System (MMARS) intercept program to intercept prize money from agents who owe MSLC money, and should consider placing liens for amounts owed when it becomes necessary to terminate agents (Page 16).
- To address concerns raised in prior reports as well as the Treasurer's Transition Team report concerning a sales agent's ability to scan instant game tickets, the new administration has taken action to improve oversight by establishing penalties and agent monitoring guidelines. The MSLC should reduce the number of allowed errors or infractions that result in agents being shut down and also charge agents a fee for turning terminals back on. Also, consideration should be given to prohibiting agents and immediate family members from purchasing tickets in their own stores. Finally, the MSLC as recommended in the Treasurer's Transition Team report, should conduct more extensive credit and background checks on sales agents (Page 18).

- Our prior audit report disclosed MSLC's noncompliance with state laws relative to reporting shortages, losses, or thefts of funds or property to the OSA; the inclusion of a statutorily required clause that allows the OSA to audit the books and records of all contractors doing business with agencies of the Commonwealth; and with certain provisions of the state's open meeting law. The current administration indicated that it intends to comply with (1) Chapter 647 of the Acts of 1989 and is working with the OSA to develop a mechanism and report all unaccounted for variances, losses, shortages, or thefts of funds or property, as required (Page 19) (2) the statutory requirement to include a contract clause in all sales agent agreements providing OSA with access to these vendors' records, which is especially important given that MSLC may experience losses, shortages, and thefts through these agents (Page 21), and (3) the open meeting law (Page 22).
- We previously reported that defective tickets needed to be recalled and reprinted at a cost, that although minimal, should have been recouped from the vendor. Instead of obtaining direct reimbursement from the vendor, MSLC extended its contract at current prices, contending that maintaining price levels compensated MSLC for the costs. Nevertheless, MSLC should keep its business dealings and accounting straightforward and obtain reimbursement instead of through indirect offsetting arrangements (Page 23).
- MSLC's internal audit position has been vacant for more than a year, and as a result no one has the primary responsibility of performing or delegating the duties and functions of the position. Therefore, controls could be overlooked, placing critical functions and activities at risk. This concern was also raised by the Treasurer's transition team. It is essential that the internal audit function be reinstated immediately, and for independent purposes report directly to the Executive Director and the Commission (Page 25).
- The MSLC needs to complete a department-wide risk assessment and internal control plan (ICP) as required by Chapter 647 of the Acts of 1989 and the Office of the State Comptroller's requirements. As the MSLC's ICP is approximately one year behind the Comptroller's expected completion time for the risk assessment the MSLC needs to expedite the process it has begun to develop these documents. The internal control plan and risk assessment are important documents because they ensure that the key internal control areas have been identified and that the MSLC has assessed the risk associated with those areas to mitigate financial or operational losses and problems (Page 28).
- Lastly, the report contains a number of suggestions to improve controls and enhance revenues some of which were also recommended by your transition team, such as expanding Keno hours and venues, designing games with a mix of higher prizes, instituting application fees for new agents, and establishing of advisory councils (Page 24).

In closing, I direct your attention to our prior MSLC audit reports, which discuss many of these continuing issues in detail.

We would like to thank you and your staff for the timely cooperation and responsiveness extended to us during the course of this review. Should you or any of your department heads desire to discuss these issues in detail, my staff will make themselves available.

Sincerely,

A. JOSEPH DeNUCCI
Auditor of the Commonwealth

cc: Ken Marchurs, First Deputy Auditor
The Honorable Timothy P. Cahill, Chairman,
Treasurer and Receiver General
Edward A. Flynn, Secretary of Public Safety
Martin Benison, Comptroller
Janice M. Saragoni, Commissioner

Transition Assistance Advisory Memorandum
for the
Massachusetts State Lottery Commission

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 Massachusetts cities and towns and state and federal tax revenues by eliminating or minimizing illegal gambling and bookmaking operations and conducting and operating various legal lottery games.

For fiscal year 2002, the MSLC generated approximately \$4.2 billion in sales, of which \$900 million was allocated for cities and towns, \$73.5 million for administrative operating costs, \$239.5 million for commissions and bonuses to its sales agents, and \$3 billion for prizes. Additionally, the prize money winnings result in potential state and federal income tax revenue for government services, programs, operations, and activities.

Due to the extent that the MSLC plays a significant role in the Commonwealth's overall budget, it is critical that it have strong internal controls to ensure that the Commonwealth's resources are safeguarded and losses are minimized, so that maximum revenues are generated to fulfill its mission and purposes.

Our report identifies areas in need of improvement, recognizes improvements being made by the new administration of the MSLC, and makes recommendations intended to assist in the strengthening of MSLC policies, procedures, and practices in order to fulfill its duties and responsibilities.

Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, of the General Laws and Chapter 647 of the Act of 1989, the Office of the State Auditor (OSA), conducted a transition audit of MSLC to determine the status of accounts, activities, and records; the adequacy of internal controls; and the

status of prior audit issues, and to identify other matters that warrant management attention as of March 3, 2003.

The purpose of our audit was to inform the new Treasurer and Executive Director of the status of fiscal and administrative operations as of the date of his appointment, to enhance the transition from the prior administration to the new administration, and identify systems and internal accounting and administrative controls needing corrective action and improvement. 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 (No. 2002-0089-3S).
- 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; analyzed various administrative, personnel and other agency documents, including sales agents contracts, various MSLC reports and records, and minutes of Commission meetings. In addition, we conducted various analysis of claims information being maintained by MSLC. 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 that we believe may warrant further investigation.

We met with MSLC officials at the conclusion of the audit to discuss our audit results and recommendations. The MSLC submitted a written response to our report which is incorporated as an appendix to this report.

1. INEFFECTIVE OVERSIGHT OF WINNER IDENTIFICATION AND FAILURE TO PURSUE TICKET CASHERS RESULTS IN HUNDREDS OF MILLIONS OF DOLLARS OF UNCLAIMED INCOME AND MILLIONS OF DOLLARS IN POTENTIAL TAX EVASION AND LOST STATE TAX REVENUE.

Prior audit reports illustrated numerous examples of certain individuals repeatedly claiming hundreds of prizes for hundreds of thousands of dollars for several years. Moreover, many of these claims occurred at one time on the same day, with little or no taxes being withheld. Our follow-up review revealed that this trend continued during calendar year 2002. Our prior reports explained that the MSLC's current practice is to withhold state and federal taxes when individual prizes (less the cost of the ticket) exceed \$5,000, except when unacceptable evidence is presented, i.e. proof of Social Security number or a Post Office Box with no identification containing a street address. In such cases, federal and state taxes are withheld at a rate of 30% and 5%, respectively, for prizes of between \$600 and \$5,000.

As detailed in Transition Result No. 2 and in related Exhibits No. 1, 2, and 3, little or no taxes were withheld from the professional or multi-ticket cashers, who continue to cash hundreds of thousands of dollars of winning tickets. Also, for the last several years, hundreds of millions of dollars of income reported on Income Reporting Form W-2G by MSLC to the Department of Revenue (DOR) has not been reported and claimed by individuals who won prizes on individual tax returns. As a result, millions of dollars in taxes were evaded, lost and not reported that could have been used for much-needed state and municipal programs.

Prize claims are not accumulated because each claim is treated as a separate occurrence, causing the issuance of a separate check and W2-G for each claim and allowing many professional cashers, gamblers, people with tax liens, and others to cash hundreds of tickets a year worth hundreds of thousands of dollars with no or minimal taxes being withheld. This practice of issuing multiple checks and W-2-Gs to one person at one time creates tax withholding inequities, advantages, and loopholes for a select group of individuals as compared to the average legitimate prizewinner and taxpayer. This practice also creates unnecessary additional administrative costs and is more prone to error, since thousands of additional unnecessary checks and W2-Gs are

printed. This burdens tax collection agencies with multiple W-2Gs that could appear to be duplicates and increases the potential that names, addresses, and Social Security numbers may be erroneously recorded. In addition, single W-2G summary report is sent out to these winners at year-end, for the amount of their total winnings in excess of \$600 for the year. (See Exhibits 1 and 2)

Our prior report discussed flaws in the system; explaining that lucky million dollar winners who collect \$50,000 per year had the standard automatic federal and state taxes withheld each year. This flaw is considerable, given that these and other winners who have taxes withheld on such prizes as \$1,000, \$2,000, \$5,000, or more a week for life or 20 years, could also win separate individual prizes of \$5,000 and have no taxes withheld on that prize. For example, one individual in our test was receiving \$1,000 per week or \$52,000 per year for life or 20 years and had federal and state taxes withheld on a weekly basis. During the same year this person redeemed eight separate additional instant game claims totaling \$10,000 without any taxes being withheld.

In fact, in response to a prior audit report that disclosed approximately 1,800 W2-Gs totaling approximately \$7 million were returned by the United States Postal Service to the MSLC as undeliverable, the prior administration changed its practice to instead give out the W2-Gs along with the prize payments. However, by mailing W2-G's in the MSLC removed a control by which it could identify those claimants who deliberately provide false information to evade taxes which could be provided to tax collection agencies.

The problem of false claimant identification is further exacerbated by the fact that the prior administration, despite concerns raised in prior reports by its own contracted outside auditor, the OSA, and the incoming Treasurer's own recent transition report, continued to allow one agent, Massasoit Greyhound Association, Inc. (MGA) to pay out individual claims in excess of the \$600 (which is not allowed for any of its other agents) in spite of the fact that the MSLC has no controls in place to ensure that this agent is obtaining proper identification and withholding taxes

on claims between \$600 to \$5,000 when claimant identification information is inadequate. In fact, MGA withheld no taxes during 2002 on claims in this range.

