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INDEPENDENT STATE AUDITOR'S REPORT ON
CERTAIN ACTIVITIES OF THE
MASSACHUSETTS STATE LOTTERY
COMMISSION
JULY 1, 2007 TO JUNE 30, 2008

OFFICIAL AUDIT
REPORT
DECEMBER 22, 2010

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INTRODUCTION

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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 by operating various lottery games. The MSLC may establish, and from time to time revise, such rules and regulations for these activities as it deems necessary or desirable.

During fiscal year 2008, the MSLC generated \$4.709 billion in sales revenue while paying prizes totaling \$3.42 billion, or 72.6% of sales. In addition, the MSLC paid \$275 million for commissions and bonuses to its sales agents and had administrative and operating expenses totaling \$101 million, for a net profit before distribution of \$913 million. There were authorized distributions totaling \$1.026 billion from the Lottery Fund, which had a deficit balance, and a transfer of \$113 million from the Commonwealth's General Fund that supplemented the Lottery Fund's shortfall. The authorized transfers were \$935 million for Local Aid to cities and towns, \$78 million for Arts Local Aid, \$12 million for the Massachusetts Arts Council, and \$1 million for the Gamblers' Treatment Program. Additionally, prize money winnings result in potential state and federal income tax revenue for government services, programs, operations, and activities. The significant role that the MSLC holds in the Commonwealth's overall budget requires strong internal controls to ensure that the Commonwealth's resources are safeguarded and losses are minimized, thereby generating maximum revenue to fulfill its mission and purpose.

The MSLC has historically used cash incentive programs to motivate and reward the performance of approximately 7,500 sales agents and to increase game promotion and sales. These cash incentives, which are paid from an agent's sales revenue during the settlement process, totaled \$9.8 million in calendar year 2007 and \$11.5 million in calendar year 2008. Due to declining sales revenues, the MSLC in recent years has used a variety of non-cash incentives, such as sports tickets, theater tickets, and sports memorabilia. These incentives were purchased through appropriated funds or provided by Scientific Games, a producer of instant game tickets.

In accordance with Chapter 11, Section 12, of the General Laws and Chapter 647 of the Acts of 1989, the Office of the State Auditor (OSA) conducted a performance audit of the MSLC for the period July 1, 2007 to June 30, 2008. The purpose of the audit was to review the MSLC's (a) internal controls for the Sales Agent Incentive Programs, (b) management of revenue streams, and (c) corrective action taken on prior audit results.

AUDIT RESULTS

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1. INADEQUATE PLANNING AND INTERNAL CONTROLS FOR THE SALES AGENT INCENTIVE PROGRAMS

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Our review determined that the MSLC's marketing research planning and related policies and procedures developed and implemented over its Sales Agent Incentive Programs (SAIP) for cash and non-cash incentives did not have sufficient and adequate internal controls to monitor its various activities. Specifically, we noted (a) questionable SAIP

accounting and rewarding practices; (b) inadequate internal controls over the accounting and reporting of sports and entertainment tickets, memorabilia, and contracts; and (c) a cost-benefit analysis for the SAIP was not performed, as discussed below. During our audit, the non-cash incentive program was cancelled and the cash incentive program was suspended. However, the MSLC was still participating in the Celtics Heroes Among Us and the Boston College Community Award programs.

a. Questionable Accounting and Rewarding Practices Regarding the SAIP **6**

Our review of the MSLC's marketing strategy for the SAIP dated May 25, 2008 and the subsequent MSLC internal audit report dated August 18, 2008 indicated that although the intent of the SAIP was to reverse declining sales by developing ways to increase revenues to benefit communities, it did not demonstrate any relationship between incentive rewards with sales increases, that is, how the plan would be targeted to specific agents, geographic areas, or specific games or how any increase in sales was projected and outcomes were measured in order to justify the awarding of cash rewards, memorabilia, and tickets to sporting and entertainment events. Instead, many agent rewards were awarded via lottery-style drawings that were either random or favored the highest-volume agents, rather than by tracking agent sales for specific games and tickets and making awards on the basis of comparative increases in total or categorical sales and program effectiveness.

b. Inadequate Internal Controls over the Accounting and Reporting of Sports and Entertainment Tickets, Memorabilia, and Contracts **8**

Our audit determined that although MSLC marketing staff maintained various worksheets, there were no policies and procedures, as well as incomplete and inadequate records for the receipt and distribution of sports and entertainment tickets. Each component of the non-cash incentive program promotes different games and involves different marketing staff members. Because of this practice, the level of documentation varies and is not consistent or comprehensive. We also determined that most of the contracts involved in the non-cash incentive program were either unsigned or could not be provided by the MSLC. In addition, tickets to sporting events were provided without any transparent cost to the MSLC by MDI Entertainment, a wholly owned subsidiary of Scientific Games, the printers of instant game tickets.

c. Cost-Benefit Analysis Not Performed **11**

The MSLC did not develop a cost-benefit analysis for its SAIP. Although the MSLC's policies and procedures require such an analysis to be performed for each SAIP sponsorship deal, they do not specify how the analysis is to be utilized in the decision-making process. Further, the MSLC has no comprehensive reporting system to assess the success of the SAIP to determine its impact on instance game ticket sales.

In response to the audit report, the MSLC indicated that it had updated its policies and procedures and that incentive contracts were executed in a timely manner as recommended by the internal audit report. The MSLC also indicated that the last cash and non-cash sales agent incentive programs were canceled in late 2008.

2. MANAGING LOTTERY REVENUE STREAMS
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During fiscal year 2008, instant game sales revenues totaled \$3.3 billion, or 71% of total MSLC revenues of \$4.7 billion. MSLC sales have not substantially increased since 2001, when annual sales totaled \$2.7 billion. Because the MSLC is heavily dependent on instant game sales to continue its sales growth, it has taken steps to improve its inventory management, review the prize structure of new games, and work with its sales agents to expand business at the point of sale.

The MSLC's marketing plan identifies several factors affecting MSLC sales, including an aging customer base, reduced consumer traffic at sales agents, a lack of new product innovation, changing consumer buying behavior, "jackpot fatigue" (when jackpot levels are low, sales decline), and a limited advertising budget. The MSLC has taken some steps to enhance its sales by allowing the sale of Keno products at non-pouring establishments, having drawings of the Numbers Game twice a day, and introducing a new racing format of Keno.

The MSLC has also worked with its ticket vendor to develop new game ideas that will increase sales. The MSLC has a paradoxical relationship with its ticket suppliers because the MSLC needs to introduce new instant games that sell well rather than remain unsold on sales agent shelves or in the MSLC's warehouse, whereas the producers of instant game tickets earn money when they produce new games, regardless of how well they sell. A common complaint from the MSLC's sales agents is that there are too many instant games and that tickets with lagging sales are not replaced fast enough, take up space, and have a negative effect on revenue. The MSLC should explore more opportunities to enhance revenues for the benefit of the Commonwealth's communities.

In response to the audit report, the MSLC stated that it is focused on finding new sources of revenue while maintaining existing relationships with local customers. The MSLC also indicated that it has launched major initiatives to increase sales volume and revenue, including the additions of Power Ball, the Billion Dollar Blockbuster instant game ticket, expanded sport-themed tickets, expanded Keno, improved sales agents instant ticket ordering, and improved account merchandising at point-of-sale.

3. PRIOR AUDIT RESULTS PARTIALLY RESOLVED OR UNRESOLVED
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a. Ineffective Internal Controls over "Professional" Ticket Cashers Results in Hundreds of Millions of Dollars in Unclaimed and Unreported Income and Lost Tax Revenue
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Our prior audit reports disclosed numerous instances in which certain individuals were repeatedly claiming hundreds of prizes valued at millions of dollars over a period of several years. Our follow-up review disclosed that this practice is ongoing and has become even more widespread. Our prior audit report No. 2005-0089-3S noted that during calendar year 2004 the "20/20 listing" (a list of individuals who cashed at least 20 winning MSLC tickets valued at more than \$20,000 in the aggregate during the calendar year) consisted of 88 individuals who cashed prizes totaling \$10,065,427. In calendar year 2005, 113 individuals cashed prizes totaling \$14,374,013, an increase of 42.8%. In calendar year 2006, 133 individuals cashed prizes totaling \$19,480,511, an increase of 35.5%. However, in calendar year 2007 the number of cashers had decreased to 123 cashers who cashed prizes totaling \$16,617,683, a decrease of 14.7%.

The top 10 cashers in calendar year 2004 cashed prizes totaling \$4,835,330. In calendar year 2005, this amount increased by 47.8% to \$7,146,372, and in calendar year 2006 this amount increased to \$9,353,961, an increase of 30.9%. There was minimal change in cashing activity among these top cashers in 2007, the total amount dropping to \$9,288,019, representing only a slight decrease in activity of 0.7%.

The MSLC should adhere to its mandate and exercise its authority, power, and duties under Chapter 10, Section 24, of the General Laws to ensure the integrity of the games. In addition, it should work with the relevant enforcement agencies to monitor professional cashing and develop measures to minimize and eventually end this practice.

In response to the audit report, the MSLC stated that it is legally required to honor valid winning tickets, but if legislation is enacted that restricts customer cashing activities, it will act accordingly.

b. Improvements Needed in Controls over Sales Agent Ticket Scanning/"Peeking"/Purchasing Activities

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Our prior reports have raised questions regarding the internal controls, policies, and procedures over sales agents' ability to scan instant game tickets. We recommended that the MSLC ensure that its Compliance Unit more closely monitor sales agents for unusual, irregular, and questionable activities and patterns, and take appropriate action as warranted. We further suggested the suspension of agents and their employees who purchase tickets from their own stores.

Our follow-up review disclosed that procedures to detect illicit scanning ("peeking") have been recently updated. This emphasis on and vigilance over scanning and peeking, as noted in our prior audit, has had a positive and marked result in reducing the occurrence of first and second incidences along with limiting the amount of third-time offenses as a result.

In response to the audit report, the MSLC indicated that the continued improvement in the reduction of instances of "peeking," along with Compliance Unit reviews and sales agent penalties, confirm the MSLC's vigilance in protecting game integrity.

c. Monitoring the Quality of Instant Game Ticket Printing

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Prior audits have disclosed that the MSLC needed to establish procedures to monitor instant game ticket quality for defects and recover payments associated with purchases of defective instant game tickets and to make public notifications when some tickets are defective.

Our follow-up review disclosed that improvements are still needed to identify all instances of defective instant game tickets and document Quality Control Committee meetings regarding defective ticket issues. According to MSLC staff, since March 2009, 13,746 individual tickets were returned to the printer out of 549,352,000 or .0025% overall, and .005% per game, falling below the reportable standard of .1% per game.

The MSLC should identify all instances of defective tickets, document all meetings of the Quality Control Committee, and ensure that all quality control procedures for each instant ticket game are fully performed.

In response to the audit report, the MSLC indicated that it had initiated a “Watch List” to record and track defective instant tickets that is sent to the Executive Director of Compliance for regular review.

d. Management of Risk Associated with Instant Game Ticket Manufacturing Needs to Be Improved

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Our prior audit disclosed that the MSLC has contracted with three vendors for the production of instant game tickets, with one vendor manufacturing 80% of the tickets. Our follow-up review determined that two vendors produce instant game tickets for the MSLC. Scientific Games acquired one of the vendors, Oberthur Gaming Technologies, on May 1, 2007. The MSLC had not recognized and considered the exposure of the potential risk of catastrophic loss of ticket production because of this situation and therefore was urged to develop a plan to address the possible interruption of the instant game ticket supply.

In response to the audit report, the MSLC stated that it contracts with three manufacturers for instant game tickets and has 62 weeks’ worth of tickets in warehouse inventory to cover sales activity. The MSLC feels that these factors support the plan to limit catastrophic risk.

e. The MSLC Supplies Prizewinners of between \$600 and \$9,999 with an Accommodation Letter That Enables the Holder to Cash Prize Checks from the MSLC at the MSLC’s Bank on the Same Day the Check Is Issued

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Our prior audit disclosed that the MSLC had designed a letter of introduction addressed to its principal bank depository, requesting that it accommodate the holder of the letter to cash a prize-winning check (of between \$600 to \$9,999) drawn from the designated bank on the same day of its issuance. This practice allows both legitimate winners and those individuals known as “professional cashers” to present the prize check and immediately obtain cash proceeds without the usual two forms of proper identification normally required by a bank for such transactions. The MSLC’s normal practice for prizewinners is to use the “positive pay” system, whereby it notifies the bank of valid checks issued so that the bank can match checks when presented to the bank for payment. This control system provides the MSLC and the bank protection against losses from altered or stolen checks.

Our follow-up review disclosed that the MSLC continues to issue accommodation letters to its customers and not use the “positive pay” system. The MSLC should discontinue issuing accommodation letters and use the “positive pay” system to protect against fraudulent transactions.

In response to the audit report, the MSLC indicated that it will continue the practice but will contact the bank to discuss initiating a call-back procedure when a check is presented for cashing to resolve the issue of financial risk.

f. Effects of Declining Revenue on Nonprofit Organizations Supported by Beano Operations

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Our prior audit disclosed that Beano gaming activities in the Commonwealth declined steadily from calendar years 2001 through 2004. These games represent the largest share of revenue generated in the MSLC Charitable Gaming Division, producing nearly two-

thirds of the revenue of the four types of charitable games offered: Beano, charity game tickets, raffles, and bazaars (casino functions).

Our follow-up review disclosed that the law governing Beano operations (Chapter 10, Sections 37 through 39A, of the General Laws) should be reviewed and possibly amended. Ultimately, the MSLC should attempt, as part of an overall strategy, to present legislation toward growth in traditional Beano games.

In response to the audit report, the MSLC stated that Beano prize levels are based on the players' paying admission, which does not generate enough income to significantly increase prize levels. The MSLC also indicated that organizations are not allowed to "front" money for prizes, and that competition from private gaming establishments and their ability to increase prize payouts impacts the MSLC's ability to make changes.

g. Prohibited Game Participation**33**

Prior audits have recommended that, to prevent MSLC employees and their household family members from playing MSLC games, the MSLC should require, as a condition of employment, the name, age, and Social Security numbers of immediate family members of all MSLC employees.

Our follow-up review determined that the MSLC continues to consider the issue closed and has not made any effort to institute a policy that stipulates as a condition of employment that random checks of employee activity in the MSLC be instituted, including the crosschecking of employee name and Social Security data against payment lists of MSLC game prizewinners. The MSLC should stipulate as a condition of employment that random checks of participation in MSLC games by employees and members of their household may be performed.

In response to the audit report, the MSLC stated that it has consistently acted upon any report of an MSLC employee purchasing or playing a MSLC game and has terminated employees who were found to have violated this prohibition.

h. Expansion of Keno Operations**34**

Our prior audit disclosed that Keno revenues had declined after the introduction in July 2004 of a statewide smoking ban in all "pouring establishments" (places that serve alcohol). We recommended that the MSLC consider changes to expand its base by allowing more "non-pouring" agents to offer Keno because of the negative impact that the smoking ban was having on local business establishments and the cities and towns that depend on the MSLC.

Our follow-up review disclosed that the MSLC implemented our recommendation and expanded its Keno base by allowing most non-pouring agents to offer Keno-to-Go in March 2008. However, there have been mixed revenue results, with year-to-date Keno revenue down by 4.6% from fiscal years 2007 to 2008 but only by 1.4% through September for the first three months of fiscal year 2009 in comparison to the first three months of fiscal year 2008.

In response to the audit report, the MSLC stated that the Keno-to-Go program implemented in 2008 has successfully generated revenue in non-pouring establishments in an effort to seek out customers at different entry point levels.

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Our prior audit disclosed that the MSLC had not developed an internal control plan (ICP) or an organization-wide risk assessment in accordance with the Office of the State Comptroller's (OSC) guidelines. Our follow-up review disclosed that the MSLC has developed a comprehensive risk assessment, has conducted reviews and activities for its various functions, and has developed an ICP for its various operations departments.	
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Our prior audit disclosed that internal control improvements were needed over the MSLC's pilot anti-litter program (the Instant Replay Recycling Program) at various fairs, events, and sites during fiscal years 2004 and 2005. Our follow-up review disclosed that the MSLC developed policies and procedures to address the issues reported in the prior audit report. Also, the MSLC discontinued the Instant Replay Recycling Program in April 2007.	
c. Internal Controls Implemented to Ensure Compliance with Advertising Agency Contract Provisions	36
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Our prior audit disclosed that the MSLC's advertising agency billings did not include sufficient documentation to support compliance with the administrative provisions of the contract. Our follow-up review disclosed that the MSLC now has procedures in place to adequately monitor its advertising agency billings.	
d. Detection and Prevention of Sales to Minors Improved	37
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Our prior audit disclosed that the MSLC has established a policy against underage gambling as promulgated under 961 Code of Massachusetts Regulations 2.13, which sets forth the policies under which the MSLC, through its Security Department, conducts periodic, unannounced, and random visits to licensed sales agents in an effort to determine whether the statutory prohibition against sales to minors is enforced. However, no such operations were conducted from 1998 to 2005. Our follow-up review disclosed that the MSLC has reinstated its undercover operations and provided documentation to support its reinstatement of the operation to detect and prevent sales agents from selling MSLC products to minors.	
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Our prior audit disclosed that the MSLC's newly created Internal Audit Department was proceeding with a multiphase plan to establish a professional and meaningful method by which risk is identified and tested. Internal audits were scheduled and conducted for certain MSLC departments, with the findings to be used to develop a reporting template that would be issued to the Office of the State Treasurer and the MSLC Executive Director on a quarterly basis. Our follow-up review disclosed that the MSLC has conducted numerous internal audits of selected MSLC operations.	
f. MSLC Kiosk Operations at Selected Malls and Other Locations Discontinued	39
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Our prior audit noted that the MSLC had established a kiosk to service patrons in the Natick Mall. The kiosk sold instant and on-line games, MSLC apparel, and other MSLC-	

themed items, and served as a regional ticket-cashing location. We recommended that the MSLC conduct demographic and marketing studies to determine whether similar operations throughout the Commonwealth in various retail locations would be viable.

Our follow-up review disclosed that the MSLC's opinion was that expanding the kiosk business is not a profitable strategy because employee costs would be much higher than the cost of an independent sales agent. The MSLC discontinued its kiosk operations as of July 31, 2009.

g. Improvements in the Collection of Accounts Receivable from Delinquent and Terminated Sales Agents, Credit and Background Checks of Sales Agents, and Bond Fees to Cover Losses and Discourage Delinquency **40**

Our prior audits disclosed that the MSLC had written off bad debts representing funds owed by sales agents totaling \$13 million from fiscal years 1999 to 2002, \$1.8 million in fiscal year 2003, and \$700,000 in fiscal year 2004.

Our follow-up review disclosed that the MSLC has made improvements and now performs a more extensive credit and financial evaluation of all new agents, as well as a more comprehensive annual licensing procedure, including more detailed security background checks and site evaluations, to mitigate risk.

h. Compliance with Statutory Requirements under Chapter 647 for Reporting Unaccounted-For Variances, Losses, Shortages, or Thefts of Funds or Property **42**

Prior audit reports disclosed thousands of unreported incidents of thefts and losses involving instant game tickets that were not reported to the OSA in a timely and sufficiently comprehensive format, contrary to Chapter 647 of the Acts of 1989. Prior audit reports recommended that, since instant game tickets are Commonwealth property, the MSLC must report all missing, stolen, and unaccounted-for tickets to the OSA as required by Chapter 647 so that the OSA may conduct an independent review of the circumstances and make recommendations to improve the internal controls over instant game tickets.

Our follow-up review disclosed that although the MSLC electronically transfers reports of unaccounted-for variances, losses, shortages, or thefts of funds or property to the OSA, the format and level of detail and information provided is insufficient in terms of allowing the OSA to independently review and render the determinations and recommendations required under the law. The OSA and MSLC will continue to work together regarding the timely submission, format and level of detail and information provided to the OSA for its independent review.

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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 by operating various lottery games. The MSLC may establish, and from time to time revise, such rules and regulations for these activities as it deems necessary or desirable.

On September 27, 1971, legislation was enacted to create a state lottery that would provide a source of revenue for the 351 cities and towns of the Commonwealth. This legislation created the MSLC, which is composed of the State Treasurer, who serves as chairman; the Secretary of the Executive Office of Public Safety; the State Comptroller; and two members appointed by the Governor for terms coterminous with that of the Governor. These members have the responsibility of approving rules and regulations, contracts, and overall policy decisions for the MSLC. The MSLC's Executive Director is appointed by the State Treasurer, subject to the approval of the Governor, and is responsible for the MSLC's day-to-day operations. Specifically, Chapter 10, Section 24, of the General Laws states that the MSLC shall have the following powers and duties:

The commission is hereby authorized to conduct a state lottery and shall determine the types of lottery or lotteries . . . and such other matters necessary or desirable for the efficient and economical operation and administration of the lottery and for the convenience of the purchasers of tickets or shares and the holders of winning tickets or shares The commission shall advise and make recommendations to the director regarding the operation and administration of the lottery. The commission shall report monthly to the governor, the attorney general and the general court, the total lottery revenues, prize disbursements and other expenses for the preceding month, and shall make an annual report to the same which shall include a full and complete statement of lottery revenues, prize disbursements and other expenses, including such recommendations as it may deem necessary or advisable

The commission is authorized to carry on a continuous study and investigation of said lottery throughout the commonwealth in order . . . to ascertain any defects in the state lottery law or in the rules and regulations issued there under whereby any abuse in the administration and operation of the lottery or any evasion of said law or said rules and regulations may arise or be practiced

The commission shall make a continuous study and investigation of the operation and administration of similar laws in other states or countries, of any literature on the subject which from time to time may be published or available of any federal laws which may affect the operation of the lottery, and of the reaction of citizens of the commonwealth to existing and potential features of the lottery with a view to recommending or effecting changes that will tend to better serve and implement the purposes of the state lottery law.

The commission shall have the power to issue subpoenas to compel the attendance of witnesses and the production of documents, papers, books, records and other evidence before it in any matter over which it has jurisdiction, control or supervision. The commission shall have the power to administer oaths and affirmations to persons whose testimony is required.

The following highlights specific powers and duties of the Executive Director as authorized by Chapter 10, Section 26, of the General Laws:

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

During fiscal year 2008, the MSLC generated \$4.7 billion in sales revenue, while paying prizes totaling \$3.4 billion, or 72.6% of sales. In addition, the MSLC paid \$275 million for commissions and bonuses to its sales agents and had administrative and operating expenses totaling \$101 million for a net profit before distribution of \$913 million. There were authorized distributions totaling \$1.026 billion from the Lottery Fund, which had a deficit balance, and a transfer of \$113 million was authorized by the Legislature from the Commonwealth's General Fund that supplemented the Lottery Fund's shortfall. The authorized transfers were \$935 million for Local Aid to cities and towns, \$78 million for Arts Local Aid, \$12 million for the Massachusetts Arts Council, and \$1 million for the Gamblers' Treatment Program. Additionally, prize money winnings result in state and federal income tax revenue for government services, programs, operations, and activities.

The MSLC compensates licensed agents through commissions and bonuses. The MSLC has historically used cash incentive programs to motivate and reward its approximately 7,500 sales agents to increase game promotion and sales. These cash incentives, which are paid from an agent's sales revenue during the settlement process, totaled \$9.8 million in calendar year 2007 and \$11.5 million in calendar year 2008. Due to declining sales revenues, the MSLC in recent years has used a variety of non-cash incentives, such as tickets to sporting events, theater tickets, and sports memorabilia.

These non-cash incentives were purchased through appropriated funds or provided by Scientific Games, a producer of instant game tickets. Non-cash incentive program expenditures totaled \$263,235 in fiscal year 2007 and \$2,119,293 in fiscal year 2008.

An August 18, 2008 report prepared by the MSLC's Internal Audit staff stated the following:

In 2007, the Lottery performed an assessment of the objectives for the marketing department. The goals were to provide products customers would buy, promote products successfully by reaching customers, and manage the sales agents effectively. The Lottery products are sold by licensed sales agents, which the lottery does not have management control. Agents are compensated through commissions and bonuses. Agent incentive programs [AIP] are a form of bonuses. Historically, the AIP have been used to encourage agents to sell specific instant tickets. Cash rewards have been a useful tool in motivating agents; however, there were a limited number of agents winning cash prizes. To increase sales, management decided to grow the non-cash incentives to motivate a wider number of agents to increase sales, sell slow moving inventory and position products in highly visible areas. In addition, some of the non-cash incentives provide an opportunity to build a rapport with the agent base. Lottery management defined a maximum internal budget of 1% of sales for total bonuses. In FY 2008 the total amount spent on agent bonuses was approximately 0.87% of sales. Approximately 0.041% of bonuses, or \$2.1 million was related to the sports ticket AIP.

A MSLC marketing plan states that the agent incentive component has historically been used in agent drawings, whereby agents who settle a pre-determined specific book of instant tickets are entered into a drawing for cash prizes. Programs awarding agents tickets to an entertainment or sports event have also historically, been part of the sales agent incentive programs.

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

The significant role that the MSLC holds in the Commonwealth's overall budget requires strong and effective internal controls to ensure that the Commonwealth's resources are safeguarded and losses are minimized, thereby generating maximum net revenue to fulfill its mission and purposes.

Generally accepted government auditing standards describe the concept of accountability as follows:

The concept of accountability for use of public resources and government authority is key to our nation's governing processes. Government officials entrusted with public resources are responsible for carrying out public functions legally, effectively, efficiently, economically, ethically, and equitably. Government managers are responsible for providing reliable, useful, and timely information for accountability of government programs and their operations. Legislators, government officials, and the public need to know whether (1) government manages public resources and uses its authority properly and in compliance with laws and regulations; (2) government programs are achieving their objectives and desired outcomes; (3) government services are provided effectively, efficiently, economically, ethically, and equitably; and (4) government managers are held accountable for their use of public resources.

Audit Scope, Objectives, and Methodology

In accordance with Chapter 11, Section 12, of the General Laws and Chapter 647 of the Acts of 1989, the Office of the State Auditor (OSA) conducted a performance audit for the period July 1, 2007 to June 30, 2008. The purpose of the audit was to review the MSLC's (a) internal controls for the Sales Agent Incentive Programs (SAIP); (b) management of revenue streams; and (c) corrective action taken on prior audit results.

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:

- Review the appropriateness and cost-effectiveness of the expenditures and the internal controls pertaining to the various promotional and advertising activities of the SAIP.
- Conduct an assessment to evaluate the activities of the SAIP to determine its necessity as a strategic mechanism to increase MSLC revenues.
- Review and analyze MSLC financial and administrative activities.
- Update the status of prior audit results and review the corrective actions implemented since our previous audit (No. 2005-0089-3S).
- Review the improvements relating to internal controls and revenue enhancements, including the appointment of an internal control officer and the development of a comprehensive internal control plan.

In order to achieve these objectives, we reviewed applicable state and federal laws, rules, and regulations as well as internal policies and procedures; interviewed selected personnel; tested and

reviewed accounting records and transactions; and analyzed various administrative, personnel, and other documents, including contracts, reports, reviews, and records.

We met with MSLC officials at the conclusion of the audit to discuss our audit results and recommendations.

AUDIT RESULTS

1. INADEQUATE PLANNING AND INTERNAL CONTROLS FOR THE SALES AGENT INCENTIVE PROGRAMS

Our review determined that the Massachusetts State Lottery Commission's (MSLC) marketing research planning and related policies and procedures developed and implemented over its Sales Agent Incentive Programs (SAIP) for cash incentives and non-cash incentives did not have sufficient and adequate internal controls to monitor its various activities. In addition, the MSLC does not have systems that measure and report the basis and results of the SAIP and lacks a level of transparency and accountability for the sales agents' cash incentive programs by paying cash incentives from revenues rather than from appropriated funds. Also, the MSLC did not account for certain related tickets and paraphernalia.

According to the MSLC's marketing staff, there have been various cash incentive programs since instant ticket games were introduced in 1974. However, because of declining MSLC sales, non-cash incentive programs using sports and entertainment tickets were introduced in hope of increasing sales in the Numbers Game, Cash WinFall, Keno, and instant games.

The cash incentive program paid cash incentives totaling \$9.8 million in calendar year 2007 and \$11.5 million in calendar year 2008. In addition, the MSLC expended at least \$2,790,263 (see Appendix I) from fiscal year 2004 through fiscal year 2008 for sports tickets and other forms of entertainment and related memorabilia. Cash incentives are paid through the standard sales agent settlement process utilizing their sales revenues, whereas sport and entertainment tickets are purchased with appropriated funds. These various incentives were in addition to commissions and bonuses paid to sales agents that totaled \$273 million during fiscal year 2008. In addition, tickets to sporting events were provided without any transparent cost to the MSLC, but by MDI Entertainment, a wholly owned subsidiary of Scientific Games, one of the printers of instant game tickets.

a. Questionable Accounting and Rewarding Practices Regarding the SAIP

Our review of the MSLC marketing strategy for the SAIP dated May 25, 2008 and the subsequent MSLC internal audit report dated August 18, 2008 indicated that although the intent of the SAIP was to reverse declining sales by developing ways to increase revenues to benefit communities, it did not demonstrate any relationship between incentive rewards with sales increases, that is, how the

plan would be targeted to specific agents, geographic areas, or specific games or further how any increase in sales was projected or outcomes measured in order to justify the awarding of cash rewards, memorabilia, and tickets to sporting and entertainment events. Instead, many rewards were awarded via lottery-style drawings that either were random or favored the highest-volume agents, rather than by tracking agent sales for specific games and tickets and making awards on the basis of comparative increases in total or categorical sales and program effectiveness.