MSLC officials explained that its policies and practices for withholding taxes are based on IRS rules. However, since DOR does not follow IRS rules and does not allow the offset of lottery losses against winnings, the MSLC could likewise not follow IRS rules and instead withhold taxes on prizes of over \$600 (less the cost of the ticket). This would bring in immediate revenue and save the cost, time, and effort of chasing evaders and filing tax liens for the evaded taxes. As shown in Exhibits I and II, our review revealed that three cashers had five unsatisfied tax liens totaling \$156,435 assessed and filed against them.

This system obviously favors and shields questionable and suspicious activities and results in the loss of much needed tax revenue for the Commonwealth.

We recognize that some winners may not be required to file or may be eligible for low-income credits or other credits or deductions, but that certainly does not account for the hundreds of millions of unreported winnings that cannot be determined unless income tax returns are properly filed and all income is accurately reported.

We also understand that because of this “catch me if you can” system, the tax collecting agencies have to chase down some of the “professionals” who are ostensibly “acting as a trade or business” and are required to pay taxes and penalties or may have liens assessed against them. Furthermore, as demonstrated from the analysis in Exhibits 1 and 2 showing the various locations in which tickets were purchased, it is highly unlikely that these individuals could themselves be purchasing tickets in so many different locations in so many communities and therefore it is unlikely that they meet the criteria to qualify as professional gamblers. These individuals are more likely professional cashers, so called “ten percenters,” who are actually conducting an illegal trade or business or “racket,” acting as straws by cashing winning tickets (also referred to as “IRS tickets”), for people who do not receive Form 1099’s from the casher for the income because they are hiding their identity, for a number of reasons, including the evasion of taxes.

According to DOR and the IRS, to qualify as a professional gambler, one must keep a log of daily gambling activities, noting the date, location, type, and amount of wins and losses. In a May 8, 2003 press release, the Tax Division of the United States Department of Justice stated, in part: “Ten percenting” is a practice by which the actual winners of gambling proceeds evade IRS reporting requirements and taxes by having another individual cash the winning ticket and complete the mandatory tax forms. In exchange for this service, the individual who completes the false tax form retains a percentage of the winnings, often set as high as 10 percent of the proceeds.” If the illegal professional cashers or 10 percenters were tracked down and taxed and penalized according to IRS and DOR regulations, they would have to be more like 30 percenters instead of 10 percenters in order to operate, and the people they are shielding would only be receiving 70 cents on the dollar. In any event they (illegal cashers) only represent a small portion of the overall problem, and do not account for the hundreds of millions of dollars that are now escaping the system.

In addition, we identified certain cashers that have tax liens for tax years four and five years before the assessment date that remain uncollected even while the individuals are claiming hundreds of thousands of dollars of lottery winnings. (See Exhibit 1.) These uncollected liens are filed with the Secretary of the Commonwealth, the Municipal Clerk, and the appropriate County Registry of Deeds. However, the liens or attachments are not offset against lottery winnings, so liens (See Exhibit 1) go unsatisfied while the individuals involved also receive funds from the government (See Exhibit 1) and purchase out-of-state property (see Transition Result No. 2). The solution to this unfair system is to withhold taxes on prizes over \$600 and let the taxpayer file returns at year end for a refund or the payment of additional taxes owed, like the ordinary taxpayer. Our test found \$179,836 of City of Boston, state, and federal tax liens that could have been easily satisfied and offset from cashers with significant claims if taxes were withheld, attached, or intercepted.

In any event, as a result of not dealing with this problem over the last several years, the Commonwealth has lost millions in needed tax revenues. In addition, since these amounts go

unreported on state tax returns, it is likely that these same amounts are unreported on the federal tax returns. If so, the loss to the federal government would be in the hundreds of millions for 2000 and 2001 respectively, depending on the taxpayers' applicable tax rate, and ability to claim losses by using Schedule A to itemize deductions or files using Schedule C, if qualified. If the standard deduction is used, losses cannot be used to offset winnings. Furthermore, if the Massachusetts condition is representative of the other lotteries across the nation, since Massachusetts lottery sales are about one-tenth of all lotteries in the nation, then the potential losses are substantial on a national basis. Moreover, these losses are likely magnified if this same condition is pervasive throughout all other legal gambling venues across the nation, such as casinos and racetracks, as recently reported in Florida.

The need to remedy this situation is made obvious by the recent indictments by the United States Department of Justice, regarding the activities of track employees, tellers, ten percenters and actual original winners as previously explained. A news release issued by the Department of Justice on May 8, 2003 indicated that the charges, including conspiracy to defraud the IRS, depending on the particular involvement or relationship, involve filing false tax reports, assisting in the preparation of false tax forms, tax evasion, and fraud. The indictment alleges that the racetrack tellers assisted a patron (ten percenter) in cashing approximately 2,200 tickets worth nearly \$2.4 million from at least January 3, 1993 to October 27, 1999 that did not belong to the patron (See Transition Result No. 2).

Accordingly, we reiterate prior audit recommendations that DOR, where most of the responsibility falls, work in cooperation with the MSLC to amend existing state regulations to withhold taxes at the point of the claim (for all claims of \$600 and above) and to withhold taxes on the basis of accumulated winnings, especially regarding professional cashers on a "pay-as-you-win" basis instead of a "catch me if you can" basis, which is more costly, time consuming, and ineffective. Withholding at the point of claim would close loopholes that foster illegal activity and tax evasion and instead gather tax revenue for citizens in need of government programs and services. In addition, at year end the MSLC should also send out a single W2-G to

all those who won \$600 or more summarizing those winnings, since many individuals who received up to 400 W2-Gs during the year are not reporting the amounts won between \$600 and \$5,000 because no taxes are withheld, as is evident from the amount of ongoing unreported income and tax evasion. This would assist taxpayers with a single form in the event that some are “lost.”

The MSLC should also reconsider its policy of issuing separate W-2Gs for each claimant submitting multiple claims at one time, since this practice undermines and runs counter to sound business accountability and tax reporting philosophy and policy. The MSLC should also cooperate and provide the DOR and IRS with detailed records and information indicating the date, time, and location, of all winning tickets claimed by suspected professional cashers (i.e. known, regular, and repeat, frequent customers) on a monthly basis and refer any suspicious cashing patterns to the proper law enforcement authorities.

The MSLC, DOR, and the Office of the State Comptroller should work together to establish mechanisms to recover winnings to satisfy any liens or attachments for taxes owed the Commonwealth or municipalities. This cooperative and collaborative effort should help these agencies curtail the continuing and growing amount of tax evasion and tax fraud associated with these practices that have been occurring.

In its response to the audit (response appended to the report), the MSLC indicated that it is not a law enforcement agency and is in full compliance with current IRS and DOR withholding laws and regulations. We recognize that MSLC is not a law enforcement agency and may be in full compliance with current IRS and DOR withholding laws and regulations but the MSLC has a fiduciary responsibility as a Commission of the Commonwealth to take all the necessary steps to mitigate, deter and eliminate the abuse of the system and illegal, questionable and suspicious activities that occur as a result of MSLC operations. This would also hold true for the ticket cashing activities of “ten percenters,” “repeat winners” or “known” or “regular,” “track customers” at Massasoit Greyhound Association (MGA) that is described in Audit Result No. 2. The MSLC also indicated in its response that the instant game ticket is an instrument payable to

the bearer “until a name is imprinted or signed in the appropriate place”. Even though the MSLC considers an instant game ticket a bearer instrument, if it is presented and signed by a “ten-percenter” the identity of the actual winner is concealed from the IRS. As a result, the IRS is not able to attribute the gambling income to the actual winner who thereby successfully evades the IRS reporting requirements. It is important that the MSLC report all suspicious ticket cashers to the appropriate authorities and take all measures possible to eliminate inappropriate and illegal ticket cashing activities.

2. SPECIAL ARRANGEMENT WITH ONE SALES AGENT

Our prior audits disclosed that only one MSLC sales agent, Massasoit Greyhound Association (MGA), out of approximately 7,300 enjoyed a unique agent arrangement that allowed for the payment of claims of up to \$50,000 in cash. This arrangement was also questioned in two separate reports by the outside auditors commissioned by the previous State Treasurer. Their October 2001 report stated, in part: “the lottery management has not limited MGA’s ability to pay out prizes in excess of the \$600 limit established for all other Lottery Agents, a recommendation made in its prior 1999 report.” Additionally, the report stated “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.” Even the recent January 2003 report by the incoming State Treasurer’s transition team questioned and expressed concern about this arrangement by stating, “Certainly, the ability to cash a ticket higher than the \$600 plateau reserved for all other agents yields an unfair advantage to MGA. This inequity allows MGA to collect a greater amount of commission revenue than it would be otherwise entitled.” In effect, with this arrangement the MSLC is directing additional business and commissions to MGA that would, except for this arrangement, go to other agents or as the transition team states, to the MSLC as additional revenue that would be distributed to the cities and towns. There is also an advantage that results from “recycling” that takes place when more tickets are purchased and repurchased after winning tickets are cashed. The loss of revenue to the MSLC or other agents as a result of this arrangement is exacerbated by the high volume of multi-cashers who bypass

MSLC offices where they are paid by check and instead go to MGA to redeem winning tickets, where, as previously noted in prior audit reports, they are paid in cash and where there are less controls such as claimant identification and Social Security verification as compared to MSLC offices, where taxes are withheld when identification information is inadequate.