According to the MSLC's marketing staff, the cash incentives paid to sales agents have historically been awarded via drawings whereby sales agents who settle a pre-determined number of instant ticket books are entered into a periodic agent drawing for cash incentive awards. The MSLC compensates its sales agents through a commission and bonus system. The amount reported as sales bonus expenses include the agent cash incentive component. Commissions, bonuses, and cash incentives are deducted from MSLC sales revenues during the sales agent settlement process, and the net sales proceeds are transferred to the Commonwealth.

The sales agent settlement process is designed to comply with Chapter 10, Section 33, of the General Laws, which states, in part:

The director . . . may permit agents to deduct from the proceeds of sales of lottery tickets the agreed amount of reimbursement and compensation for services rendered.

The practice of deducting cash incentives that have been awarded to sales agents from MSLC sales proceeds lacks transparency and understates the cost of MSLC promotional operations. Sales commissions and bonuses represent the amount of compensation paid to sales agents and are deducted from sales proceeds, whereas cash incentives are promotional costs, based on sales volume, and should be paid from the MSLC's appropriated funds and fully disclosed. The approximately \$11 million paid as sales agent cash incentives during fiscal year 2008 is slightly less than 10% of the MSLC's appropriated funds for that fiscal year. Like its advertising budget, the MSLC's payment of cash incentives should be part of the annual budget debate.

The process for selecting winning sales agents for the sports and entertainment agent incentive program lacked guidelines, policies, or procedures and was purposely arbitrary so that agents outside of the top sellers, who were the primary recipients of sales agent cash incentives, had a chance of winning. This is in contrast with selection procedures for cash incentives, which are based on instant game ticket books opened during a set period. This process gave large-volume sales agents a

distinct advantage in winning cash incentives. However, for ticket and entertainment incentives, sales lists were used but winners were often selected from low-volume sales agents to avoid the large-volume agents and give others a chance.

b. Inadequate Internal Controls over the Accounting and Reporting of Sports and Entertainment Tickets, Memorabilia, and Contracts

Our audit determined that, although MSLC marketing staff maintained various worksheets, there were no policies and procedures, as well as incomplete and inadequate records for the receipt and distribution of sports and entertainment tickets. Each component of the non-cash incentive program promotes different games and involves different marketing staff members. Because of this practice, the level of documentation varies and is not consistent or comprehensive.

An MSLC internal auditor's report disclosed that prior to May 2008, the MSLC had no policies and procedures in place for the receipt and distribution of tickets distributed in the SAIP. The report stated:

The non-cash incentives are administratively complex and the focus of the documentation was on the agent data which was used to effectively manage the program. Although reconciliation was not formalized in the P&P [policies and procedures], the necessary information to perform reconciliation was available for the major sponsorship deals and related AIP [Agent Incentive Program] in 2007-2008. . . . The reconciliation process was more difficult to assess prior to 2007 due to missing information.

A reconciliation is defined as: number of tickets purchased as per contract/ tickets distributed to agents and lottery representatives as per marketing attendance lists/unused tickets (stored in marketing file cabinet)

Prior to May 2008 . . . the Lottery had no written Policies and Procedures stating what information should be maintained. Based on our inquiry with Lottery management the key documents used to assess the completeness and accuracy of ticket distribution would include the following: (1) contract with terms defining how many tickets would be received, (2) agent and additional communication, (3) agent winner selection procedures, (4) MIS [Management Information System] report used as source document for winner selection, if applicable, (5) overview of agents and Lottery representatives/others that received tickets and (6) agent confirmation of prize receipt. The Lottery's record retention policy is to maintain documents 6 years after expiration.

Also, the MSLC's internal audit report disclosed that the MSLC implemented a policy for hosting and event management in May 2008, as follows:

The practice of having MSLC representatives work at sales agent incentive events started in 2005 – 2006. IA [Internal Audit Department] observed that information about tickets

being distributed to MSLC representatives was included in the agent attendance overviews for the first time in 2006. . . . Management informed IA that because MSLC representatives were asked to work outside their regular work hours during evenings and on weekends, they were allowed to bring one guest. . . . Senior management did not receive additional compensation for working after business hours and other lottery employees did not get paid overtime. However, based on the collective bargaining agreement employees can refuse to work outside of regular business hours. For evening events "employee safety" was also an important criterion for implementing the policy. Based on the public comment following the news articles, MSLC management revised the established host-guest practice and implemented a formal policy for hosting and event management. This policy should establish criteria for hosting events, the responsibilities and duties of the MSLC representatives and clearly state that MSLC representatives will receive access to the location of the event. Additionally, the policy should state how this will be documented to ensure accountability and provide an audit trail.

There were inadequate internal controls over the non-cash incentive program's related tickets and memorabilia. Our audit disclosed that there were unused and unaccounted-for items, as follows:

- The MSLC hosted two Boston Celtics basketball fantasy camps. On the first of these events, on February 24, 2008, the MSLC awarded 46 tickets and 34 sales agents attended. The second camp was on March 16, 2008, for which the MSLC awarded 78 tickets and 70 sales agents attended. There were 20 unused tickets valued at \$200 each totaling \$4,000. The MSLC hosted a Boston Bruins Slice the Ice event on Monday, March 17, 2008, for which 90 tickets were awarded. According to MSLC documentation, 50 sales agents attended and tickets were valued at \$100 each.
- The MSLC offered framed New England Patriots football game towels as an incentive to top sales agents in each region who won tickets to a Patriots playoff games by selling the Blockbuster instant game tickets or season tickets or by having the top sales in their district. The MSLC had 110 towels framed at a cost of \$4,730. Records indicate that 82 agents received this incentive. The remaining 28 framed towels valued at \$1,204 were unaccounted for.
- The MSLC received 100 hooded sweatshirts and 100 hats from the Patriots as part of a marketing agreement contract for the 2007-2008 season. These items were to be used as incentives for sales agents. The contract as well as proper documentation of who received these items is kept on file. Six sweatshirts were reported as missing, 35 have not been given out and are being stored, 38 were put in different vendor holiday gift bags, 15 were given to sales agents who attended Patriots football games, four were given to MSLC game hosts, and two were used for the Celtics Heroes Among Us Program. In addition, 68 hats were given to sales agents who attended Patriots football games, 11 were used in various holiday gift bags, 10 were taken out of an office without a requisition, eight were given to MSLC employees who worked games as hosts, two are still in an office not being used, and one was used for the Celtics Heroes Among Us Program. There was no documentation available to support the removal of the 10 Patriots hats and the six hooded sweatshirts from the marketing department.

- The MSLC also had a contract with the Patriots for the 2007-2008 season to receive 156 polo shirts and 276 authentic hats. However, the MSLC never received these items. In lieu of the shirts and hats, the MSLC received 110 gift cards with a face value of \$100, for a total value of \$11,000. These gift cards have not been used and are stored in a locked file cabinet in an MSLC office.

In addition, the MSLC internal audit report indicated that the MSLC did not maintain adequate records and documentation over the non-cash incentive program, as follows:

The Lottery should maintain records and documents sufficient to properly reflect the amount and receipt, of all AIP elements and the total cost of the AIP. Generally accepted government accounting principles and adequate supporting documentation should be maintained in such detail to provide an audit trail which would permit tracing transactions from the contract to the accounting records and the supporting documentation. Additionally, sufficient records and documents should be maintained to assist management with monitoring the execution of business objectives and the effectiveness of operations. All records relevant to the AIP should be preserved in accordance with the Lottery's record retention policy.

We determined that a majority of contracts involved in the non-cash incentive program were either unsigned or unavailable for review. No contracts were in the files for the 2004 and 2005 New England Revolution soccer team or the 2005 and 2007 Boston College football, men's basketball, women's basketball, and hockey teams. In addition, a \$36,000 invoice for Boston College football tickets for the period September 10, 2005 to November 2005 was received in May 2006 and paid; the Boston Bruins contract for games beginning November 2007 was not signed until December 2007; and the University of Massachusetts 2005 contract for football, hockey, and men's and women's basketball was not signed or available in the files.

Promotional items such as tickets to sporting events were provided to the MSLC by MDI Entertainment, LLC (MDI), which is a wholly owned subsidiary of Scientific Games and provides licensing and promotional support to various lotteries worldwide. MDI provided packages of tickets to sporting events as part of its support of instant games sales featuring the Boston Red Sox and Boston Celtics names. These ticket packages were awarded as part of the non-cash incentive program. During the 2006 basketball season, MDI provided 494 tickets to Celtic games, including regular game ticket packages and suite packages. During the 2006 baseball seasons, MDI provided 1,530 Red Sox game tickets that were part of the non-cash incentive program and allowed winners access to suites or the Players Club, a VIP lounge. During the 2007 Red Sox season, MDI provided 340 game tickets that were part of the SAIP and allowed winners access to suites or the Players Club. Since MDI is a wholly owned subsidiary of Scientific Games, the printer of instant game

tickets, there was no transparency or full disclosure as to the promotional cost for items supplied by MDI. Also, the MDI had a contractual relationship with the MSLC; however, the MSLC did not make the contract available for our review.

c. Cost-Benefit Analysis Not Performed

During fiscal year 2006 the MSLC established a task force to review the operations of its various games after experiencing several years of declining sales (see Appendix II). One of the task force's recommendations was to initiate the sports incentive program. In addition to expanding its existing incentive programs, the MSLC has changed the format of its Numbers Game to a twice-daily game, started Keno-To-Go at non-pouring establishment as recommended by the Office of the State Auditor (OSA), and introduced the Daily Race Game, a racing format of Keno.

The MSLC marketing plan, as well as management's Analysis and Discussion contained in the MSLC's independent Financial Audit Report, identifies several factors impacting MSLC sales, including an aging customer base, reduced consumer traffic at sales agents, a lack of new product innovation, changing consumer buying behavior, "jackpot fatigue"(when jackpot levels are low, sales decline), and a limited advertising budget.

An analysis of sales data performed by the MSLC marketing department determined that more than half of its agent base, or more than 3,000 sales agents, fell into the \$500,000 to \$1 million sales range. This analysis also determined that convenience stores and convenience stores with gas stations comprised the majority of this sales base. The analysis further found that foot traffic in these stores was declining by 17% per year and that increasing gas prices would have an additional negative impact on foot traffic in these establishments. Our analysis of MSLC sales data for fiscal year 2008 determined that the top 100 sales agents had total sales of \$406,096,682, whereas total MSLC sales were \$4.7 billion for all of the MSLC's approximately 7,500 agents. The MSLC has no data that indicates how such incentives motivate large- or medium-size sales agents beyond the 5% sales commission already received by all sales agents.

The MSLC internal audit report dated August 18, 2008 indicates that the MSLC determined that a limited number of sales agents were winning cash incentives. Accordingly, the MSLC decided to increase the non-cash incentives to motivate a wider number of sales agents to increase sales. The report states, in part:

In 2007, the Lottery performed an assessment of the objectives for the marketing department. The goals were to provide products customers will buy, promote products successfully by reaching customers, and manage the sales agents effectively. The Lottery products are sold by licensed sales agents, which the lottery does not have management control. Agents are compensated through commissions and bonuses. Agent incentive programs are a form of bonuses. Historically, the AIP have been used to encourage agents to sell specific instant tickets. Cash rewards have been a useful tool in motivating agents; however, there were a limited number of agents winning cash prizes. To increase sales, management decided to grow the non-cash incentives to motivate a wider number of agents to increase sales, sell slow moving inventory and position products in highly visible areas. In addition, some of the non-cash incentives provide an opportunity to build a rapport with the agent base. Lottery management defined a maximum internal budget of 1% of sales for total bonuses. In FY 2008 the total amount spent on agent bonuses was approximately 0.87% of sales. Approximately 0.041% of bonuses, or \$2.1 million was related to the sports ticket AIP.

The MSLC's internal audit report on the non-cash incentive program also noted that the MSLC's policies and procedures require that a cost-benefit analysis be performed for each sponsorship deal, but do not specify how the analysis will be utilized in the decision-making process. The report states, in part:

The Lottery's Policies and Procedures [P&P] do not clearly specify how the evaluation of the costs and benefits of a deal . . . that ensures that a deal meets the Lottery's goals and objectives, is included in the decision making process and final approval of a sponsorship deal. Furthermore, the P&P do not specify how the evaluation of costs and benefits and available budget will be evidenced and maintained.

IA [Internal Audit Department] recommends documenting in the P&P, how the evaluation of the costs and benefits is included in the decision-making process and evidence of final approval of a sponsorship deal. In addition, IA recommends specifying in the P&P how the evaluation of costs and benefits and available budget will be evidenced.

Our review found no evidence of a cost-benefit analysis being performed for the SAIP as a whole or on an individual event basis. Our review further determined that the MSLC had outsourced the task of performing a cost-benefit analysis of the SAIP to its advertising contractor, who performed this task on an individual event basis. In addition, there was no cost-benefit analysis performed on the cash incentives paid to sales agents through the years. Moreover, the MSLC had no comprehensive reporting system to assess the SAIP's impact on instant game ticket sales. In fact, in a recent published newspaper article, an MSLC official stated that the increase in MSLC sales could be attributed to the introduction of \$20 instant game tickets. Our review of the marketing plan did not demonstrate justification for the non-cash incentive program or conclusive, specific results.

We also determined that the MSLC does not have a comprehensive database of information that could be used in controlling and monitoring its many non-cash incentive programs. Rather, the

MSLC's marketing staff maintains a unique set of data for each event, making it difficult to determine such information as total tickets received, total tickets awarded, total tickets remaining, dollars spent, program outcomes, and outcomes achieved.

In order to have adequate internal controls over the non-cash incentive programs, the MSLC should maintain proper accounting records as well as supporting documentation and conduct cost-benefit analyses to determine the feasibility of incentive programs. As noted in the MSLC's internal audit report, generally accepted accounting principles require adequate records and supporting documentation for all aspects of the SAIP:

The Lottery should maintain records and documentation sufficient to properly reflect the amount and receipt, of all AIP elements and the total cost of the AIP. Generally accepted government accounting principles and adequate supporting documentation should be maintained in such detail to provide an audit trail which would permit tracing transactions from contracts to the accounting records and the supporting documentation. Additionally, sufficient records and documents should be maintained to assist management with monitoring the execution of business objectives and the effectiveness of operations. All records relevant to the AIP should be preserved in accordance with the Lottery's record retention policy.

During the conduct of our audit, the MSLC suspended its cash incentive programs and canceled its non-cash incentive programs. However, the MSLC was still participating in the Celtics Heroes Among Us and the Boston College Community Award programs, which require the State Treasurer or his designee to attend games when awards are presented to winners.

Recommendation

We concur with the MSLC's decision to suspend the cash incentive programs and cancel the non-cash incentive programs and instead channel the millions of dollars in savings to the Commonwealth's cities and towns. In the future, before any such program is implemented, the MSLC should continuously conduct agent surveys and studies that would guide it toward decisions that would result in increased sales. Studies and surveys should consider developing and constantly introducing a steady stream of new games (innovations), and an effort should be made to replace older, slow-selling games rather than provide incentives to sales agents for selling them. Also, proper internal controls over the accounting and reporting of sports and entertainment tickets, memorabilia, and contracts should be established for any future SAIPs. In addition, the MSLC should consider the other revenue enhancement recommendations outlined elsewhere in our report.

Auditee's Response

The MSLC canceled the cash and non-cash sales agent incentive programs in late 2008. These cash incentives were paid from the agent's sales revenue during the settlement process and represent .21% and .26% of sales revenues for calendar year 2007, and 2008. As of FY2008, the Lottery had signed contracts for the incentive programs, and maintained the information necessary for performing ticket reconciliation; although Marketing policies did not formally reference the reconciliation process. However, prior to FY2008, the Lottery did have limited procedures in place to account for tickets, document contract specifics, and determine reward allocations. These issues were addressed as part of the August 2008 Internal Audit report. The last non-cash agent incentive program that included sports tickets concluded in November 2008. The Internal Audit follow up review, completed February 2009, indicated that policies and procedures were updated per the recommendations in the August 2008 report with the continued issue of timely execution of incentive contracts. During the execution of the SAIP, the MSLC outsourced the cost/benefit analysis to its advertising agency that provided their expertise in this matter. The MSLC utilized this expertise in their overall SAIP decision making process; although the SAIP policies did not adequately indicate this fact. Since these programs have been canceled, the original concerns for formalized documents, allocation criteria and reconciliation risk is removed.

2. MANAGING LOTTERY REVENUE STREAMS

The MSLC is heavily dependent on instant game sales to continue its sales growth. During fiscal year 2008, instant game sales revenues totaled \$3.3 billion, or 71% of total MSLC revenues of \$4.7 billion. MSLC sales have not substantially increased since 2001, when annual sales totaled \$3.9 billion and instant game sales totaled \$2.7 billion, or 69% of total sales

The MSLC offers a variety of games both on-line and instant games. The familiar on-line games include Mega Millions, Megabucks, Keno, and the (twice daily) Numbers Game. Each game type has different sales characteristics requiring different methods for monitoring, directing, and controlling activities. An additional consideration that the MSLC must recognize is that each game has a diverse customer base that requires different inducements to play. Therefore, for the MSLC to be more successful in expanding and increasing its revenues, it must expand into new locations and partner with entities where there is untapped traffic. The MSLC is looking into improving its inventory management systems, reviewing the prize structure of new games, and working with its sales agents to expand business at the point of sale.

During the last five fiscal years, MSLC sales revenues have not substantially increased. In 2007 the MSLC was the second-largest lottery in the United States, with total sales of approximately \$4.5 billion. Although New York State had the largest state lottery, with total sales of \$6.7 billion, 2007 per capita sales in Massachusetts was \$710 compared to \$347 per capita in New York. The 2007

population of Massachusetts was 6.5 million compared to New York's 2007 population of 19.3 million. This data reflects both the success of the MSLC and the challenges it faces in attempting to continuously increase its sales for cities and towns that depend on state financial assistance for the services they provide.

A five-year summary of total MSLC revenues, including a breakout of its four largest revenue-producing games follows (see Appendix II for additional details):

Five-Year Revenue Summary (Figures in Thousands)

Game	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	\$ Change	% Change
Instant Game	\$2,977,732	\$3,135,418	\$3,115,069	\$3,066,440	\$3,341,491	\$363,759	12%
Keno	775,523	742,007	772,253	775,488	\$ 739,881	(35,642)	-5%
Numbers Game	362,524	352,453	342,568	344,155	\$ 343,691	(18,833)	-5%
Mega Millions	95,997	97,066	134,761	119,788	\$ 128,430	32,433	25%
Other Revenues	<u>170,001</u>	<u>155,966</u>	<u>156,479</u>	<u>154,913</u>	<u>\$ 155,850</u>	<u>(14,151)</u>	-8%
Total Revenues	<u>\$4,381,777</u>	<u>\$4,482,910</u>	<u>\$4,521,130</u>	<u>\$4,460,784</u>	<u>\$4,709,343</u>	<u>\$327,566</u>	7%

The MSLC's marketing plan identifies several factors affecting sales, including an aging customer base, reduced consumer traffic at sales agents, lack of new product innovation, changing consumer buying behavior, "jackpot fatigue," and a limited advertising budget. According to the MSLC's Marketing Director, when jackpot levels are low, Mega Millions sales decline, a phenomenon referred to "jackpot fatigue." As the jackpot levels rise, there is a corresponding increase in Mega Millions sales. Total Mega Millions sales in fiscal year 2007 were \$119.8 million, a decrease of \$14.9 million or 11.1% from the previous fiscal year. In fiscal year 2007, jackpot levels exceeded \$200 million on only one occasion, as compared to fiscal year 2006, when jackpot levels exceeded \$200 million on four occasions. The MSLC has taken some steps to enhance its sales by changing the Keno game's drawing time from every five minutes to every four minutes, having two daily Numbers Game drawings, adding a third drawing day (Sunday) to the Mass Cash game, and introducing a new racing format of Keno.

A common complaint from MSLC sales agents is that too many instant games remain idle and unsold on their shelves. The MSLC has worked with its ticket vendor to develop new game ideas that will increase sales. However, the MSLC has a paradoxical relationship with its ticket suppliers because the MSLC needs to introduce new instant games that sell well rather than remain unsold on

sales agents shelves or in the MSLC's warehouse, whereas the producers of instant game tickets earn money when they produce a new instant game, regardless of how well that game sells.

We reviewed the weekly sales data of instant games during the audit period and determined that during a typical week eight to 10 instant games produced 50% or more of weekly instant game sales revenues, whereas 25 or more instant games each produced 1.5% or less of weekly sales revenue. For example, during the week ended June 28, 2008 there were 71 active instant games that had weekly sales of \$62,480,971. The top eight selling games accounted for 52.9% of weekly sales, or \$33,079,546, and 46 instant games had sales revenue of \$29,401,425, or 47.1% of that week's instant game sales. There were 17 active instant games that produced no sales revenue (see Appendix III for additional sales information).

Recommendation

The MSLC should consider the following to increase revenues:

- Study and determine the optimum mix and number of instant game tickets that would enhance revenues in the most cost-effective manner. Given that there are over 70 active instant game tickets, the MSLC should consider whether the additional ancillary costs associated with carrying such an array of tickets is efficient and economical.
- Consider the potential of attracting revenue from out-of-state visitors by finding ways to enter into agreements to partner with the state's transportation entities to sell instant and on-line games and utilize vending machines. This could also generate additional revenues for the state's cash-strapped transportation system, including the Massachusetts Turnpike Authority, the Massachusetts Port Authority, the Massachusetts Bay Transportation Authority, and the Massachusetts Highway Department.
- Other revenue enhancement and cost avoidance recommendations provided in this report.

Auditee's Response

The Massachusetts State Lottery is by far the most successful Lottery in the United States in terms of per capita sales and profits. This trend continued during the audit period and remains true today.

It is important to note that Instant ticket sales were not stagnant between fiscal 2001 and fiscal 2008. In fiscal 2001, the MSLC sold \$2.729 billion in instant tickets with total revenue of \$3.936 billion. In fiscal 2008, the MSLC sold a record \$3.341 billion in instant tickets with record sales of \$4.709 billion. During this time period, the MSLC enjoyed an increase of more than \$610 million in instant tickets with overall sales increasing by more than \$770 million.

MSLC executives, staff, experts and analysts are focused on finding new sources of revenue while maintaining existing relationships with our loyal customers. Our research shows that 80 percent of Massachusetts adults are occasional Lottery players. This historic relationship between the MSLC and the average citizen provides the greatest opportunity to increase sales. The MSLC has launched major initiatives to increase sales volume and revenue as follows:

- The addition of Power Ball on Jan. 31, 2010. This second multi-state high jackpot game will generate about \$50 million in sales in Fiscal 2011.*
- In 2008, the MSLC created the Billion Dollar Blockbuster instant ticket that has become the best selling ticket of all time. This ticket has been followed up by similar tickets, such as Billion Dollar Bonanza and Mega Cash.*
- Expanded our financial and creative leadership in sports-themed tickets. Products included five Red Sox tickets; two Boston Celtics instant tickets, a New England Patriots instant ticket and a Boston Bruins instant ticket. Sports-themed games, which appeal to our occasional players, will top \$1 billion in total sales this fiscal year.*
- Massachusetts Lottery was among the first to enter into a product and marketing agreement with an MLB and NFL franchise.*
- The Lottery revitalized and revamped its portfolio of on-line games; increasing sales and profits. Improvements included: Mid-Day Numbers Drawing, Mass Cash Sundays; Megabucks Doubler.*
- Developed extended-play market niche for instant tickets. Games, including Cashword and Match & Win, reach out to a new demographic.*
- Dramatically expanded our ability to offer KENO and other monitor games to our customers. Improvements including: the development of KENO-to-Go and the licensing of thousands of agents to sell tickets; launching the Daily Race Game (second monitor game) and the development of the Daily Race Game-to-Go. Major KENO expansion initiatives such as a joint effort with the ABCC [Alcoholic Beverages Control Commission] to license more pouring establishments as KENO agents. KENO expansion also included the addition of full KENO to existing KENO-to-Go agents. The MSLC is in the midst of KENO expansion efforts among fraternal organizations and social clubs.*
- The Lottery pushed deeper into the digital age with numerous advancements on the internet. Some accomplishments are: a. virtual play of KENO and Race Game with our "to-go" products; b. a multi-functional VIP on-line club; c. numerous second-chance on-line games.*
- Acquisition and implementation of the NotePad tablet system greatly improved instant ticket ordering for 7,500 agents. The system operates with secure wireless access and helps streamline inventory and associated costs.*
- Major account merchandising "makeovers" that consisted of placement of point-of-sale material consistent throughout each store. Stop & Shop (135 branches) and Shaw's (85 branches) are two examples.*

In conclusion, the MSLC keeps an eye toward the future for opportunities, new products and possibilities. The overall gambling marketplace will continue to evolve in Massachusetts with on-going discussions of casino gambling, slot machines at racetracks and internet gambling. While the MSLC has no role in any of these decisions, our organization is poised to take advantage of the changing landscape to increase sales. The MSLC will leverage its existing resources – our loyal customer base, network of 7,500 agents and dynamic portfolio of games – to maximize sales if there is any augmentation of the overall gambling footprint in the Bay State. The MSLC is responsible for providing local aid to 351 cities and towns per MA statute and is not in the position to aid other state entities.

3. PRIOR AUDIT RESULTS PARTIALLY RESOLVED OR UNRESOLVED

During our follow-up review, we determined that the MSLC had not yet adequately resolved certain issues identified in our prior audit report. Specifically, we noted (a) ineffective internal controls over “professional” ticket casher activities (b) inadequate internal controls over agent scanning/purchasing activities, (c) instant game production inadequacies, (d) inadequate management of risks associated with potential interruption in instant game ticket supply, (e) the continued practice of providing accommodation letters to prizewinners, (f) declining revenue for Beano operations, (g) prohibited game participation, and (h) expansion of Keno operations.

a. Ineffective Internal Controls over “Professional” Ticket Cashers Results in Hundreds of Millions of Dollars in Unclaimed and Unreported Income and Lost Tax Revenue

Our prior audit report disclosed numerous instances in which certain individuals were repeatedly claiming hundreds of prizes valued at millions of dollars over a period of several years. Our follow-up review disclosed that this practice is ongoing and has become even more widespread.

Our prior audits noted the existence of these “professional cashers” cashing large numbers of MSLC tickets for significant amounts of money. We noted the cashing of many winning tickets by many of the same individuals, some of whom cashed multiple tickets on a daily basis that were purchased at diverse geographic locations. Not only do professional cashers compromise the integrity of MSLC games, they allow the actual winners to avoid tax reporting and withholdings on winnings and any state-mandated garnishment of income for such things as taxes and child support. In addition, professional cashers could contribute to the Commonwealth’s exposure to potential fraud against various government assistance programs.

Our prior audit recommended that significant steps be taken by the MSLC, including alerting the OSA’s Bureau of Special Investigations (BSI) when such activity was detected by submitting the so-called “20/20 listing” of cashers, which is a list of individuals who cashed 20 winning MSLC tickets

valued at more than \$20,000 in the aggregate during the calendar year. The report is provided to the Internal Revenue Service (IRS), the Massachusetts Department of Revenue (DOR), and the Office of the Attorney General on a monthly and cumulative basis for the calendar year. However, BSI officials indicated that there has been a lack of correspondence concerning the notification by the MSLC as to the activities of these cashers and that BSI has not been provided with the “20/20 listings.” Our prior audit noted \$95,200 of potential recoverable benefits through BSI investigations of public assistance fraud.

Our follow-up review disclosed that several individuals engaged in this cashing activity continued to do so. For example:

- In calendar year 2007 one individual cashed 1,492 tickets valued at \$2,588,761.50. This individual cashed tickets on 182 days throughout the year, including 60 days in which he cashed at least 10 tickets. Moreover, there were 43 winning tickets valued at \$64,102 that were purchased at various geographically dispersed agent locations and cashed on a single day, June 4, 2007. This individual, who was noted in our last two audits as a being a “professional casher,” has cashed millions of dollars in MSLC tickets and continues to do so.
- Another individual cashed 1,120 tickets valued at \$1,604,666 over a 14-day time period in calendar year 2007, including five days in which over 100 tickets were cashed. On December 24, 2007, the individual cashed 265 winning tickets valued at \$241,039. These 1,120 winning tickets were purchased from only three agents during 2007: 505 tickets valued at \$675,419 were acquired from an agent in Belmont; 319 tickets valued at \$475,156 were purchased from an agent in Boston; and 296 tickets worth \$454,091 were purchased from another Belmont agent.

Our prior audit also indicated that in many instances winning tickets were being cashed a significant distance from the point of sale, although a regional MSLC office was closer, in order to conceal the cashing activity.

Our follow-up review disclosed that this practice continues. In fact, the cashing activities of these individuals have not relented either in dollar amount or in the number of tickets cashed from calendar years 2004 through 2007, as shown by the following:

- Our prior audit reported that during calendar year 2004, the “20/20 listing” consisted of 88 individuals who cashed prizes totaling \$10,065,427. In calendar year 2005, 113 individuals cashed prizes totaling \$14,374,013, a 42.8% increase in cashing activity. In calendar year 2006, 133 individuals cashed prizes totaling \$19,480,511, an increase of 35.5%. However, in calendar year 2007 the number decreased to 123 individuals who cashed prizes totaling \$16,617,683, a decrease of 14.7%.