A significant amount of MGA's business results from it being allowed to pay cash for claims in excess of \$600, of which more than 50% went to professional cashers. During calendar year 2002, MGA paid out \$11,419,028 in combined claims, and of this amount, like no other agent, MGA was allowed to pay in cash 2,823 claims of over \$600 totaling \$5,149,781. The largest "repeat winners" or "known" or "regular" "track customers," made 1,457 claims totaling \$2,612,613, as listed in Exhibits 1 and 2. Although the MSLC's 2001 and 2002 internal compliance reports have raised concerns about this activity, it has continued, with our audits identifying over \$10 million during the last four years in claims by these type of cashers.

A significant number of cashers bypass by MSLC offices (Exhibits 1 and 2), where they would be paid by check, and to go to MGAs instead to redeem tickets in cash. In fact, we spoke to some agents who told us that they will "take care of" or "get cashed" (arrange to cash tickets) in excess of \$600. The United States Department of Justice press release previously mentioned (see Result Number 1) indicated that some of the Florida individuals that were indicted were track employees charged with "assisting in the preparation of false tax forms." These or similar charges may also apply to sales agent employees and MSLC employees should they participate in any such scheme. MGA also benefits further because much of these winnings are reinvested or recycled at MGA until the cash is gone.

By allowing this practice to continue, the MSLC is fostering and facilitating through this agent, the payoff of original winners in cash by the professional cashers, destroying the audit trail for the DOR and IRS for tax purposes and the United States Department of the Treasury for tracking original winners and transactions in excess of \$10,000. Requiring that all prizes in excess of \$600 be claimed at MSLC offices, where more stringent identification and withholding controls exist and where payment is by check instead of cash, would significantly curtail this

problem because there would be an audit trail since all the checks to the cashier would have to be endorsed, cashed, or deposited.

This and prior reports indicated that some of these high-volume cashers did so while they had outstanding, unpaid federal and state tax liens, which were not intercepted or attached at the point of cashing. Others with liens were found to be collecting disability assistance and have a residency in Naples, Florida, while collecting winnings with existing tax liens not being satisfied (See Exhibit 1).

We also determined that some repeat winners have been collecting government assistance such as Emergency Assistance for the Elderly and Dependent Children (EAEDC) and disability payments (See Exhibit 1). We have turned these cases over to our Bureau of Special Investigations for further review and action.

In addition, the Department of Transitional Assistance (DTA) four times a year sends a tape to MSLC to match the MSLC winner's file against DTA's list. Unlike DOR's intercept program for child support whereby funds are withheld from winners by MSLC, any action taken on these winners is done by DTA.

Furthermore, MSLC provides a list to DOR and the IRS of those individuals who cash 20 or more tickets for \$20,000 or more. We noted that some of those on the 2001 list have divided the claims with other members from the same household address in order to avoid appearing on the 2002 list because they do not meet both threshold criteria. For example, the individuals may claim less than 20 tickets for more than \$20,000 or more than 20 tickets for less than \$20,000.

In December 2002, the exiting administration reduced MGA's ability to pay individual claims from a limit of \$50,000 to \$25,000. However, this change is relatively meaningless, since only one of all the 2,823 claims in excess of \$600 at MGA exceeded \$10,000 and the instructions on the back of tickets indicated winners to claim prizes for less than \$600 at sales agents and for prizes \$600 or more to claim at the MSLC offices.

The potential for tax evasion, false identifications being accepted, and claimants with outstanding tax liens cashing tickets at MGA is much greater because it is not an MSLC-operated

office. It is evident that this venue needs to be treated the same as all other agents by restricting claims to the \$600 limit and requiring all claims above this amount to be paid at MSLC offices, where more controls are in place to obtain proper identity and alert taxing agencies of questionable and suspicious activity on an ongoing basis.

As previously mentioned, the U.S. Attorney in Florida has indicted various individuals involved in the cashing of tickets at a Florida dog track. All those involved, including the so-called professional cashers or ten percenters, track employees, tellers, and actual winners who are hiding their identities through the use of cashers, can be charged with assisting in the preparation of false tax returns, filing false tax returns, and fraud for failing to report income (tax evasion).

Accordingly, we repeat our prior recommendations, and those of other outside auditors and reviewers, that the MSLC should:

- Limit cash payments at MGA to \$600 and ensure that MGA abides by the rules and regulations subject to all other MSLC sales agents.
- Evaluate MGA's controls and strengthen the oversight at MGA to prevent professional cashers from evading the system.
- Work with the appropriate agencies to change laws to use the Massachusetts Management Accounting and Reporting System (MMARS) program to intercept gambling proceeds from winners who owe money to the Commonwealth.
- Request DOR to give notice of tax liens on multi cashers on the 20-20 list to MSLC.
- Provide taxing agencies with detailed records and information pertaining to all winning tickets claimed by professional cashers, including the date, time, and location of sales and claims. These cooperative and collaborative efforts should help to curtail and minimize the significant amount of revenues lost through tax evasion and fraud associated with these practices as well as those who participate or assist in the preparation or filing of false tax returns.
- Include in training and education programs for agents as well as MSLC employees information regarding the serious ramifications of participating or assisting in any schemes to direct actual winners to professional cashers to conceal identities and evade taxes.

3. *INADEQUATE COLLECTION OF BAD DEBTS AND RECEIVABLES FROM DELINQUENT AND TERMINATED SALES AGENTS AND INSUFFICIENT BOND FEES TO COVER LOSSES AND DISCOURAGE DELINQUENCY*

Prior audits 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. As a result, the MSLC wrote off \$13 million in bad debts representing funds owed by sales agents from fiscal years 1999 to 2002. As of June 30, 2002, MSLC reported that sales agents owed a total of \$9 million, of which \$2 million was outstanding for over 90 days.

The current MSLC collection policy requires notification to all agents on Mondays to deposit an amount that reflects MSLC's net revenue for the previous week, which will be electronically swept (collected) by MSLC's bank on Friday. Should the Friday sweep be rejected for whatever reason (e.g., insufficient funds), a second attempt is made on Tuesday. Should that attempt fail, the agent is called and required to bring a certified check to the MSLC. Agents failing to do so have their on-line services shut off and are put on a 15-day billing cycle through the Office of the State Comptroller's Billing and Accounts Receivable System (BARS), while MSLC personnel concurrently attempt collection. After 90 days a decision is made on whether to turn the delinquency over to a collection agency.

In addition, our prior audit report indicated that the MSLC charges each agent, as a self-insurance mechanism to cover bad debts, an amount equal to \$.35 per day per location for each day of operation, which brings in a little over \$900,000 per year. The report also demonstrated that the \$.35 rate neither had a deterrent effect nor was sufficient to cover the losses that the MSLC had been suffering from delinquent or terminated sales agents.

According to MSLC officials, when the \$.35 rate was initiated, the average annual agent's commission was approximately \$13,000. During 2002, the average commission was approximately \$32,000. Obviously, the fee has not kept pace with agents' revenue growth. As of February 28, 2003, the MSLC reported that sales agents owe a balance of \$6.8 million after bad debts totaling \$880,000 were written off.

Accordingly, consistent with our prior recommendation, the new MSLC administration is in the process of developing and implementing a fair revised sliding-scale fee structure for old and new agents that will take into consideration the payment performance history of each agent, which should not only curtail and cover losses in total but also act as a deterrent against delinquency.

We again recommend, however, that the MSLC consider placing liens on those agents for the amounts owed when it becomes necessary to terminate them as agents. In addition, the MSLC should, as recommended in the Treasurer's Transition Team report, conduct more extensive credit and background checks, not limited only to their Massachusetts history, on all new agents and annually thereafter for all agents.

4. SALES AGENTS TICKET SCANNING AND PURCHASING ACTIVITIES

Prior reports as well as the new Treasurer's recent Transition Team Report raised questions regarding the administration's internal controls, policies, and procedures over sales agents' ability to scan instant game tickets. The Treasurer's Transition Report indicated that this practice of scanning or "peeking" allows an agent to check over "700 scratch tickets per year without paying for the tickets. This permits the unscrupulous agent to check a significant amount of tickets . . . allowing an unfair advantage . . . to the disadvantage of the customers. This amounts to over 5 million tickets per year statewide."

In January 2003, the new administration established new agent monitoring guidelines. These new guidelines include not only daily, weekly, and monthly reports of errors for review by the compliance unit, but also on-line instant reporting of infractions.

Depending on the type, combination, and frequency of daily infractions, the agent is either inconvenienced, by having to validate manually instead of automatically for three infractions or is disabled and completely shut down from cashing instant tickets (11 infractions). However, the agent is then automatically reinstated with the start of business the next day, and an audit trail is established. The agent is sent warning letters in three stages, including telephone calls, depending upon the frequency of abuse. The penalties range from a warning, to a 30-day suspension, to a permanent suspension for which the agent may request a hearing. In the three months since implementing this new procedure, the MSLC has reprimanded and disciplined over 70 agents for their infractions.

In addition, the MSLC should consider reducing the number of errors or infractions that results in agents being completely shut off from cashing instant game tickets from 11 instances to

six instances. The MSLC should also consider instituting a scale of fines, penalties, or fees for turning terminals back on to restore their ability to cash tickets.

Prior audits also disclosed instances in which agents or their family members in the same household won several large prizes, including \$1 million dollar prizes. During this review, our sample disclosed an agent on the so-called 2002 multi casher 20-20 list with 21 claims for \$243,483. Nine of these claims for \$221,000 of instant game tickets were purchased at his own location (Exhibit 3). Our review also determined that this agent uses several derivations of her name but the same Social Security number when redeeming winning tickets.

It is essential that strong oversight, monitoring, and enforcement be exercised over sales agents in order for the public to have confidence in the fairness of games. The MSLC should consider, as in the case with MSLC employees, prohibiting agents (principles/owners) and immediate family members in the same household from purchasing tickets from their own stores. To monitor this activity, the MSLC should periodically cross-reference the addresses of winners with those of their agents.

The MSLC should also ensure that its compliance unit monitors sales agents for unusual, irregular, and questionable activities and patterns and take appropriate action, as warranted. Also, the MSLC should institute controls and measures to offset or intercept prize money from any active, suspended, delinquent, or terminated agent who owes any money.

5. NONCOMPLIANCE WITH STATUTORY REQUIREMENT FOR REPORTING SHORTAGES, LOSSES, OR THEFTS

Chapter 647 of the Acts of 1989 requires agencies to immediately report all unaccounted for variances, losses, shortages, or thefts of funds or property to the OSA. The statute requires that the OSA determine the internal control weaknesses that contributed to the cause of the incident; the effect of the problem or condition; make recommendations that address the correction of the condition and cause; identify the internal control policies and procedures that need modification; and report the matter to appropriate management and law enforcement officials.

The state Legislature, recognizing the inherent problem of agencies policing themselves, enacted this statute and directed the OSA to review the internal controls and investigate losses,

shortages, and thefts within agencies and instruct the agency about what needs to be corrected to prevent repeat occurrences, since such a review may not be effectively accomplished in an open and unbiased manner by an agency itself.

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 that 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 [emphasis added].

Prior reports have disclosed thousands of unreported incidents of thefts and losses involving instant game tickets, as well as shortages at various MSLC offices, despite the MSLC's having the OSA reporting forms and a copy of the statute in its internal manuals.

During the course of this transition review, the new administration indicated its intention to willingly comply with the law and was in the process of working with the OSA to develop an efficient and useful reporting mechanism in order to comply with the statute to report all such incidents accordingly.

In discussions, MSLC officials identified various types of common lottery losses required to be reported under the law and stated that the losses are currently investigated by the MSLC's Security Division, for which internal reports are maintained. As a result, there may not be a need to develop a special format to report the losses to the OSA. Accordingly, we will review the MSLC's in-house reporting format to determine whether it will satisfy the MSLC's responsibility for carrying out the requirements of the law.

In its response to the audit (response appended to the report), the MSLC indicated that any instant game tickets that are reported missing from a Sales Agent had no value since they were not yet activated or if they had become activated were rendered valueless upon being reported and deactivated. We disagree. The instant game tickets that were reported missing or stolen not

only have a value with regards to the manufacturing cost but have a face value regardless if they are activated or not activated. Losses or thefts of tickets at sales agent locations need to be reported, evaluated, and investigated to determine the nature and extent of abuse, if any exists. Since the tickets are Commonwealth property and are missing, stolen and unaccounted for they should be reported to the OSA as required by Chapter 647 so that the OSA can independently review the circumstances and make recommendations to improve the internal controls over instant game tickets.

6. OSA'S AUDIT AUTHORITY CLAUSE IMPROPERLY OMITTED FROM MSLC CONTRACTS

As prior audit reports have disclosed, 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, 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 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 prior audit we reviewed a sample of MSLC contracts that were in effect and determined that, in most instances, MSLC uses the standard contract form for contracts with its

vendors for various goods and services. However, we found that the standard contract form for its Lottery Sales Agent Agreements does not contain the required clause providing the OSA with access to these vendors' records, contrary to Chapter 11, Section 12, of the General Laws. Although former MSLC officials stated that, in their opinion, it is not necessary to have this clause in its Sales Agent Agreements, the language of Chapter 11, Section 12, clearly indicates that inclusion of this clause in all contracts with those who do business with state agencies is mandatory, not discretionary.

Given the billions of dollars in revenue being generated by the approximately 7,300 sales agents that are under contract and the fact that the MSLC is continuously experiencing losses, shortages, thefts, and variances through these agents, the inclusion of this language in its contracts and agreements making agents aware that they are subject to audit by the OSA may help to deter or minimize these incidents.

During this transition review the new administration has indicated that it intends to comply with the statute by notifying all agents of this requirement via electronic transmission of an amendment to the standard contract containing the statutory language. The agents will be required to acknowledge receipt within a week of notification.

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

Chapter 30A, Section 11A1/2, 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 activities and decisions being made by public agencies that operate through the use of public funds. This statute details specific criteria for the conduct of meetings of governmental bodies.

During our prior audit, we found that despite the statutory requirements, at least five meetings occurred in which the 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, the 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.

Moreover, on all five occasions there was no declaration that the regular meeting would reconvene after the executive session, when in fact it did. In four cases, no reason was given for going into executive session, and in one case the reason given was “personnel matter.” Thus, it is not possible to discern whether the session was appropriate or whether a deliberate circumvention of the law allowing public access occurred. In all five cases, proper roll calls were not taken, and in one case, a motion was made by someone in attendance who had no authority to do so. Finally, no minutes or record was made of the executive session meetings.

The MSLC’s prior General Counsel told our auditors that no minutes were required to be maintained because no votes were taken in executive session. However, this position is not supported by Chapter 30A, Section 11 A ½ , of the General Laws; opinions of the Attorney General’s Office, District Attorney’s Offices, or Court rulings; or Massachusetts Practice, Administrative Law, Chapter 18, Section 1421.

However, our follow-up transition review revealed that there were no executive sessions since our last audit, and the MSLC has indicated that it intends to comply with all requirements of the open meeting law.

8. *QUALITY OF INSTANT GAME TICKETS*

The prior audit report indicated that there were three instances in which Instant Game tickets were determined to have significant defective security coating over the numbers on the ticket, which necessitated tickets for the following games being recalled and reprinted:

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

Accordingly, it was recommended that the MSLC determine and recover any additional costs that the MSLC incurred as a result of these defective tickets. During our review, MSLC officials indicated that security coating formulas had been changed and that quality control measures had been put in place to provide assurance over product performance. Instead of billing the ticket

vendor/supplier for the costs (\$8,500) associated with destroying these tickets, the MSLC exercised an option to extend its contract for printing instant game tickets for one year at the current year prices, contending that the company's concession to maintain pricing levels covers the costs to the MSLC.

The MSLC should keep its business dealings simple and straightforward and should obtain reimbursement for any future costs or losses it is entitled to that are caused by contractor error or deficiencies in the product.

This issue should no longer be a problem because the MSLC now tests the security coating on a sample of tickets in each shipment received. However, if in the future it is determined that tickets are defective for any reason, the MSLC should make public notification that some tickets are defective and void, reprinting and replacing defective tickets, and ensure that the reprinted tickets contain the same prizes as the original tickets. Moreover, the MSLC should consider paying off winning tickets purchased before the recall date as a matter of good will.

9. OPPORTUNITIES FOR INTERNAL CONTROL IMPROVEMENTS AND REVENUE ENHANCEMENT

In addition to the millions of dollars a year that could be generated by withholding taxes on claims in excess of \$600, strengthening controls at MGA, and the other recommendations contained throughout this report, the MSLC should consider implementing the following measures, some of which have also been recommended and endorsed by the new Treasurer's Transition Team Report.

1. Consider expanding Keno into other venues with appropriate hours which would increase sales, aid to cities and towns and commissions to agents.
2. Consider designing games with a matrix or distribution of payouts with higher-level prizes (i.e. some mix of \$100 to \$1,000 or more) to be offset from smaller prizes, in order to generate more sales.
3. Consider introducing additional \$10 tickets and an additional \$20 ticket at key times during the year.
4. Determine the cost-effectiveness of more frequent collections (sweeps) from agents to eliminate the float and increase cash flow to the MSLC. Agents have the benefit of using MSLC funds (float) for anywhere between one and two weeks, depending on when revenue is swept. This float time is longer if a sweep cannot be made and is rejected. In

any event, the MSLC should ensure that, during the annual fiscal year-end cash and revenue cut off, all net revenue due the Commonwealth is properly recorded as income in the proper fiscal year.

5. Consider specific late fees or a percentage of the amount due, whichever is greater, for agents whose accounts cannot be swept because of insufficient funds or failure to deposit funds.
6. Charge a reasonable application fee of \$100 for new agents to cover the cost of processing, background and credit checks, training, etc. to discourage applicants who are not serious.
7. Establish regional advisory councils of sales agents and sales representatives to meet regularly to discuss issues and ideas to improve operations with representatives from each region, meeting periodically with the Executive Director and Treasurer.
8. To better control employees and their family members in the same household from playing lottery games, which is a statutory prohibition, require as a condition of employment, the name, age, and social security number of all family members and periodically cross check them against the winners.
9. Follow up on our prior audit results and incorporate all policies regarding employee benefits for both union and non-union employees as well as in-state and out-of-state travel policies, into its Policies and Procedures.
10. Follow up our prior audit results to ensure that a disputed telecommunication overbilling is adjusted and credited to future billings. Additionally, MSLC should review and comply with OSC's bill paying policy reiterated in MMARS Memorandum No. 289 to ensure that bill paying steps are necessary and adequate and that unacceptable invoices are returned within 15 days. Furthermore, MSLC should consider taking advantage of the statewide contingent fee contract for the Telecommunications Audit Services to possibly identify current or past overcharges and/or improper tariff rates and to negotiate a refund on behalf of the MSLC (Comptrollers Memorandum No. 2003-24).

10. LACK OF INTERNAL AUDIT FUNCTION

Chapter 647 of the Acts of 1989 requires the MSLC to at least annually, or as conditions warrant, evaluate the effectiveness of the agency's internal control system and implement changes necessary to ensure the integrity of the system. The Job Description of the Internal Audit Manager (IA) for the MSLC states specifically.

Under the Direction of the Executive Director, [the IA] is responsible for the review of procedures, policies, and systems within the MSLC. Prepares reports detailing steps of review, findings and recommended changes. Supervises recommendations that result from review.