- Our prior audit reported indicated that the top 10 cashers in calendar year 2004 cashed prizes totaling \$4,835,330. In calendar year 2005, this amount increased by 47.8% to \$7,146,372. Subsequently, in calendar year 2006, this amount increased by 30.9% to \$9,353,961. There was minimal change in cashing activity among these top cashers in 2007. The total dollar value dropped to \$9,288,019, which represents a decrease in activity of only 0.7%.
- In 2004 the top 10 cashers cashed 2,836 tickets. The number of tickets they cashed increased by 34.2% to 3,806 tickets in 2005 and then increased again by 39.2% to 5,298 in 2006. This number of tickets cashed by the top 10 cashers continued in 2007 when 5,938 tickets were cashed, an increase of 12.1% in the number of tickets cashed.

The following chart illustrates the activities of the top 10 cashers for the calendar year 2007, ranked by number of tickets, with a comparison of their activity in the prior calendar year.

Resident City	Prizes Cashed	2007 Amount	Prizes Cashed	2006 Amount	2006/2007 Comparison Increase/(Decrease)
Lynn	1,492	\$2,588,761.50	1,312	\$2,284,706.25	\$304,055.25
Cambridge	1,120	1,604,666.00	679	1,008,232.00	596,434.00
W. Bridgewater	708	1,126,887.75	592	1,052,904.00	73,983.75
Chestnut Hill	825	1,063,534.00	429	648,115.00	415,419.00
Andover	491	723,508.00	847	1,858,481.00	(1,134,973.00)
West Newton	487	655,773.50	638	930,812.75	(275,039.25)
Westford	324	528,437.00	279	347,787.00	180,650.00
Watertown*	283	393,015.50	380	603,754.00	(210,738.50)
Wilmington	52	304,250.00	52	338,000.00	(33,750.00)
Lynn	<u>156</u>	<u>299,186.00</u>	<u>90</u>	<u>281,168.50</u>	<u>18,017.50</u>
Total	<u>5,938</u>	<u>\$9,288,019.25</u>	<u>5,298</u>	<u>\$9,353,960.50</u>	<u>(\$65,941.25)</u>

* A family member of the Watertown casher is also listed on the "20/20 listing." The activity of the family member (80 tickets worth \$141,453) was not enough to be included in the top 10 in 2007, but when considered in total with her husband would result in the "household" cashing activity to be \$534,468.50. This would place them in the top 10 as the seventh most active cashers, and would result in an overall negligible decrease from 2006 to 2007.

The increase in cashing activity, which is indicated in the following table, is so significant that the total dollar value and number of tickets cashed for 2001 for all 10 of the top cashers is lower than the single top casher in 2007, as shown below:

Comparison of Yearly Aggregate Activity of Top 10 Professional Cashers			
Calendar Year	Tickets Cashed	Amount	Year to Year Dollar % Change
2001	1,241	\$2,305,793	N/A
2002	1,000	\$2,543,487	10.3%
2003	1,629	\$2,872,000	12.9%
2004	2,836	\$4,835,330	68.4%
2005	3,806	\$7,146,372	47.8%
2006	5,298	\$9,353,961	30.9%
2007	6,018*	\$9,429,472*	0.8%

*Includes family activity

Recommendation

The MSLC should adhere to its mandate and exercise its authority, powers, and duties under Chapter 10, Section 24, of the General Laws to ensure the integrity of the games and continue to work in cooperation with the relevant enforcement agencies (i.e., the Office of the Attorney General, the Office of the Inspector General, the Department of Revenue, and the Internal Revenue Service) in order to monitor the practice of professional cashing and develop measures to minimize and eventually eliminate this practice. Also, the MSLC should provide BSI with the “20/20 listing” so that they may investigate the possibility of public assistance fraud. The MSLC should consider conducting and cooperating with other authorities in sting operations against frequent cashers as a deterrent to professional cashing. This strategy would be in accordance with the MSLC’s internal control risk assessment with regard to the integrity of MSLC games and would parallel measures it employs to deter underage gamblers from participating.

Auditee’s Response

The MSLC is legally required to honor valid winning tickets as presented with a properly completed claim form. Since 1999, a monthly report has been issued from the MSLC to the Internal Revenue Service, Department of Revenue, and the Office of the Attorney General to report individuals who have accrued significant winnings based on the quantity and value of cashing. The MSLC will gladly include the State Auditor’s Office on this distribution for use by their investigators. If, in the future, legislation is enacted that restricts customer cashing activities, then the MSLC will act accordingly.

b. Improvements Needed in Controls over Sales Agent Ticket Scanning/"Peeking"/Purchasing Activities

Our prior reports have raised questions regarding the internal controls, policies, and procedures over sales agents' ability to illicitly scan instant game tickets. We recommended that the MSLC should ensure that its Compliance Unit more closely monitor sales agents for unusual, irregular, and questionable activities and patterns, and take appropriate action as warranted. We further suggested the suspension of agents and their employees who purchase tickets from their own stores.

Our prior audit noted that sales agents must scan sold tickets into the MSLC terminal to register a winning ticket into the MSLC system for redemption. "Peeking," however, is the illicit practice of scanning unsold tickets for the purpose of determining which ones are winning tickets. In order to control this improper activity, the MSLC investigated all instances in which a sales agent has scanned eight or more unsold losing tickets in a single day, an indication that a sales agent may be "peeking."

Our follow-up review has disclosed that policies and procedures to detect illicit scanning have been recently updated. These procedures, in the form of "MSLC Compliance Policy and Procedure Manual 'Clear Errors' Reporting, Policy Reference 1.00," were issued on October 17, 2008. This policy makes clear that sales agents will be subject to review for "clear errors," which are defined as follows:

Two or more clear errors (intentionally or unintentionally abusing their auto-cash privileges, a potential indicator of attempted peeking), three or more days of the previous week.

The prior MSLC policy, as noted, investigated the incidence of sales agents' scanning and peeking based on eight scans of losing tickets in a single day. That practice was also considered by the MSLC as one in which agents were looking for unsold winning tickets. The emphasis and vigilance over scanning and peeking, as noted in our prior audit, has had a positive and marked result in reducing the occurrence of first and second incidences and limiting the amount of third-time offenses as a result.

Our prior audit disclosed a reduction of "peeking" incidences annually, and our follow-up review disclosed a continued trend toward improvement in first-time offences, as shown in the following table:

Calendar Year/Offense	First Offense	Second Offense	Third Offense
2005	131	11	2
2006	88	12	3
2007	126	19	1
2008	87	17	1

During fiscal years 2006, 2007, and 2008, 53 sales agents were documented as having second and third offences of peeking, 42 of whom had their licenses suspended. There were no sales agent license revocations during this period. The following table reflects the number of sales agent licenses that were suspended for peeking, by fiscal year.

Fiscal Year	Sales Agents Suspended
2006	12
2007	16
2008	<u>14</u>
Total	<u>42</u>

Our prior audit suggested the suspension of sales agents and their employees who purchase tickets from their own stores. The MSLC, in its response, indicated that its agent code of conduct strongly discourages agents and their employees from playing MSLC games, including scratching instant tickets, at their location.

Our follow-up review also examined data provided by the MSLC that describes its efforts to monitor and act upon questionable sales agent activities. In one instance, the MSLC determined that an investigation was warranted after reviewing customer complaints that a Watertown sales agent was scanning illicitly unsold tickets and then returning them to the dispenser, as well as cheating customers out of MSLC prizes. It was decided that a member of the MSLC's Compliance Unit would use a "live" winning (\$1,000) instant game ticket to test the sales agent's compliance with MSLC rules and regulations.

On May 7, 2007, an MSLC compliance officer presented a winning \$1,000 instant game ticket that the sales agent did not scan. Rather, he informed the Compliance Officer that the ticket was a \$50 winner. On May 10, 2007, the sales agent tried to claim the \$1,000 prize at the MSLC's Boston regional office, but the ticket was flagged by the MSLC's computer system as stolen. On May 18, 2007, a cashier (also in Watertown; see Table of Top 10 Cashers in Audit Result No. 3A) presented a \$50,000 winning ticket as well as the "live" \$1,000 winning ticket at the MSLC headquarters. Again, when the ticket was scanned the MSLC's computer system identified it as stolen.

When questioned on how he came to possess this winning ticket, the cashier responded that he could not recall. When informed that the ticket was stolen, the cashier stated that an acquaintance who was a sales agent asked him to claim the winnings for him. The cashier further stated that he was doing the sales agent a favor and not making money on the exchange. After a hearing, the sales agent's license to sell lottery products was suspended for 90 days, at which point the sales agent was to be placed on probation. No action was taken against the cashier.

In addition, during our follow-up review we performed an Internet search of newspaper articles and determined that a number of state lotteries are reporting that a number of their sales agents are winning multiple prizes on lottery games that they sell, and that store employees have defrauded players who present winning lottery tickets, as follows:

- California – The California State Lottery scrutinizes all repeat winners when they are claiming any winning tickets and conducts sting operations to determine whether sales agents are properly paying winning claims.
- North Carolina – A newspaper article reported that a number of lottery sales agents have had multiple lottery wins. During the period reviewed, 162 sales agents had wins that were greater than \$600. One sales agent had claimed 12 prizes totaling in excess of \$150,000 in a 12-month period. North Carolina has no provision prohibiting sales agents from playing the lottery.
- Michigan - The Michigan State Lottery conducts sting operations to determine whether sales agents are paying out the proper amounts on winning tickets. Eight sales clerks have been indicted for defrauding winners of prize money.
- Iowa – The Iowa State Lottery monitors sales agents who claim multiple prizes. One sales agent claimed \$264,000 in prizes during a 13-month period. The Iowa State Lottery also conducts sting operations to determine whether sales agents are paying out the proper amount on winning tickets.

A stricter interpretation of the laws and regulations governing the activities of sales agents based on prior references to laws, rules, and regulations, along with references to internal control improvements suggested in audit results from recent MSLC internal audit reports, should be the basis of an enforcement regimen going forward. Specifically, Section 7.5 of the “Massachusetts State Lottery Commission – Lottery Sales Agent Agreement under Additional Obligations of the Agent” states, in part:

To be bound by the terms of the Massachusetts State Lottery Law, G.L. c. 10, and the rules and regulations of the Massachusetts State Lottery Commission, 961 CMR

2.00, et seq., as either or both may be amended from time to time, which are expressly incorporated herein by reference.

In addition, 961 Code of Massachusetts Regulations (CMR) 2.00 defines a sales agent as follows:

Sales Agent means a person who has been licensed to sell Lottery tickets or register bets on behalf of the player under M.G.L. c 10, sections 22 through 35 and 36.

Moreover, Chapter 10, Section 31, of the General Laws describes the following people as being ineligible to participate in MSLC games:

No ticket or share shall be purchased by, and no prize shall be paid to any of the following persons: any member or employee of the commission or to any spouse, child, brother, sister or parent residing as a member of the same household in the principal place of abode of any member or employee of the commission.

These laws, license agreements, and regulations taken in their entirety bind sales agents as agents of the MSLC to sell MSLC products. Accordingly, the close transactional relationship of sales agents to the MSLC appears to define them as being ineligible to purchase or share in the proceeds of MSLC products.

The MSLC has reviewed and reported sales agent activity in its internal audit reports, one of which illustrates the dilemma of sales agent participation in the acquisition of MSLC products at their place of business. The audit, titled, "Massachusetts State Lottery Commission Audit of Pull Tabs Operations," outlines the internal control problems identified by the MSLC's Internal Audit Department. There were seven audit issues identified in the report, one of which was titled, "Inadequate controls in place to monitor pull tab agents." In its recommendation, the MSLC's internal auditors suggested that the integrity of the game was at issue, given the potential for sales agents or their designees to participate in the game at their location:

Further, any participation by agents or their designee in controlling the size of a gaming pool or acting as a participant in seeking to gain financial reward from the gaming enterprise(s) at their location, a gaming enterprise from which they are a direct financial beneficiary of the MSLC through the payment of percentage bonuses and commissions on selling and cashing of MSLC products, should be strictly prohibited by the MSLC across their product lines.

Recommendation

The continued improvement in the reduction of the instances of "peeking" is an indication of the MSLC's vigilance in protecting the integrity of these games. This vigilance should continue, and the MSLC's practices should be continually improved toward the ultimate goal of eliminating all illicit

scanning activities by sales agents and their employees. The MSLC should also create an enforcement regimen to eliminate the practice of agents or their employees' participating in playing the MSLC games at the sales agent's location by introducing sanctions against agents that are similar to those in place to reduce the incidences of "peeking" into instant game tickets. This regimen would include reviews, warnings, and suspensions of auto-cash privileges with the ultimate penalty of an agent's license being revoked for continued noncompliance.

Auditee's Response

The continued improvement in the reduction of instances of "peeking" along with Compliance department review and sales agent penalties established confirms the Lottery's vigilance in protecting game integrity.

c. Monitoring the Quality of Instant Game Ticket Printing

Prior audits have disclosed that the MSLC did not have procedures in place to monitor instant game tickets quality for defects and recover payments associated with purchases of defective instant game tickets. In addition, the MSLC did not make public notifications when some tickets are defective. Prior audits recommended that the MSLC recover costs associated with defective tickets purchased from its instant game ticket vendors and that the MSLC make public notifications when some tickets are defective. These audits recommended that the MSLC ensure that the defective tickets are replaced with tickets in order to ensure that the same amount of prizes as the original tickets is available to MSLC customers for that particular game.

The MSLC responded to these audits with proposed management procedures to address the instant ticket game quality control procedures, including the establishment of a permanent Quality Control Committee to monitor defective tickets, the maintenance of a Watch List to track identified defective tickets, and the development of reporting patterns. Also, concerns regarding defective tickets are reported to the MSLC's Executive Director with suggested courses of remediation. These actions were considered necessary, as the manufacturer had reimbursed the MSLC for damaged tickets from a game in compliance with our recommendation that all reimbursements be in the form of cash rather than credit, thereby keeping these business dealings straightforward.

Our follow-up review disclosed that the MSLC has the ability to monitor and identify potential instances of defective instant game tickets that could result in reimbursements from the vendors should the tickets be found to be defective. The Quality Assurance (QA) Department is involved in

the introduction process of new instant tickets. The QA Department reviews the work papers and tests the ticket quality of each new game using a methodology for testing outlined in the MSLC document “Procedure for Testing Instant Game Tickets – New Games.” The QA Department receives the first book of every new ticket and performs a series of tests from this method.

The MSLC has not formally documented the identified instant game ticket defects in a Watch List because none of its tickets introduced in the period since our prior audit have reached the threshold level of defects. However, the MSLC ticket return room keeps a spreadsheet detailing the defects so that a threshold measurement can be made. The spreadsheet lists the game, manufacturer, book number, date returned, number of tickets, full book, and the nature of the problem as its attributes. The Watch List is a spreadsheet that is created and maintained to monitor the levels of identified defects and identify patterns and concerns when the threshold for defects is reached with the information obtained from the return room spreadsheet. Typically, the quality threshold for defects is .01% of total tickets manufactured for the game. Our prior audit suggested that the Watch List should include the reason for the defect, the total number of related defects, and the number of defective tickets required to reach the defective ticket threshold level.