In addition, the MSLC's job description details the essential functions of the internal audit function:

Verify the accuracy of accounting records and reports, i.e., compare reports with source information, prove entries in source records, account for all serially numbered forms, verify statistical reports, and utilize test programs to verify ... data. Verify the underlying assets, equities, and operating results, i.e., count cash and undeposited receipts, confirm accounts receivable, prove bank reconciliations, compare inventory quantities as shown by detailed inventory records with actual quantities on hand, compare asset records with machinery and equipment actually in use. Evaluate accounting procedures, evaluate internal control from the standpoint of how well the accounting system provides information that is correct, protection of resources, control over all phases of operations; evaluation of clerical and accounting efficiency from the standpoint of effectiveness of procedures, use of mechanical/computerized equipment, adequacy of personnel, program of records retention; evaluation of overall performance of various departments from the standpoint of plan of organization, policies in effect, procedures followed, individual performance. Make recommendations to improve operations and strengthen controls. Insure compliance with written procedures that have been implemented by inquiry and observation, examination of records and reports. Perform detailed review through special project audits where weaknesses exist. Perform operational audits from a management viewpoint. Review Lottery drawing controls.

We noted that the internal control plan for the Office of the State Treasurer (OST) describes the general oversight and scope of the internal audit function rather than the IA's job description.

The internal control plan of the OST states in part as follows:

Internal Audit provides an oversight function to management as a control over various aspects of the Treasury's operations. Generally, Internal Audit will independently evaluate the adequacy of internal controls and report the results to the Treasurer and senior management. Internal Audit will conduct, as a service to the Treasurer and senior management, independent reviews of the operations of the Office of the State Treasurer and Receiver General.

In addition, the OST's internal control plan states that the scope of the internal audit function:

Encompasses the examination and evaluation of the adequacy and effectiveness of the Treasurer's system of internal controls . . . by conducting either financial audits which . . . address the accounting and reporting of financial transactions, testing of transactions for validity and accuracy, reviewing controls for reconciliation, a segregation of duties and safeguarding of assets . . . or compliance audits . . . to evaluate the degree of adherence to laws, regulations, policies or terms of a contract . . . or information systems audits which address . . . the processes which are used to enter, record, and summarize accounting information technology. . . system input, processing, output, backup, system security and business recovery plans.

The IA position at the MSLC has been vacant since March 15, 2002, when the former IA retired. We were informed that the prior administration had chosen to leave the IA position vacant to allow the new administration to fill the position. The MSLC indicated that the

functions of the IA are now being carried out by various personnel who meet on occasion, as necessary.

Because no one person has the primary responsibility of overseeing internal audit function or delegating the duties and functions and coordinating with the Security and Compliance functions of the MSLC, it is possible for controls to be overlooked or not regulated, placing critical functions and activities of the MSLC at risk. As a result of this void, the MSLC's internal audit function is not effective and cannot be responsive to its stated mission and needs.

Since an effective internal audit function is critical to the integrity of the MSLC's operations and systems, which handles billions of dollars annually through 7,300 sales agents across the state, we recommend that the MSLC immediately reinstate this important oversight function and in doing so determine the efficiency, effectiveness, and benefit of retaining the internal audit function in-house or outsourcing it to a professional service organization. In either case, the MSLC needs to conduct a comprehensive analysis of internal audit duties and responsibilities including the Security and Compliance functions, to further develop a plan, based on a MSLC-wide risk assessment, for a series of scheduled reviews and tests conducted over the course of each year to test the integrity of all MSLC systems, functions, programs, activities, and operations. This internal oversight must include regional offices and MSLC sales agents and ensure that the MSLC is fulfilling its responsibilities and has adequate systems, policies and procedures in place to ensure efficient and effective operations. As noted by the incoming Treasurer's transition team, the importance of periodic tests, particularly of the Information Technology systems, cannot be over emphasized during these times of a rapidly changing and increasingly sophisticated technological environment.

Given the importance of the internal audit function in the MSLC's overall financial management and control it is essential that these functions be performed independent of ongoing operations and be reported directly to the Executive Director and the Commission.

11. INTERNAL CONTROLS

a. Status of Internal Control Plan

The MSLC needs to complete its department-wide Risk Assessment and Internal Control Plan (ICP). Chapter 647 of the Acts of 1989 requires all Commonwealth agencies and departments to develop and document internal controls that, in accordance with the OSC's Internal Control Guide for Commonwealth Departments, Volume II, must be prioritized and summarized into a departmental, organization-wide internal control plan. The OSC defines an internal control plan as:

A high level summarization, on a department-wide basis, of the department's risks (as a result of a risk assessment) and of the controls used by the department to mitigate those risks. This high level summary must be supported by lower level detail, i.e. departmental policies and procedures. Responsibility for the department internal control plan resides with the departments Internal Control Officer (ICO). . . . [who] is described as. . . an official, equivalent in title or rank to an assistant or deputy to the department head, whose responsibility . . . shall be to ensure that the agency has written documentation of its internal accounting and administrative control system on file. . . .

Large and/or complex departments will find it useful to replicate this plan for major programs, bureaus, institutions, or other department subdivisions. The department level internal control plan is, however, always required.

At the time of our review, the MSLC's ICP was a work-in-progress that the MSLC had been developing for approximately one year. To date, the MSLC's ICP contains an internal control mission statement and sections for a number of MSLC divisions, of which only the Security, Management Information Systems (MIS), and Finance Department sections contain information (the Finance Department section is the more complete of the three). The substance of each section should consist of a Statement of Function, explaining the responsibility of the particular division; a Statement of Objectives; a Statement of Risks associated with attaining the objectives; and the internal controls that mitigate the risks. The Finance Department's section relates these aspects for its Accounting and Budget Procurement functions. However, there are no control activities identified to mitigate stated risks for the Claims Department and the Season Ticket, Return Ticket, On-line Accounting, and Revenue Recovery units within the Finance Department.

Moreover, the stated controls for Accounting and Budget Procurement are not cross-referenced to the actual procedural manuals and documents evidencing the control factors.

The Security and MIS sections of the ICP contain a Statement of Objectives and a Statement of Risks; however, controls that will prevent the stated risks from occurring have not been identified. The remaining divisions, Human Resources, Legal, and Operations, also need to complete their plans of these three. Operations is the largest department, consisting of Facilities, Agent Relations, Distribution and Technical Support, Customer Service, Regional Operations, Licensing, and Promotional Development and Sales units.

However, it is important to note that the MSLC has a comprehensive set of procedural manuals entitled “Internal Control Manual” that sets forth steps and control activities for all MSLC functions. These procedures have been developed over a period of time and continue to evolve. The manuals cover the Finance Department, MIS, and Customer Services. There also are procedures for distribution, mailroom, vehicles, licensing, receiving/accounts payable and facilities that need to be finalized.

In addition to manuals covering specific aspects of its operations, the MSLC has also established an Internal Control Policy manual, which also is in the developmental stage. To date it contains stated policies for the Finance Department with provisions to expand it to include other MSLC departments.

As part of our review, we reviewed Volume VIII of the Internal Control Manual, which contain procedures for the Finance Department’s activities. The procedures, although sound, could be improved by indicating the individual by name or title who will be responsible for completing the procedure. Without this specificity, the procedures become similar to a policy statement without assurance that it will be carried out by appropriate personnel. Furthermore, the designation of persons responsible has the added advantage of ensuring that there is proper segregation of duties, approval, and authorization inherent in the processes and that incompatible actions are not performed by individuals. The Financial Control Manager (FCM) inquired whether a “spreadsheet approach” could be used for designating procedures and individuals

responsible for them, suggesting that it may be more feasible than including the information within the procedural manual. Such an approach may be feasible, and the MSLC should determine the best way to document responsibility for the procedures not only in the Finance Department, but for all procedures.

Regarding updating and periodic reviews, there is no set procedure or policy in place for the routine updating of the ICP. Changes as needed are developed at the respective unit level, reviewed by the applicable manager, forwarded to the FCM for review and edit and returned to the unit manager for review. When properly approved, the changes are incorporated into the unit's procedural manual, the master copy of which is kept by the FCM. The MSLC should develop a procedural routine for the periodic review, monitoring, and updating of the procedures and the plan.

b. Internal Control Officer

The Assistant Director of the Finance Department is the MSLC's Internal Control Officer (ICO). As previously stated, Chapter 647 requires the ICO to be at a level equivalent in title or rank to an assistant or deputy to the department head. One of the reasons for this requirement is to ensure that the ICO is in a position of authority to effect change and implement controls throughout the agency that reflect the attitude of upper management. The Assistant Director of Finance was delegated responsibility to develop the ICP for the MSLC. The ICO's approach, with the Executive Director's support, was to work with the MSLC's Executive Staff to develop an organization-wide risk assessment and to have them provide the objectives, risks, and internal controls for their respective areas of responsibility. However, before proceeding with the full ICP, the ICO first concentrated on completing the ICP aspects for the Finance Department so that it could be used as a guide by the executive staff in completing the ICP for their divisions by providing a template for the staff to follow.

The ICP includes elements of the OSC's suggested format for an ICP as outlined in Chapter 5 of the *Internal Control Guide for Managers*. Two important features suggested by OSC not yet incorporated into the plan that should be considered are:

- A brief statement of the integrity and ethical values expected of all staff and especially the ethical values top management has laid down for itself.
- Sections describing to whom the plan is to be distributed and how the plan is to be monitored.

The MSLC's ICP is a good start, but it needs to be completed. Although the Finance Department's section of the ICP is almost complete, the other divisions' sections are not. The ICO indicated that the Executive Staff have been instructed to identify for their sections five significant risks that could affect meeting their section's objectives. The risk assessment was intended to be a high-level risk assessment. Since the risks identified were intended to be only the three to five major risks faced by each division, as the first step in accomplishing a department-wide risk assessment, the MSLC should, in completing the ICP, ensure that all risks from which there would be significant loss or harm are included for each unit.