According to MSLC staff, since March 2009, 13,746 individual tickets were returned to the printer out of 549,352,000, or .0025% overall and .005% per game, falling below the reportable standard of .1% per game. This information is included in the “Watch List” that is sent to the Executive Director of Compliance for regular review.

Our follow-up review also disclosed the introduction of a new meeting structure that includes the MSLC’s Executive Director, Chief of Staff, and Marketing Director. The new meeting structure includes the discussion of instant ticket quality issues as part of regular meetings of the Chief of Staff; the Executive Director; and the Legal, Finance, Marketing, and Sales departments in discussions of ongoing operational topics. The product manager of instant game tickets monitors issues related to ticket quality on an ongoing basis, and any issues are discussed in the daily meeting or a separate meeting with the MSLC’s Chief of Staff, Executive Director, and Legal and Marketing departments, during which other relevant managers are called immediately to review the situation at hand and decide on necessary actions.

Further, the MSLC notifies the appropriate vendor to research their quality assurance to determine whether they recorded any mishaps during the printing of the particular books in question. On occasion, the vendor asks for a scan of the ticket front and back for review to determine the possible range in which the mishap may have occurred during printing. This information is then transmitted to MSLC retail services and the MSLC Assistant Executive Director for Compliance.

Recommendation

The MSLC should ensure that all instances of defective instant game tickets are placed on a Watch List and that, once the number of defects exceeds the threshold level for a particular ticket, it receives reimbursements from the vendor for the instant game ticket involved. The Watch List should document the identified defect; accumulate the total number, and outline the number necessary to reach the threshold level for the particular ticket. The MSLC should further document all meetings held, including meetings of the Quality Control Committee, as ticket problems with the potential to reach the defective ticket threshold arise, whereupon the MSLC should review the quality control procedures for each instant game ticket in order to determine that these procedures were fully performed.

Auditee's Response

In late 2008, the MSLC initiated a "Watch List" to record and track defective instant scratch tickets. Lottery personnel are assigned to monitor this list and report to the Quality Control Committee if the level of defective tickets reaches the unacceptable standard of .1% of tickets produced per game. . . .

d. Management of Risk Associated with Instant Game Ticket Manufacturing Needs to Be Improved

Our prior audit disclosed that the MSLC has contracted with three vendors for the production of instant game tickets, with one vendor manufacturing 80% of the tickets. Our follow-up review determined that two vendors produce instant game tickets for the MSLC. Scientific Games acquired one of the vendors, Oberthur Gaming Technologies, on May 1, 2007. The MSLC had not recognized and considered the exposure of the potential risk of catastrophic loss of ticket production because of this situation and therefore was urged to develop a plan to address the possible interruption of the instant game ticket supply.

In response to the prior audit, the MSLC indicated that it contracted with three vendors to ensure the continued production of instant tickets should the primary vendor suffer a catastrophic loss.

The MSLC also indicated that, to reduce the risk of loss, it maintains approximately a three-month supply of instant tickets. Also, subsequent to our audit, the MSLC contacted other vendors and has been informed that they have the capacity to handle the ticket production should a major disaster occur at the primary vendor's manufacturing facility. Further, in the most recent Request for Responses for the manufacture of instant game tickets, the MSLC inserted a requirement that the vendor obtain an insurance policy to cover such an event. Accordingly, the main supplier of tickets took out an insurance policy that would compensate the MSLC should this vendor not be able to meet delivery requirements. However, this insurance policy does not cover catastrophic losses for the MSLC. Mitigating this factor is that the current instant ticket game vendors indicated that they have disaster recovery plans in place; however, they do not want to provide their full plans to the MSLC because of the sensitive and confidential nature of this proprietary information. The MSLC does have excerpts of these plans, which are available from these vendors for audit review. Nevertheless, the MSLC indicated that it has no internal control system in place to routinely check the implementation of these disaster recovery plans, including onsite visits to the manufacturers.

Further, these manufacturers cannot insure catastrophic loss for a third party such as the MSLC. The MSLC indicated that it believes the risk is mitigated because the state of Massachusetts is self-insured against the financial loss of the complete cutoff of instant game ticket revenue in a catastrophic loss event.

Recommendation

The MSLC should mitigate the risk of revenue losses that would result from a disruption or major disaster to its instant game ticket manufacturers. The MSLC should verify that the manufacturing facilities of its instant game ticket suppliers have adequate disaster recovery plans and check the extent to which its vendors are testing and implementing them, so as to minimize the effect of a disaster on MSLC revenues, since the notion of self-insurance does not cover the loss of revenue to the MSLC and ultimately the Commonwealth's cities and towns.

Auditee's Response

The MSLC contracts with three manufacturers for instant game tickets. The lottery currently has 62 weeks of instant game tickets in warehouse inventory to cover sales activity. These factors support the lottery's plan to limit catastrophic risk.

e. The MSLC Supplies Prizewinners of between \$600 and \$9,999 with an Accommodation Letter That Enables the Holder to Cash Prize Checks from the MSLC at the MSLC's Bank on the Same Day the Check Is Issued

Our prior audit disclosed that the MSLC had designed a letter of introduction addressed to its principal bank depository, requesting that it accommodate the holder of the letter to cash a prize-winning check (of between \$600 to \$9,999) drawn from the designated bank on the same day of its issuance. This practice allows both legitimate winners and those individuals known as “professional cashers” to present the prize check and immediately obtain cash proceeds without the usual two forms of proper identification normally required by a bank for such transactions. The letter, in effect, serves as the second form of identification. Approximately 70% to 80% of all prizewinners cash their checks at the MSLC's bank on the same day that the MSLC issues the check to them.

The MSLC's normal practice for prizewinners is to use the “positive pay” system whereby it notifies the bank of valid checks issued so that the bank can match checks when presented to the bank for payment. This control system provides the MSLC and the bank protection against losses from altered or stolen checks. In response to the audit, the MSLC stated that it views the accommodation letter as a convenience to its customers and that it is not aware of an instance where a loss has occurred due to this practice.

Our follow-up review disclosed that the MSLC continues to issue accommodation letters to its customers in order for them to cash winning prizes. The MSLC indicated that it continues to this practice as a convenience to its customers. However, as cited in our prior audit, the practice of issuing accommodation letters for cashing MSLC-generated checks for prizes on a same-day basis continues to enable winners to cash checks in a more expeditious manner than other bank customers. Although this practice provides a benefit to legitimate winners, it also helps perpetuate the undesirable activities of “professional cashers,” which could compromise the integrity of the MSLC games. In addition, this practice favors a selected group of bank customers and encourages the bank to breach the internal control practices that it employs (e.g., requiring two forms of identification), thus increasing the risk of loss from altered or stolen checks with forged endorsements that it is designed to prevent.

Recommendation

The MSLC should discontinue providing a letter addressed to banks as a second form of identification for prizewinners to cash MSLC checks on the same day that they are issued by the MSLC. Also, the MSLC should strive to comply with banking practices designed to prevent fraud by using the “positive pay” system that is designed to process only valid checks.

Auditee's Response

The MSLC continues to use this practice as a convenience to customers and is not aware of any instance where a loss has been incurred. In recognition of the OSA report, the MSLC will contact our banking partner to discuss initiating a call back procedure when a check is presented for cashing. This will support the observation and seek to resolve the issue of financial risk.

f. Effects of Declining Revenue on Nonprofit Organizations Supported by Beano Operations

Our prior audit disclosed that Beano gaming activities in the Commonwealth declined steadily from calendar years 2001 through 2004. These games represent the largest share of revenue generated in the MSLC Charitable Gaming Division, producing nearly two-thirds of the revenue of the four types of charitable games offered: Beano, charity game tickets, raffles, and bazaars (casino functions).

The overall reduction in charitable game revenues has had a broader negative effect. This negative effect not only impacted the MSLC and, by extension, aid to cities and towns, but extended to the community-based charitable and fraternal nonprofit organizations, educational institutions, food pantries, and hospitals, etc., causing concern for local groups and adversely affecting the quality of life in the communities when services offered by these organizations to their patrons is impaired or curtailed.

The aging of the population, the declining rates of volunteerism, and the public's aversion to joining social organizations were cited in the prior report as underlying cultural issues related to the decline in Beano game revenue. The MSLC noted reasons for the decline in revenue, as follows:

- Beano halls at casinos have no restriction on the maximum prize offered, thereby putting them at a competitive advantage. The law only allows a maximum prize of \$3,000 for any charitable Beano game, which is a significant disadvantage for MSLC-licensed Beano games.
- Only volunteers can work at MSLC-sponsored games. None of the volunteer workers are allowed payment for their services, and conducting Beano games for these organizations generally requires a weekly commitment from a declining number of volunteers. As noted,

service to and membership in these nonprofit charitable and fraternal organizations for these functions is on the decline.

- The statewide smoking ban has discouraged attendance due to the need to interrupt the games for players to leave the hall to smoke, thereby interrupting the continuity of the games.

Our follow-up review disclosed that the law governing Beano operations (Chapter 10, Sections 37 through 39A, of the General Laws) should be reviewed and possibly amended. Ultimately, the MSLC should attempt, as part of an overall strategy, to present legislation that would enhance growth in traditional Beano games.

Our follow-up review also disclosed that the MSLC has implemented various measures with little success in addressing the decline in revenue. The MSLC has been testing electronic Beano in the western part of the Commonwealth (specifically, Chicopee) and is drafting regulations to govern this Beano activity, which is not prohibited under the above-cited statute. However, the difficulty remains that Beano activity is down throughout North America; this is not just a Massachusetts phenomenon. There are many gambling options available, many of which are quicker than Beano and have a larger payout. This type of competitive environment cuts into the business of operating Beano games and requires an overall strategy, including changing legislation.

This decline in the Massachusetts charitable games revenues is illustrated below:

Calendar Year	Net Charitable Revenue (Gross Revenue Less Expenses)		
	Gross Charity Gaming Revenue	Beano Revenue	Available to Community-Based Nonprofit Groups
2005	\$111,135,734	\$63,875,496	\$20,895,241
2006	\$101,888,091	\$58,947,507	\$18,995,130
2007	\$92,117,286	\$52,819,314	\$16,779,932

The intense competitive environment confronting the operation of Beano and various gaming activities intended to supply needed revenue for charitable organizations highlights the need for the MSLC to support legislation toward increasing revenues.

Recommendation

The MSLC should research ways of stimulating revenue growth and, if needed, work toward having the laws governing Beano amended.

Auditee's Response

Since bingo prize levels are based on the players paying admission they do not generate enough income to significantly increase prize levels. Also, the organizations are not allowed to "front" money for prizes. Competition from private gaming establishments and their ability to increase prize payouts impacts the Lottery's ability to make changes. Regarding the initiation of legislation to enact changes, the MSLC is not in a legal position to file legislation.

Auditor's Reply

The MSLC should work with the Legislature to promote and enact changes in the Commonwealth's gaming laws. Accordingly, we recommend the MSLC work with the Legislature to support legislation designed toward increasing Beano revenue.

g. Prohibited Game Participation

Prior audits have recommended that, to better prevent MSLC employees and their household family members from playing MSLC games, the MSLC should require, as a condition of employment, the name, age, and Social Security number of immediate family members of all MSLC employees.

Our follow-up review determined that the MSLC continues to consider the issue closed and that no effort has been undertaken to institute a policy that stipulates as a condition of employment that random checks of employee activity in the MSLC be instituted, including the crosschecking of employee name and Social Security data against payment lists of MSLC game prizewinners.

Recommendation

The MSLC should stipulate as a condition of employment that random checks of employees and their immediate members be performed for participation in the MSLC games, including crosschecking employee names and Social Security numbers against payment lists of MSLC prizewinners. This stipulation itself would act as a deterrent and protect the integrity of the MSLC.

Auditee's Response

Every MSLC employee must sign a form acknowledging the prohibition of playing MA lottery games, including games that cross state lines (Powerball). MSLC has consistently acted upon any report that a Lottery employee has purchased or was playing a Lottery game. MSLC's consistent enforcement practice is evidenced by the fact that MSLC has terminated employees who were found to have violated this prohibition.

h. Expansion of Keno Operations

Our prior audit disclosed that Keno revenues had declined after the introduction in July 2004 of a statewide smoking ban in all “pouring establishments” (places that serve alcohol). MSLC revenue received for the nine months of October 2003 to June 2004 (before the ban) was \$583,812,992, whereas MSLC revenue received for the nine months of July 2004 to March 2005 (after the ban) was \$549,336,502, demonstrating not only a loss of revenue totaling \$34,476,490 to the MSLC, but also a loss of business revenue to the affected establishments.

Keno was introduced to the Commonwealth in September 1993 and instantly became one of the MSLC’s more popular and successful games. Keno makes up roughly 16% of the MSLC’s total annual revenue and is now offered in both pouring and non-pouring establishments. Keno revenue totaled \$775,488,000 in fiscal year 2007 but fell 4.6% to \$739,881,000 in fiscal year 2008.

Our prior audit recommended that the MSLC consider changes to expand its customer base by allowing more non-pouring establishments to offer Keno because of the negative impact that the smoking ban was having on local business establishments and the cities and towns that depend on the MSLC. The MSLC accomplished this with the introduction of Keno-To-Go in March 2008, which is a non-pouring establishment alternative to the offering of Keno. These non-pouring establishments were additional Keno agents that did not offer traditional Keno facilities to watch the drawing. Players could reference their winning Keno ticket numbers on-line at the MSLC web page or with an agent after the drawing based on the game number of their ticket.

There have been mixed revenue results, with annual Keno revenue down by 4.6% from fiscal years 2007 to 2008, a period in which overall MSLC revenues were up by 5.6%. In addition, Keno revenues were down by 1.4% from the first three months of fiscal year 2009 to the first three months of fiscal year 2008, during which time overall MSLC revenues were down 0.8%.

Recommendation

The MSLC should continue its efforts in this regard and consider allowing more non-pouring establishments to offer full-service Keno to enhance revenue.

Auditee’s Response

The Keno-to-go program was implemented in 2008 and has successfully generated revenues in non-pouring establishments in an effort to seek out customers at different

entry point levels. Keno revenues of \$739,881,000 and \$741,828,000 for FY08 and FY09, respectively, representing an increase in Keno activity.

4. PRIOR AUDIT RESULTS RESOLVED

During our follow-up review, we determined that several issues cited in our previous audit were resolved, as follows:

a. Risk Assessment/Internal Control Plan Improved

Our prior audit disclosed that the MSLC had not developed an internal control plan (ICP) or an organization-wide risk assessment in accordance with the Office of the State Comptroller's (OSC) guidelines.

Our follow-up review disclosed that the MSLC has developed a comprehensive risk assessment, has conducted reviews and activities for its various functions, and has developed an ICP for its various operations departments. The ICP was developed utilizing the guidance of Chapter 647 of the Acts of 1989 and OSC guidelines, which outline measures for state agencies in developing internal controls. The ICP identifies the internal control standards as well as the framework for Enterprise Risk Management. It is a high-level, department-wide summarization of risks and internal controls for all of its business processes incorporating lower level detail. Internal controls are a basic responsibility of all managers, and the MSLC distributed the ICP to all department managers after the ICP was approved by the Executive Director and Chief of Staff.