In discussions with MSLC officials, it became obvious that many of the divisions not yet incorporated into the ICP have operating procedures that will be enhanced once they are identified within the ICP and tied to objective statements and a risk assessment for the particular units. The ICO was confident that the executive staff had developed the risks as requested and expected that the Finance Section would be complete by May 15th and that the ICP will be complete within the year, preferably by the Fall. In order to stay on schedule the importance and status of the plan should be emphasized at executive staff meetings.

c. Department-wide Risk Assessment

In the fall of 2001, the OSC directed all state agencies to prepare an organization-wide risk assessment. Also, in the spring of 2002, in a letter to all ICO's Single Audit liaisons, the State Comptroller distributed an Internal Control Questionnaire reemphasizing that:

By the start of fiscal year 2003, all departments should have prepared department wide risk assessments. Departments should then use these risk assessments to focus on the next step in the Internal Control Plan process, listing the control activities (policies and procedure) that mitigate the risks identified in organization wide risk assessments.

The MSLC is behind schedule in preparing its risk assessment. As mentioned above, the ICO has directed the MSLC's executive staff to identify major risks of their divisions as the first step,

and is confident that they have developed them as requested. However the MSLC is behind the OSC's timeline for developing the assessment and should work toward accomplishing it as the first step in preparing the ICP. The ICO needs to obtain the risks identified by the various divisions, and the Executive Director needs to review the risks to develop the department-wide risk assessment for the overall mission of the MSLC.

d. Reporting losses and shortages

Volume I, of MSLC's procedural manual includes general information and reference data for MSLC. The volume includes a section entitled "Process to Report Unaccounted For Items," which contains copies of Chapter 647 and the OSA Reporting Forms for reporting losses. The section does not, however, explain in-house procedures for reporting losses and filing a report of losses with the OSA. The section should be revised to include such procedures and distributed to all MSLC employees. See Transition Review Result No. 5.

We recommend that MSLC expedite preparation of the risk assessment and internal control plan. As a first step toward complying with the OSC's directive to complete the internal control plan the MSLC should concentrate on the organization's wide-risk assessment. The ICO should obtain all of the risk assessments prepared for each of the MSLC divisions. The risk assessments should be based on division objectives and indicate the risks associated with the objectives and the controls to mitigate them. The ICP can then be formulated based on these steps and the outline established for the Finance Department and Chapter One of the OSC's, Internal Control Guide, Volume II.

Exhibit 1

**Lottery Tickets Purchased at Various Lottery Agents in Different Communities and Cashed at
MGA Park by Professional Cashers**

	***Casher	Number of Days at MGA	Total Number of Claims	Number of Cities and Towns Where Tickets Were Purchased	Number of Different Agents Where Tickets Were Purchased	Total 2002 Claims	Tickets Purchased at MGA		Tickets Purchased Outside of MGA	
							Number	Amount	Number	Amount
	1	186	434	96	278	\$ 694,656.00	20	\$ 33,803.00	414	\$ 660,852.00
	2	85	*	158	60	318,023.50	5	9,601.00	153	308,422.50
	3	135		286	61	555,827.25	18	30,619.00	268	525,208.25
	4	51	*	80	39	130,271.00	1	1,000.00	79	129,271.00
	5	75	*	163	62	220,621.75	7	8,660.00	156	211,961.75
	6	2		24	1	24,800.00	-	-	24	24,800.00
	7	37		54	29	95,485.75	3	4,210.00	51	91,275.75
	8	10		22	15	50,990.00	-	-	22	50,990.00
	9	20	*	34	19	44,328.50	4	4,618.00	30	39,710.50
	10	58		100	37	166,585.25	2	2,000.00	98	164,585.25
	11	52		78	35	164,980.25	6	8,000.00	72	156,980.25
	12	23		24	16	146,045.00	1	1,000.00	23	145,045.00
	Totals	734	1,457	**	-	\$ 2,612,614.25	67	\$ 103,511.00	1,390	\$ 2,509,102.25
* Represents only three to eight months activity.										
** Includes two ticket claims at the Braintree Lottery Office and five claims at the Fairhaven Lottery Office.										
*** See Notes to Exhibit 1 for more details.										

Notes to Exhibit 1

Casher 1 from Marshfield redeemed 434 tickets at MGA for \$694,656. These tickets were sold by 278 separate agents in 96 communities. Some of the different communities in which the winning tickets were sold are Boston, Braintree, Provincetown, Orleans, Attleboro, Medway, Somerville, and Fall River.

Casher 2 from Sharon redeemed 158 tickets at MGA for \$318,024. These tickets were sold by 119 agents in 60 communities, including Braintree, Oak Bluffs, Vineyard Haven, Watertown, South Boston, Brookfield, Franklin, and Wayland. Casher 2 had the following tax liens released during 2002.

<u>Type</u>	<u>Original Filing Date</u>	<u>Release Date</u>	<u>Amount</u>
Federal Tax Liens - 1	07-16-98	06-21-02	\$ 4,779.00
Federal Tax Liens - 2	02-26-99	07-05-02	1,677.00
State Tax Liens	12-08-98	07-01-02	<u>\$ 8,571.00</u>
			<u>\$15,027.00</u>

Records indicate that Casher 1 and Casher 2 have their motor vehicle registered from the same address in Sharon, Massachusetts and combined have redeemed more than \$1,000,000 in cash in lottery claims at MGA Park. Total withholding taxes during the 2002 calendar year are as follows:

<u>Cashers</u>	<u>Federal Taxes Withheld</u>	<u>State Taxes Withheld</u>
1	\$ 8,100.00	\$ 1500.00
2	<u>4,295.70</u>	<u>795.50</u>
	<u>\$12,395.70</u>	<u>\$2,295.50</u>

Casher 3 from Fall River redeemed 286 claims at MGA for \$555,827. These tickets were sold by 174 agents in 61 communities, including Abington, Arlington, Braintree, Edgartown, Orleans, Ware, Roslindale, Quincy, and Plymouth. Total withholding taxes during the 2002 calendar year were \$23,378.22 in federal taxes and \$4,329.20 in state taxes.

Casher 4 from Kingston redeemed 80 tickets at MGA for \$130,271. These tickets were sold by 69 agents in 39 communities, including Boston, Brockton, Norwood, Pepperell, Salisbury, Waltham, and Yarmouth.

Casher 5 from Kingston redeemed 163 tickets at MGA for \$220,622. These tickets were sold by 129 agents in 62 communities. Some of the different communities where the winning tickets were sold are Braintree, Buzzards Bay, Fall River, Framingham, Hyannis, Natick, Norwood, South Boston, Vineyard Haven and Weymouth.

Casher 4 and Casher 5 listed the same address as their residence in Kingston, Massachusetts on MSLC claim forms. The two cashers have redeemed a total of 243 claims receiving \$350,892.75 in cash at MGA.

Notes to Exhibit 1 (Continued)

Casher 4 had the following outstanding state tax liens:

<u>Filing Date</u>	<u>Amount</u>
08-07-97	\$ 26,003.12
02-26-99	\$107,414.04

The following are the two Notice of Massachusetts Tax Lien forms for Cashier 4:

Notes to Exhibit 1 (Continued)

BK 15385 PG 346

Commonwealth of Massachusetts Department of Revenue
NOTICE OF MASSACHUSETTS TAX LIEN

80498



No. 0440 3000 0853

Pursuant to the provisions of Section 50 of Chapter 62C of the General Laws, notice is hereby given that there have been assessed against the following-named taxpayer taxes (including interest and penalties) which remain unpaid, and that the amount of said taxes is a lien in favor of the Commonwealth of Massachusetts upon all property and rights to property belonging to said taxpayer.

Tax Type	Period End Date	Assessment Date	Assessment Amounts	Statutory Additions	Balance Due
INCOME	12/31/93	12/01/95	\$14,686.00	\$12,391.60	\$26,003.12
					Received & Recorded PLYMOUTH COUNTY REGISTRY OF DEEDS 07 AUG 1997 03:00PM JOHN D. RIORDAN REGISTER Bk 15385 Pg 346
TOTAL					\$26,003.12

PLACE OF FILING

Registry of Deeds PLYMOUTH COUNTY, PLYMOUTH, MA
Clerk-City or Town Hall
Secretary of State-Boston, Ma.

PAUL QUINN
TAX EXAMINER

Signature *Ang A. Pitt*
Title DEPUTY COMMISSIONER

← END OF INSTRUMENT →

Notes to Exhibit 1 (Continued)

Commonwealth of Massachusetts Department of Revenue					
NOTICE OF MASSACHUSETTS TAX LIEN					34137
					No. 0440 3000 1222
<p>Pursuant to the provisions of Section 50 of Chapter 62C of the General Laws, notice is hereby given that there have been assessed against the following-named taxpayer taxes (including interest and penalties) which remain unpaid, and that the amount of said taxes is a lien in favor of the Commonwealth of Massachusetts upon all property and rights to property belonging to said taxpayer.</p>					
Tax Type	Period End Date	Assessment Date	Assessment Amounts	Statutory Additions	Balance Due
INCOME	12/31/95	11/15/99	\$8,348.00	\$8,752.15	\$17,100.15
	12/31/96	11/15/99	\$49,596.00	\$40,717.89	\$90,313.89
TOTAL					\$107,414.04

Received & Recorded
PLYMOUTH COUNTY
REGISTRY OF DEEDS
05 APR 2000 02:10PM
RICHARD C. SEIBERT
REGISTER
Bk 18414 Pg 193

PLACE OF FILING

Registry of Deeds PLYMOUTH COUNTY, PLYMOUTH, MA
Clerk-City or Town Hall
Secretary of State-Boston, Ma.