The MSLC identified and analyzed risks that may affect the achievement of its goals and objectives presented as part of the fiscal year 2008 ICP. Risks were identified in terms of likelihood and impact. Both factors were taken into consideration in determining overall risk measured at low, medium, or high. The risk response is also included, which identifies internal control measures that are currently in place to mitigate the potential effect of identified risks to acceptable levels. Three areas were identified as high risk as follows:

1. Interruption of information technology (IT) systems service that would result in a major negative impact on business continuity.
2. Outdated IT systems and lack of qualified and experienced IT staff (due to possible retirement of key IT staff).
3. Fraud by agents, which would result in negative publicity.

The MSLC has existing internal controls in place to mitigate these risks. They include goals, objectives, risks and the likelihood thereof, scoring risk, classification of risks, responses to risk, and the controls. The areas identified for risk and their assessments are:

- Generate a dependable flow of revenues for the cities and towns of Massachusetts.
- Maintain MSLC reputation of guaranteeing game integrity for honest and fair games.
- Maintain MSLC reputation of safeguarding sensitive data.
- Maintain efficient MSLC operations.
- Promote responsible gambling.

b. "Instant Replay" Recycling Program Internal Controls Improved

Our prior audit disclosed that internal control improvements were needed over the MSLC's pilot anti-litter program (the Instant Replay Recycling Program) at various fairs, events, and sites during fiscal years 2004 and 2005. Under this program, individuals would receive one instant game ticket for every 20 non-winning tickets they returned at selected community fairs and events throughout the state.

Our follow-up review disclosed that the MSLC participated in only the Eastern States Exposition in Springfield, Massachusetts and that the MSLC developed policies and procedures to address the issues reported in the prior audit. Instant game ticket custody policies and procedures reflect the sale of tickets and not simply the redemption of tickets as cited in the prior report. We reviewed these policies and procedures and determined that they addressed the issues outlined in the prior audit. Moreover, we found that the "Instant Replay" recycling program was discontinued in April 2007 and that MSLC participation in all other fairs was discontinued.

c. Internal Controls Implemented to Ensure Compliance with Advertising Agency Contract Provisions

Our prior audit disclosed that the MSLC's advertising agency billings did not include sufficient documentation to support compliance with the administrative provisions of the contract. The MSLC and its advertising agency entered into an agreement on July 1, 2003 with the purpose of rendering advertising services. The contract provided for a maximum total obligation of \$14.5 million through June 30, 2005, with annual renewals possible. The contract for July 1, 2007 to June

30, 2008 has a Basic Service Fee of \$75,000 a month, or \$900,000 per year, with additional fees upon the rendering of specific advertising services. The additional fees include fees for special assignments, media buys, production, and miscellaneous out-of-pocket costs associated with advertising.

Our follow-up review disclosed that the MSLC now requires the following procedures to address the prior audit issues:

- All media and production need to be approved in advance. The Executive Director or Chief Financial Officer will sign an authorization form. All invoices are reviewed and approved by the Director of Marketing to ensure that the vendor is following all the requirements of their contract. The agency sends a monthly summary invoice with individual back-up invoices specifying the billed amounts and copies of the authorization. The agency maintains a detailed overview of the budget, amounts paid, and amounts committed per cost category. A detailed breakdown per cost category is also included. This overview is informally discussed almost weekly, and formally at least monthly.
- Most media costs are paid after the advertising services have been “delivered,” depending on the specific contracts. A review of media costs/payments for the first quarter of fiscal year 2009 showed no prepayments.
- The Executive Director must sign off on all media authorizations, production estimates, and statements of work before the work can be performed.

d. Detection and Prevention of Sales to Minors Improved

During our prior audit we reviewed the MSLC policy against underage gambling as promulgated under 961 CMR 2.13, which sets forth the policies under which the MSLC, through its Security Department, conducts periodic, unannounced, and random visits to licensed sales agents in an effort to determine whether the statutory prohibition against sales to minors is enforced. There were no such operations conducted from 1998 to 2005. We recommended that the sting operations be reinstated and be a routine part of MSLC operations. The MSLC indicated that it intended to test approximately 1% or more of sales agents each year during selected school vacation periods, beginning in fiscal year 2005.

Our follow-up review indicated that the MSLC has reinstated its undercover operations and provided documentation to support its reinstatement of the operation to detect and prevent sales agents from selling MSLC products to minors. The reinstatement of the MSLC’s undercover operation yielded the following results:

Fiscal Year	Agents Visited	Sales to Minors
2006	97	25
2007	96	20
2008	92	6
2009*	25	0

*July 1, 2008 through October 13, 2008

e. Internal Audit Function Improved

Our prior audit disclosed that the MSLC's newly created Internal Audit Department was proceeding with a multiphase plan to establish a professional and meaningful method by which risk is identified and tested. Internal audits were scheduled and conducted for certain MSLC departments, with the findings to be used to develop a reporting template that would be issued to the Office of the State Treasurer and the MSLC Executive Director on a quarterly basis, and will encompass all remaining departments.

During our follow-up review the MSLC provided organization charts and ICPs outlining the function and reporting responsibilities of an internal auditor who was hired on February 19, 2008 (this person resigned from this position effective January 30, 2009). The organization chart effective for July 2008 notes the primacy of the Assistant Executive Director for Internal Audit controlling the Internal Audit Function. This individual reports to the Audit Advisory Committee of the MSLC along with directly reporting to the MSLC's Executive Director and the First Deputy State Treasurer. The purpose of the internal auditor as provided in the position's job description is as follows:

To provide independent, objective assurance and consulting services designed to add value and improve the organization's operations. IA will help the MSLC accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Further, the MSLC's Employee Handbook for December 2006, "Compliance and Internal Audit," states the functional aspect of the department's mission, as follows:

The division conducts audits, operational and financial of all lottery functions and reports to the Director as well as the Treasurer with all findings and recommendations.

It is the responsibility of the Compliance Unit to insure the integrity of the Lottery by monitoring all policies and procedures and insure that they are carried out with

impartiality and fairness. The goal of this unit is to help everyone (Sales Agents, employees, vendors and customers) understand the role they play in the organization and give them understanding of what is expected of them.

Our follow-up review included an examination of selected internal audits conducted since our last review. There have been 12 such audits conducted along with random inventory and television station drawing audits in the last three fiscal years. The first internal audit performed by the new internal auditor was an audit of the SAIP.

f. MSLC Kiosk Operations at Selected Malls and Other Locations Discontinued

Our prior audit disclosed that the MSLC had established a kiosk to service patrons in the Natick Mall. The kiosk sold instant and on-line games, MSLC apparel, and other MSLC-themed items, and served as a regional ticket-cashing location. The 100-square foot office offered similar services as the other five MSLC regional offices and provided winning customers with payments of up to \$49,999. The kiosk did not have Keno service and employed two MSLC employees.

Our prior audit indicated that the MSLC did not provide sufficient financial analysis to demonstrate whether the kiosk was a viable operation, whether the \$20,000 in weekly sales justified its existence, or whether an operation of this sort could be viable throughout the state in various underserved locations. Moreover, there were no plans to perform this type of analysis at the time of our prior audit. We recommended that the MSLC conduct demographic marketing studies to determine whether similar operations throughout the Commonwealth in various retail locations would be viable, including studies of Keno operation viability.

During our follow-up review we obtained the recent studies the MSLC performed for the Natick kiosk, which were annual profit-and-loss studies conducted for the last two fiscal years. The lack of potential consistent profitability at this kiosk due to employee costs is reflected in the study. The study indicates that employee costs for fiscal year 2008 were approximately \$370,000 annually, whereas average per-agent costs in commissions and bonuses for that year were 10 times less (approximately \$36,000) on average for each of the 7,500 MSLC agents. Based on the results of these studies, the MSLC decided to close the kiosk at the Natick Mall.

g. Improvements in the Collection of Accounts Receivable from Delinquent and Terminated Sales Agents, Credit and Background Checks of Sales Agents, and Bond Fees to Cover Losses and Discourage Delinquency

Our prior audits disclosed that the MSLC had written off bad debts representing funds owed by sales agents totaling \$13 million from fiscal years 1999 to 2002, \$1.8 million in fiscal year 2003, and \$700,000 in fiscal year 2004.

Our follow-up review disclosed that sales agents' accounts receivable has been on a downward trend since the prior audit, as noted in the following table:

Fiscal Year	Total Accounts Receivable
2003	\$5,700,000
2004	\$6,300,000
2005	\$4,580,659
2006	\$4,132,155
2007	\$4,208,604

An aging of accounts receivable for the last three fiscal years is as follows:

Fiscal Year	Number of Agents	Total Accounts Receivable	Amount under 120 Days	Amount over 120 Days	Amount over One Year
2006	398	\$4,132,155	\$1,151,135	\$500,936	\$2,480,084
2007	412	\$4,208,604	\$1,113,638	\$712,325	\$2,382,641
2008	334	\$3,560,921	\$1,274,128	\$601,545	\$1,685,248

The most significant decreases in the account balance were between fiscal years 2004 and 2005 (26%) and between fiscal years 2005 and 2006 (17%). The balance increased slightly in one year, with an increase of 2%, but the declining trend continued again in fiscal year 2008, with a 15% decline. The long-term trend of declining balances indicates positive action in assessing the issue over a period of six years, during which time the outstanding balance dropped from \$9 million on June 30, 2002 to \$3.56 million on June 30, 2008, a drop of 60% in seven years.

This decline is due in part to better collections and to a more aggressive posture in charging sales agent fees so that aged and delinquent accounts can be more quickly evaluated and then disposed of as bad debt, using the proceeds of those fees to offset the loss. Moreover, the MSLC has implemented a revised sliding scale fee structure for new and existing sales agents. The fees are

intended to cover the MSLC's bad debt expense losses as a result of the costs associated with delinquent or terminated sales agents. The relevant fees and categories as of July 2008 are listed on the table below:

Bonding Fee Categories and Counts as of July 2008

Description	Fee Per Day	No. of Agents
Standard Bonding (Grandfathered Agents)	\$.35	5,474
New Agent Bonding (Licensed less than one year)	\$2.00	665
New Agent Bonding (Licensed greater than one year)	\$1.50	539
New Agent Bonding (Licensed greater than two years)	\$1.00	780
Agents Placed on Probation	\$2.00	69

Since our prior audit, the sales agent fees collected initially nearly equaled, then later exceeded, the amounts written off as bad debt expense on an annual basis, as follows:

Year	Bad Debt Expense	Agent Fees Collected
2006	\$1,479,038	\$1,439,000
2007	896,816	1,578,000
2008	<u>1,650,415</u>	<u>1,729,274</u>
Total	<u>\$4,026,269</u>	<u>\$4,746,274</u>

Our follow-up review determined that the MSLC now performs a more extensive credit and financial evaluation of all new agents, as well as a more comprehensive annual licensing procedure, including more detailed security background checks and site evaluations, to mitigate risk. There are five basic improvements that have been made in the collection of accounts receivable from delinquent and terminated sales agents since our last audit, as listed below:

1. All sales agent receivables are evaluated regularly and forwarded to one of two collection agencies for further efforts, including legal action, if necessary. In fiscal year 2008 accounts were sent to collection agencies seven times during the year in comparison to past years, which were done at the end of the quarter. In fiscal year 2008 103 accounts totaling over \$1,097,790 were forwarded to collection agencies.
2. New agents that are deemed by the MSLC's Credit and Collections Department to have greater risk are not only swept weekly but now may have their instant game inventory limited.
3. Sales agents who miss a weekly sweep (electronic transfer of funds from an MSLC bank account to the Office of the State Treasurer) are no longer given 30 days to pay

before a hearing is mandated. Within five working days of notification of a missed sweep and payment not being made to an MSLC office, the Credit and Collections Department instructs the MSLC's Asset Protection Department to collect the missed payment and conduct a mock settlement, which calculates the full liability of an agent to the MSLC at that time. If sales agents cannot produce the requested funds and demonstrate they have the full MSLC liability, they are submitted for a finance hearing.

4. Mock settlements are also conducted if the Credit and Collections Department is given cause for concern that a sales agent does not have all MSLC funds on deposit. A trigger for a mock settlement may include a conversation with the agent, a cashing ratio that is unusual, or two missed sweeps within a recent period.
5. The Credit and Collections Department has developed a new report to assist in identifying agents who have an abnormally low cashing-to-sales ratio. This report is reviewed weekly and will assist in identifying agents that may be scratching instant tickets and cashing them at another location. This new report will assist in reducing the total potential liability for this activity.

The declining balances and new policies concerning the collection of agent accounts receivable since our prior audit have significantly reduced the long- and short-term aged agent accounts receivable on the balance sheets of the MSLC. Moreover, the new policies for the collection of accounts receivable from delinquent and terminated sales agents, along with a more realistic agent fee structure, have mitigated the potential losses from writing off uncollectible accounts receivable. These actions, coupled with an aggressive posture taken by the MSLC in forwarding accounts to collection agencies for review and collection prior to being written off, are the significant contributing factors to the reduction. These policies and the results indicate an improved credit and collection environment and reveal a more aggressive posture taken by the MSLC as it pertains to the collection of sales agents' accounts receivable.

h. Compliance with Statutory Requirements under Chapter 647 for Reporting Unaccounted-For Variances, Losses, Shortages, or Thefts of Funds or Property

Prior audit reports disclosed thousands of unreported incidents of thefts and losses involving instant game tickets that were not reported to the OSA in a timely and a sufficiently comprehensive format, contrary to Chapter 647 of the Acts of 1989. Prior audit reports recommended that, since instant game tickets are Commonwealth property, the MSLC must report all missing, stolen, and unaccounted-for tickets to the OSA as required by Chapter 647 so that the OSA can conduct an independent review of the circumstances and make recommendations to improve the internal controls over instant game tickets.

The MSLC instructs sales agents to take inventory of their instant game tickets on a daily basis and report any missing inventory to their local police department and the MSLC Security Department, which will complete and file an incident report. Security Department employees enter this information in the MSLC database and submit the report to the computer staff to ensure accuracy and accountability. The stolen or missing instant game tickets are then rendered invalid and “valueless.” After the incident report has been submitted, a file will be opened and receive a tracking number, and an investigator will be appointed to further investigate the incident. A form letter is then generated and sent to the sales agent and, depending on the nature of the incident, an MSLC security investigator may investigate the issue further, if warranted. A typical case averages less than 30 days to resolve. Upon the conclusion of an investigation, the Security Department will submit a report to the OSA detailing the cause and effect of the incident, and a follow-up review by the MSLC will then be conducted. This follow-up review involves MSLC sales representatives performing follow-up research, acting as an MSLC liaison with the sales agent. A security appraisal will also be conducted at the behest of a sales agent. These steps are coordinated through the MSLC’s asset management group.

Our follow-up review disclosed that the MSLC is electronically transferring reports of unaccounted-for variances, losses, shortages, or thefts of funds or property to the OSA.

The OSA is charged with reviewing the reported incident to determine the amount involved and the internal control weaknesses that contributed or caused the condition and to make recommendations to management to correct the causal conditions to preclude their recurrence. The OSA and the MSLC will continue to work together regarding the timely submission, format and level of detail and information provided to the OSA for its independent review.

APPENDIX I

SAIP Ticket Expenses

Five Fiscal Years Ended June 30, 2008

Fiscal Year	Team/Vendor	Tickets	Sports Merchandise	Sports Legends	Total	Product Promoted
2004	N.E. Revolution	\$21,000			\$21,000	Keno
	N.E. Patriots	40,500			<u>40,500</u>	Keno
					<u>\$61,500</u>	
2005	N.E. Revolution	14,000			\$14,000	Cash WinFall
	N.E. Patriots	90,000			<u>90,000</u>	Cash WinFall
					<u>\$104,000</u>	
2006	Boston College (Football/Basketball/Hockey)	36,000			\$36,000	Numbers Game
	Red Sox	27,475			27,475	Instant Game/ Mega Millions
	Celtics	45,000			45,000	Cash WinFall/Numbers Game
	Concerts	69,700			69,700	Numbers Game
	Minor League Baseball	4,060			4,060	None
	NE Patriots	45,000			45,000	Numbers Game
	Ski Passes and Vegas Trip	15,000			<u>15,000</u>	Instant Game
					<u>\$242,235</u>	
2007	Boston College (Football/Basketball/Hockey)	45,000			\$45,000	Blockbuster IG
	Red Sox	21,475			21,475	Instant Game/Top Cashing Agent
	Minor League Baseball	4,060			4,060	None
	Celtics	65,000			65,000	Numbers Game/Keno
	Concerts	17,500			17,500	Numbers Game
	Deutsche Bank Golf	45,000			45,000	Numbers Game
	NE Patriots	45,000			45,000	Instant Game
Ski Passes and Vacations	20,200			<u>20,200</u>	Keno	
					<u>\$263,235</u>	
2008	Boston College (Football/Basketball/Hockey)	140,000			\$140,000	Community Award Program
	Red Sox	132,000		\$23,181	155,181	Instant Game
	Boston Bruins	256,284			256,284	Keno/Instant Game
	Celtics	516,398			516,398	Instant Game/Hero Among Us
	Concerts	143,700			143,700	Numbers Game
	N.E. Patriots	892,000	\$11,000		903,000	Blockbuster IG
	Patriots Towels	_____	<u>4,730</u>	_____	<u>4,730</u>	None
			<u>\$15,730</u>	<u>\$23,181</u>	<u>\$2,119,293</u>	
		<u>\$2,751,352</u>	<u>\$15,730</u>	<u>\$23,181</u>	<u>\$2,790,263</u>	

APPENDIX II

Five-Year Revenue and Expense Trend (Figures in Thousands)

	<u>Fiscal Year 2008</u>	<u>Fiscal Year 2007</u>	<u>Fiscal Year 2006</u>	<u>Fiscal Year 2005</u>	<u>Fiscal Year 2004</u>
Instant Games	\$3,341,491	\$3,066,440	\$3,115,069	\$3,135,418	\$2,977,732
Mega Millions	128,430	119,788	134,761	97,066	95,997
Numbers Game	343,691	344,155	342,568	352,453	362,524
Mass Cash	40,497	41,690	42,678	43,880	46,198
Keno	739,881	775,488	772,253	742,007	775,523
Cash WinFall	38,535	46,744	47,039	41,797	-
Race Game	15,331	1,514	-	-	-
Charity Game Tickets	2,236	2,409	-	2,545	3,253
Beano Tax (2/5)	1,006	1,124	2,499	1,392	1,699
Pull Tabs	1,127	1,327	1,229	1,808	2,245
License Fees	174	166	1,681	141	-
Bonds Fees and Fines	1,729	1,578	164	1,113	990
Service Fees	5,531	5,478	1,439	5,523	5,495
Clean Fun	-	-	5,510	1	-
Megabucks	40,518	39,357	-	44,559	48,283
Mass Millions	-	-	42,195	6,727	59,889
Miscellaneous Income	33	22	-	33	33
Interest	9,133	13,504	32	6,447	1,916
Stock Div. Demutualization	<u>-</u>	<u>-</u>	<u>12,013</u>	<u>-</u>	<u>-</u>
Total Revenues	<u>\$4,709,343</u>	<u>\$4,460,784</u>	<u>\$4,521,130</u>	<u>\$4,482,910</u>	<u>\$4,381,777</u>
Prizes Paid	<u>\$3,419,706</u>	<u>\$3,225,036</u>	<u>\$3,231,547</u>	<u>\$3,211,541</u>	<u>\$3,148,458</u>
Prizes as % of Sales	72.62%	72.30%	71.48%	71.64%	71.85%
Commissions and Bonuses					
Commissions	\$234,109	\$221,713	\$224,936	\$223,211	\$218,278
Bonuses	<u>41,098</u>	<u>29,942</u>	<u>30,086</u>	<u>30,523</u>	<u>29,806</u>
Total Commissions Paid	<u>\$275,207</u>	<u>\$251,655</u>	<u>\$255,022</u>	<u>\$253,734</u>	<u>\$248,084</u>
Net Revenue from Operations	<u>\$1,014,430</u>	<u>\$984,093</u>	<u>\$1,034,561</u>	<u>\$1,017,635</u>	<u>\$985,236</u>

APPENDIX II (Continued)**Five-Year Revenue and Expense Trend (Figures in Thousands)**

	<u>Fiscal Year 2008</u>	<u>Fiscal Year 2007</u>	<u>Fiscal Year 2006</u>	<u>Fiscal Year 2005</u>	<u>Fiscal Year 2004</u>
Administrative Operating Expenses					
Salaries	\$27,433	\$24,998	\$24,063	\$23,209	\$22,529
Advertising	1,198	1,137	1,196	1,079	762
Equipment Rental	784	344	82	77	78
Admin./Facilities	19,871	16,976	15,127	15,829	14,458
Facilities Rental	3,511	3,353	3,304	2,965	2,713
Telephone	11,239	7,828	6,408	2,270	2,346
Travel	188	183	177	138	145
Employee Benefits	996	3,112	4,393	3,885	3,702
Off./Other Equipment	9,518	10,752	9,219	12,480	14,460
Postage and Freight	2,472	2,301	1,916	2,537	1,835
Maintenance	1,654	1,401	1,926	2,256	1,690
Professional Services	11,124	11,007	12,021	11,489	6,033
Other	33	42	45	50	35
Vehicles	584	640	208	-	45
Building Improvements	540	579	-	-	-
Prior-Year Adjustments	14	1,282	2	4	1
Fringe Benefit Allotment	<u>10,223</u>	<u>5,958</u>	<u>3,234</u>	<u>3,232</u>	<u>2,393</u>
Total Admin. Oper. Expenses	<u>\$101,382</u>	<u>\$91,893</u>	<u>\$83,321</u>	<u>\$81,500</u>	<u>\$73,225</u>
Net Surplus for Distribution	<u>\$913,048</u>	<u>\$892,200</u>	<u>\$951,240</u>	<u>\$936,135</u>	<u>\$ 912,010</u>

APPENDIX III

**Active Instant Games – Total Tickets Per Game
Week Ended June 28, 2008**

<u>Game</u>	<u>Introduced</u>	<u>Game Name</u>	<u>Price</u>	<u>06/28/08 Weekly Sales</u>	<u>Total Tickets Printed</u>	<u>Total Winning Tickets</u>
2	February 27, 2007	Stacks of Cash	\$1	\$234,977	50,400,000	10,372,750
3	February 27, 2007	Happy Mother's Day	\$2	2,400	10,080,000	2,118,850
4	February 27, 2007	25 Grand	\$2	74,108	40,320,000	8,489,720
5	February 27, 2007	Precious Gems	\$5	798,910	30,240,000	6,318,910
6	March 20, 2007	Red Sox	\$10	1,297,700	30,240,000	8,517,725
7	March 8, 2008	Bingo 2008	\$2	803,580	43,230,000	9,506,570
8	April 24, 2007	Pinball Wizard	\$5	603,330	30,240,000	6,319,120
9	April 24, 2007	Lucky Dad	\$2	3,000	10,080,000	2,118,850
10	August 7, 2007	Strike It Rich	\$2	607,676	30,240,000	6,368,760
11	January 2, 2008	Gold Rush	\$2	740,688	40,320,000	8,492,800
14	June 13, 2006	Jackpot Riches	\$2	398,136	40,320,000	8,495,760
15	August 15, 2006	Sizzling Hot Cash	\$2	305,190	40,320,000	8,507,080
16	August 8, 2006	Bingo	\$2	5,250	40,320,000	10,586,500
17	January 2, 2007	Dublin Dollars	\$2	273,792	30,240,000	6,371,829
18	April 24, 2007	Double Doubler	\$2	668,772	40,320,000	8,341,110
20	April 8, 2008	Lmt. Ed. WS Bost. Red Sox	\$20	4,536,360	10,800,000	3,372,602
21	April 24, 2007	Blackjack	\$1	200,636	50,400,000	10,379,100
24	June 17, 2008	Max A Million	\$10	7,130,640	50,400,000	13,915,933
25	January 2, 2008	Triple Dough	\$2	809,590	30,240,000	6,336,580
26	January 2, 2008	Valentine's Day Doubler	\$5	399,870	9,072,000	1,925,418
27	January 2, 2008	Cash Money	\$5	1,268,805	30,240,000	6,318,910
28	May 22, 2007	Cash Word	\$2	2,535,636	100,800,000	23,658,900
29	January 10, 2006	Lucky Spin	\$2	2,116	40,320,000	8,495,760
31	March 4, 2008	Mother's Day	\$2	301,670	10,080,000	2,118,850
33	August 7, 2009	Fabulous Fortune	\$5	676,820	30,240,000	6,496,355
34	February 28, 2006	Easy 10	\$1	216,803	50,400,000	10,375,050
35	April 25, 2006	Sapphire Blue 5's	\$2	9,000	40,320,000	8,492,800
36	September 25, 2007	Billion Dollar Blockbuster	\$20	7,756,740	65,520,000	21,934,456
37	October 30, 2007	Frosty the Doughman	\$2	67,126	20,160,000	4,245,840
41	January 10, 2006	Wild Cherries	\$1	160,572	50,400,000	10,370,850
42	October 30, 2007	Deck the Halls	\$1	122,737	20,160,000	4,148,980
43	March 4, 2008	Lucky Shamrocks	\$2	798,882	30,240,000	6,224,520
44	June 13, 2006	Cash Fireworks	\$2	343,304	40,320,000	8,299,360
45	September 25, 2007	Hallo-Win	\$5	104,450	8,064,000	1,687,964
48	October 30, 2007	Jumbo Bucks	\$5	1,114,785	30,240,000	6,335,110
49	November 1, 2005	Lucky Holiday	\$1	900	25,200,000	5,188,050
50	January 10, 2006	Caesars Palace	\$5	425,860	30,240,000	6,459,410
51	June 19, 2007	Red Hot Cash	\$1	294,332	50,400,000	10,381,350
52	September 25, 2007	Lucky Dice	\$2	654,660	30,240,000	6,380,310
53	March 8, 2008	Fast 50's	\$1	696,624	50,400,000	10,563,850

APPENDIX III (Continued)

Active Instant Games – Total Tickets Per Game
Week Ended June 28, 2008

<u>Game</u>	<u>Introduced</u>	<u>Game Name</u>	<u>Price</u>	<u>06/28/08</u> <u>Weekly Sales</u>	<u>Total Tickets</u> <u>Printed</u>	<u>Total Winning</u> <u>Tickets</u>
54	January 10, 2006	Daily Double	\$2	\$ 11,712	40,320,000	8,478,800
55	August 8, 2006	On A Roll	\$1	120,641	50,400,000	10,377,300
58	September 6, 2005	In The Chips	\$2	8,122	40,320,000	8,492,800
59	November 1, 2005	Mistledough Doubler	\$2	1,800	20,160,000	4,239,400
60	April 11, 2006	Boston Red Sox	\$5	683,775	40,320,000	8,724,220
61	April 22, 2008	Father's Day	\$2	1,083,072	10,800,000	2,118,850
62	June 19, 2007	Cash Explosion	\$2	576,720	40,320,000	8,491,680
63	April 22, 2008	Hot Slots	\$2	1,219,646	30,240,000	6,380,310
64	April 25, 2006	One-Eyed Jack	\$1	118,047	50,400,000	10,535,200
65	August 8, 2006	\$100,000 Club	\$5	603,560	30,240,000	6,316,480
67	September 27, 2005	Scream for Cash	\$2	600	20,160,000	4,271,460
68	April 22, 2008	5 Times Lucky	\$5	2,967,095	25,200,000	5,279,800
69	February 28, 2006	\$800 Million Spectacular	\$10	2,449,230	99,792,000	27,410,230
70	September 26, 2006	\$5,000,000 Jackpot	\$10	2,407,350	80,640,000	22,195,890
72	September 6, 2005	Money Talks	\$2	600	40,320,000	8,495,760
74	September 27, 2005	Set for Life	\$10	2,654,980	99,792,000	27,382,897
75	October 31, 2006	Jingle Bell Cash	\$1	9,000	20,160,000	4,151,640
76	October 31, 2006	Winner Green	\$2	600	20,160,000	4,239,400
77	January 2, 2007	Quick Silver	\$1	120,594	18,144,000	3,799,300
78	June 19, 2007	Emerald Green 7's	\$5	768,915	30,240,000	6,488,165
79	October 31, 2006	Bah Humbucks	\$5	9,000	18,144,000	3,799,300
80	October 31, 2006	Boston Celtics Green	\$5	700,305	15,120,000	3,170,220
81	July 12, 2005	Wild Doubler	\$1	48,345	50,400,000	10,538,700
82	July 12, 2005	Silver & Gold	\$2	1,200	40,320,000	8,299,360
86	July 12, 2005	\$200,000 Payday	\$5	22,500	30,240,000	6,315,990
87	October 30, 2007	Season's Greetings	\$5	480,265	18,144,000	3,726,234
89	January 2, 2007	Diamonds and 7s	\$5	817,940	30,240,000	6,418,870
92	June 17, 2008	Wild Millions	\$5	3,048,865	30,240,000	6,319,750
93	June 17, 2008	Triple Win	\$1	913,921	40,320,000	8,305,080
96	June 17, 2008	Happy Birthday	\$2	2,149,744	15,120,000	3,196,122
97	March 29, 2005	\$10 Mil. Hold 'Em Poker	\$10	<u>1,026,400</u>	<u>80,640,000</u>	<u>22,223,500</u>
71 Active Games/Total						
Tickets				<u>\$62,470,971</u>	<u>2,588,862,000</u>	<u>585,215,350</u>