Signature



Title DEPUTY COMMISSIONER

ALEXANDER SIMAO
TAX EXAMINER

← END OF INSTRUMENT →

Notes to Exhibit 1 (Continued)

Our prior audit report (2002-0089-3S) identified the same outstanding state tax liens for Cashier 4. Records indicate that a Florida driver's license was issued on November 4, 2002 to Cashier 4, who has a residency in Naples, Florida.

Cashier 4 stopped redeeming claims at MGA on August 30, 2002. Records indicate that this cashier received public assistance Emergency Assistance for Elderly and Dependant Children (EAEDC) while cashing winning tickets at MGA.

Cashier 5 started cashing claims on September 6, 2002 and in only four months redeemed 129 claims for \$220,621.75 in cash. Coincidentally, Cashier 4 and Cashier 5 have the same residence.

Cashier 6 from Stoughton redeemed 24 tickets at MGA for \$24,800. These tickets were sold by one agent in one community. No federal or state taxes were withheld.

Cashier 7 from Westwood redeemed 54 tickets at MGA for \$95,486. These tickets were sold by 45 agents in 29 communities, including Boston, Braintree, Quincy, Roslindale and Weymouth. No federal or state taxes were withheld.

Cashier 8 from Stoughton redeemed 22 tickets at MGA for \$50,990. These tickets were sold by 21 agents in 15 communities, including Amesbury, Boston, Haverhill, Quincy, Salisbury, Swansea and Taunton. Of the 22 tickets redeemed, 21 tickets totaling \$40,990 were cashed at MGA Park in a three-month period.

Cashier 9 from Providence, RI redeemed 34 tickets at MGA for \$44,329. These tickets were sold by 29 agents in 19 communities, including Brockton, Framingham, Franklin, Hingham, Norwood, South Boston, and Weymouth. No federal or state taxes were withheld.

Cashier 10 from Quincy redeemed 98 tickets at MGA and two tickets at the MSLC's Braintree Lottery Office for \$166,585. Federal withholding taxes were \$8,251.20 and State withholding taxes were \$1,528.00. These tickets were sold by 79 agents in 37 communities, including Boston, Brockton, Fall River, Mashpee, Newburyport, Roslindale, Salisbury, and Weymouth.

Cashier 11 from Raynham redeemed 78 tickets at MGA for \$164,980. Federal withholding taxes were \$5,400 and state withholding taxes were \$1,000. These tickets were sold by 64 agents in 35 communities, including Quincy, Amesbury, Boston, Dorchester, Norwood, Saugus, and Roslindale. Eight of these tickets for \$8,000 were purchased at MGA.

Cashier 12 from North Dighton redeemed 19 tickets at MGA and five tickets at the MSLC's Fairhaven Lottery Office for \$146,045. These tickets were sold by 22 agents in 16 communities. Of the 24 tickets cashed, 12 tickets, or 50% of the total, were for individual \$10,000 Instant Game tickets that were purchased in New Bedford, Boston, Buzzards Bay, Norton, Taunton (three), Dedham, Plymouth, Holbrook, Wareham, and Franklin. We noted that one ticket was cashed at MGA on July 21, 2002, a Sunday, one ticket was cashed at the Fairhaven Lottery Office on Monday July 22, 2002, and five \$10,000 Instant Game tickets were cashed at MGA in December 2002.

Exhibit 2

Lottery winning tickets redeemed by other cashers at three regional offices (Worcester, Boston, Woburn).

Worcester Regional Office Lottery Claims

1. Cashier 13, who resides in Framingham, MA, redeemed 145 winning ticket claims amounting to \$174,147.00. Cashier 13 redeemed these winning tickets at the Worcester Lottery Office 66 different times during calendar year 2002. These claims were purchased in 14 different communities and from 43 different agents. Cashier 13 cashed winning numbers game tickets at this regional office on nine different days during a three-month period (February, March, and April 2002) each time cashing six individual claims of \$706.50 each totaling \$4,239 each day. These winning number claims were purchased at the same agent in Worcester.* Sixty two percent of total ticket claims, or 90 individual claims, were purchased at three separate agents in Framingham and Worcester.

We were informed by a MSLC official that Cashier 13 is disabled and receiving some financial disability assistance.

* Because the MSLC considers each claim as a single transaction the claimant received 54 individual W-2G's for \$706.50 each rather than 1 W-2G for \$38,151.00 (54 x \$706.50). No Federal or State withholding taxes were taken out of the total winnings of \$174,147.00

2. Cashier 14, who resides in Fitchburg, MA, redeemed 39 winning claims for \$291,610 at the Worcester Regional Office and two claims at the Braintree office for \$300,000. These claims were for two Instant Game tickets and 39 Keno tickets totaling \$591,610. All of the Keno claims were wagered at one agent in Fitchburg and redeemed by Cashier 14.

Boston Regional Office Lottery Claims

1. Cashier 15, who resides in Attleboro, MA, redeemed 46 Daily Number Game tickets at the Boston regional Office, as follows:

<u>Date Cashed</u>	<u>Type of Claim</u>	<u>Amount</u>
7-18-02	6 individual Daily Number Games @ \$623.00 each	\$ 3,738
9-19-02	<u>40 individual</u> Daily Number Games @ \$2,635.50	<u>105,420</u>
	46 claims	<u>\$109,158</u>

No federal or state withholding taxes were taken out on any of these transactions. Because the MSLC considers each claim as a single transaction (regardless if 40 claims were redeemed in a single visit), the claimant was given 46 separate W-2Gs forms, (six on July 18, 2002 and 40 on September 19, 2002). This claimant cashed all his winnings at the Boston Office even though there are MSLC offices in Fairhaven and Braintree closer to the claimant's residence.

2. Cashier 16, who resides in East Boston, redeemed 81 tickets totaling \$393,851.50. A total of 78 tickets were cashed at the Boston Office for \$141,352.50, and three claims totaling \$252,499 were cashed at the Braintree Office. Federal taxes withheld were \$75,600 and state taxes withheld were \$14,000.

Exhibit 2 (Continued)

Casher 16 cashed winning claims that were purchased in 12 different communities and from 33 different lottery agents. Two of the agents (one in East Boston and one in Boston) accounted for 42 winning claims, or 52% of all claims redeemed by Cashier 16.

Casher 16 had the following City of Boston Property tax liens outstanding:

- Original Filing Date 11-08-95
Amount \$452.00
- Original Filing Date 11-06-96
Amount \$1,823.00
- Original Filing Date 01-03-01
Amount \$796.00

We have been informed by appropriate officials that cashier 16 receives public assistance for four dependents.

Woburn Regional Office Lottery Claims

Casher 17 of Lynn, MA had 30 winning ticket claims totaling \$168,164.50 that were cashed at the Woburn Office. Of the 30 claims, 10 (33%) were for \$10,000 Instant Game tickets.

Casher 18 of Waltham, MA had 153 winning tickets totaling \$256,258.50 that were cashed at the Woburn Regional Lottery Office. Cashier 18 came to the Woburn Office 105 times during the 2002 calendar year and redeemed winning ticket claims that were purchased in 26 different communities from 62 different lottery agent. A total of 67 winning tickets (44%) cashed by Cashier 18 came from five lottery agents located in the towns of Waltham and Watertown. Withholding taxes for Cashier 18 were federal taxes of \$5,400.00 and state taxes of \$1,000.

Casher 19 of Everett, MA had 104 winning tickets totaling \$218,167.50 that were cashed at the Woburn Regional Lottery Office. Cashier 19 came to the Woburn office 60 times during the 2002 calendar year and redeemed winning tickets that were purchased in 28 different communities and 63 different lottery agents. Seven claims were for \$10,000 Instant Game tickets purchased in seven communities. Withholding taxes for Cashier 19 were federal taxes of \$18,900 and state taxes of \$3,500.

Casher 20 of Lynn, Ma had 392 winning ticket claims totaling \$726,199.00 that were redeemed at the Woburn Regional Lottery Office. Cashier 20 came to the Woburn Office 136 days during calendar year 2002 and cashed winning tickets that were purchased in 45 different communities from 194 lottery agents. Total withholding taxes withheld for Cashier 20 were federal taxes of \$21,738.24 and state taxes of \$4,025.60. Also, Cashier 20 had the following state tax lien on file:

Exhibit 2 (Continued)

Original Filing Date	10-23-98
Release Date	11-28-00
Amount	\$7,578

MSLC's current procedures would indicate that Cashier 20 received a total of 392 W-2Gs for 2002 calendar year.

Cashier 21 of Lynn, MA had 67 winning ticket claims totaling \$132,820 that were purchased in six different communities from 27 different agents during the calendar year. Thirty of these claims were cashed on one day, January 3, 2002, claims for which the MSLC gave this cashier 30 different W-2Gs totaling \$49,948.00 without withholding any taxes.

Cashier 22 of West Newton redeemed 49 claims totaling \$108,087 at the Woburn Office. Withholding taxes for Cashier 22 were federal taxes of \$5,400 and State taxes of \$1,000.

Also, Cashier 22 had the following state tax lien outstanding:

Original Filing Date	12-19-00
Amount	\$20,743
Plaintiff	MA DOR

Exhibit 3

A cashier/owner and a MSLC lottery agent of East Weymouth redeemed 21 Instant Game ticket claims totaling \$243,483.00 at the Braintree Lottery Office. We noted that nine winning tickets were purchased at the cashier/owner/MSLC agent's facility as follows:

<u># of Tickets</u>	<u>Ticket Amount</u>	<u>Amount</u>	Withholding	Withholding
			Taxes	Taxes
			Federal	State
1	\$200,000.00	\$200,000	\$54,000	\$10,000
1	10,000.00	10,000	2,700	500
1	4,000.00	4,000	-	-
1	2,000.00	2,000	-	-
<u>5</u>	1,000.00	<u>5,000</u>	<u>-</u>	<u>-</u>
<u>9</u>		<u>\$221,000</u>	<u>\$56,700</u>	<u>\$10,500</u>

Also, winning ticket claims were redeemed in calendar year 2002, as follows:

4	January 2002	\$13,000
1	March 2002	200,000
3	April 2002	4,000
<u>1</u>	August 2002	<u>4,000</u>
<u>9</u>		<u>\$221,000</u>

Appendix

Massachusetts State Lottery Commission

60 Columbian Street

Braintree, Massachusetts 02184-1738

Tel: (781) 849-5555

Fax: (781) 849-5546

Tty: (781) 849-5678

TIMOTHY P. CAHILL
Treasurer and Receiver General

JOSEPH C. SULLIVAN
Executive Director

August 29, 2003

A. Joseph DeNucci
Auditor of the Commonwealth
Executive Office
State House
Room 229
Boston, MA 02133

RE: Transitional Audit Report

Dear Auditor DeNucci:

Thank you for providing me the opportunity to discuss the Transitional Audit Report (the "Audit"), requested by Treasurer Cahill, with your staff. The Audit provides me with a solid starting point for the beginning of this Fiscal Year to constructively address the issues identified. I am pleased to note that your concerns mirror that of the Massachusetts State Lottery Commission (MSLC), and many of the suggestions contained in your report have already been adopted or are in the process of being adopted.

As a preliminary matter, please note that the Audit generally grouped the issues into several categories. For ease of reference, I have presented my comments similarly. However, the order of these responses does not necessarily reflect the importance of the subject, as the MSLC considers all of these issues important.



Supporting the 351 Cities and Towns of Massachusetts
Visit our Web Site: www.masslottery.com



Appendix (Continued)

The Audit correctly stated that the so-called bond fee that is charged to MSLC Sales Agents is insufficient to protect the Lottery's interests. In February of this year, the MSLC developed a sliding fee scale model in order to address this issue. Under this new model, a higher bond fee will be required of new agents and higher risk Sales Agents, particularly those who have missed a bank account sweep in a fiscal year or are on probation. In an effort to further protect the MSLC's interests, we are in the process of reviewing the current practice of biweekly sweeps of Sales Agent accounts for instant games to weekly sweeps, as is the current practice for on-line games. This policy adjustment will be initiated for all new Sales Agents and any existing Sales Agent who misses the current biweekly sweep. We will also review the cost of converting the remaining Sales Agents to the weekly settlement.

The Audit pointed out that the MSLC had, in the past, received a credit from the manufacturer of certain defective instant game products and recommended that any future accounting for defective products be resolved through a reimbursement from the manufacturer. The current contracts for production of the instant games products expire in 2004. The new contracts will include appropriate language, drafted by the MSLC's General Counsel, that complies with this recommendation. The Audit also recommended that the MSLC include language referencing M.G.L. Chapter 11, Section 12 in all Sales Agent contracts. The MSLC will include appropriate language referencing the statute in all new Sales Agent contracts and in all existing contracts upon renewal.

The Audit noted that the MSLC had not fully complied with the Commonwealth's Open Meeting Laws in past Commission meetings. The past two Commission meetings

Appendix (Continued)

have been conducted in accordance with the Open Meeting Law, and the MSLC will continue to do so in the future.

The Audit addresses the subject of an Internal Auditor and internal controls. The Audit pointed out that the MSLC's position of Internal Auditor was vacant. In fact, this vacancy occurred as the result of a retirement last year. Recently, we created a new Internal Auditor management position reporting directly to Executive Director and the Treasurer of the Commonwealth. The Internal Auditor will be responsible for the oversight of the Compliance responsibilities of the MSLC. Regarding the Internal Controls and Risk Assessment documents of the MSLC, the Audit noted that while much had been accomplished in these areas, it is still a work in progress. We agree. The task that remains to be done is primarily one of updating and editing. Most of the detailed Internal Controls have been documented, however, they do not appear in one executive summary compilation. We are in the process of developing a Lottery-wide Risk Assessment Plan and editing the Internal Control documents for all of our operations. Each department has been charged with conducting a Risk Assessment of their operations, reviewing and updating their current Policies and Procedures, and documenting the Internal Controls in place to address the issues raised in the Risk Assessment. This effort will be overseen by the Internal Auditor and is scheduled to be completed in this Fiscal Year.

The Audit stated that the MSLC was not in compliance with Chapter 647 of the Acts of 1989 regarding the reporting of certain losses with respect to instant games. One of the keys to the success of the Lottery business in Massachusetts is to provide Sales Agents with instant game products on consignment. Once the Sales Agent activates an

Appendix (Continued)

instant game book and reaches a certain cashing level, the Sales Agent owns that game book and the MSLC is paid. It is the position of the MSLC that any instant game products that are reported missing from a Sales Agent either had no value since they were not yet activated, or, if they had been activated, were rendered valueless upon being reported and deactivated. While the auditors recognized this fact, they asserted that the instant game products had some monetary value since the MSLC paid to have them manufactured. Accordingly, we have begun to work with your staff to initiate a categorized reporting mechanism and schedule for recognizing the loss of instant game products which may occur as a result of an armed robbery, theft, arson, breaking and entering or larceny.

The Audit offers a number of suggestions regarding improving revenues. The Treasurer recognized many of these same areas during the transition. The MSLC has already addressed some of these items, such as implementing Keno game improvements and resolving the \$2.1 million telecommunications billing dispute in the Commonwealth's favor. The MSLC has been evaluating license application fees and other potential revenue generating initiatives as well.

As noted by the Treasurer during the transition, the Audit also raised concerns regarding a Sales Agent's ability to inappropriately scan instant game products. The MSLC has taken affirmative steps to mitigate the potential for inappropriate scanning by reducing the number of scanning errors for the most serious infractions. These steps result in the immediate disabling of the auto cash privilege of the Sales Agent's terminal. In addition, a MSLC compliance officer, working under the direction of the Internal Auditor, will meet with each Sales Agent who has exceeded the limit set for acceptable

Appendix (Continued)

scanning errors, to review the Sales Agent's scanning practices. The compliance officer will also provide the Sales Agent with a report identifying the Sales Agent's actual scanning instances by date and time of day, which will assist our Sales Agents in identifying problem employees. This effort has substantially reduced inappropriate scanning practices.

Much of the Audit focused on cooperating with the Internal Revenue Service (IRS) and the Department of Revenue (DOR) with respect to identifying professional cashers. This is an area that the MSLC has given much attention. It is important to note that for the past several years, the MSLC has been transmitting monthly reports to the IRS and DOR detailing certain information regarding specific individuals who were appearing as frequent cashers. Since February, the MSLC has met with representatives from the IRS on two occasions and representatives of the DOR on five occasions to discuss the utility of these reports and to explore options for improving our collective efforts. As a result of those meetings, we have amended the report to include more information, requested by the DOR, to help in their enforcement efforts.

Regarding the professional cashers, it should be noted that the MSLC is not a law enforcement agency and is in full compliance with current IRS and DOR withholding laws and regulations. Moreover, the instant game ticket is an instrument payable to the bearer "until a name is imprinted or signed in the appropriate place" (see 961CMR 2.39). As such, the MSLC is obligated to honor a claim presented by the individual bearing the winning ticket(s). However, the MSLC would support a review of the withholding threshold established by the DOR and IRS in an effort to deter the so-called professional casher and instances of unreported earnings. Further, the MSLC is establishing an

Appendix (Continued)

internal committee to make additional recommendations to address this issue. The committee will be comprised of legal, operations, compliance, finance and security staff who will present their recommendations to the Executive Director by December 1st of this year.

In addition, The MSLC is working with DOR on programs that will authorize the MSLC to withhold prizes claimed by individuals who have been adjudged to be delinquent in their tax reporting. It is anticipated that this legislation will be similar to the current Child Support Enforcement Intercept program. (See attached letter to the DOR.)

The Audit cited the contract between the MSLC and the Massachusetts Greyhound Association. This contract came to the Treasurer's attention during the transition, and it had been noted in the KPMG Audit Report commissioned by the MSLC in 2002. The MSLC recognizes that this is an area of concern and that action needs to be taken. We are currently reevaluating this contract and are weighing several options to address this issue.

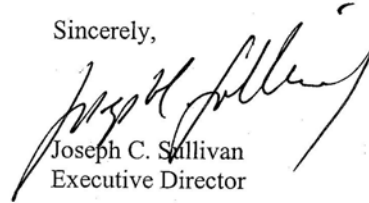
On behalf of Treasurer Timothy P. Cahill and the Massachusetts State Lottery Commission, I want to thank you for your advice and suggestions for improving the operations of the MSLC.

The MSLC, if it were a private corporation, would be a Fortune 500 company with four billion dollars in revenue and a net profit of almost nine hundred million dollars. Therefore, the MSLC takes very seriously its responsibilities of maintaining the integrity of the MSLC operations and our legislative directive to generate revenue for the cities and towns of the Commonwealth of Massachusetts.

Appendix (Continued)

In closing, I respectfully request that this letter be incorporated in the final Audit Report in its entirety.

Sincerely,



Joseph C. Sullivan
Executive Director

Enc.

cc: Timothy P. Cahill, Treasurer and Receiver General
Martin Benison, Comptroller
Edward A. Flynn, Secretary of Public Safety
Janice M. Saragoni, Commissioner