

A. JOSEPH DeNUCCI
AUDITOR

The Commonwealth of Massachusetts

AUDITOR OF THE COMMONWEALTH

ONE ASHBURTON PLACE, ROOM 1819
BOSTON, MASSACHUSETTS 02108

TEL. (617) 727-6200

NO. 2005-0089-3S

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

JULY 1, 2003 TO JANUARY 31, 2005

OFFICIAL AUDIT
REPORT
JULY 27, 2006

TABLE OF CONTENTS/EXECUTIVE SUMMARY

INTRODUCTION

1

The Massachusetts State Lottery Commission (MSLC) is authorized by Chapter 10, Sections 22 through 35 of the Massachusetts General Laws (MGL), to raise revenue 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 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 for 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.

In fiscal year 2004, the MSLC generated \$4.606 billion in revenue, of which \$3.358 billion was paid in prizes, \$248 million was used for commissions and bonuses to its sales agents, \$73 million was used for administrative and operating expenses, \$740 million was allocated to cities and towns, \$8 million was divided between the Massachusetts Arts Council and the Gamblers' Treatment Program, \$164 million was transferred to the Commonwealth's General Fund, and \$15 million was added to the MSLC fund balance. 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, generating maximum revenue to fulfill its mission and purpose.

In accordance with MGL Chapter 11, Section 12, the Office of the State Auditor (OSA) conducted an audit of certain activities of the MSLC for the period July 1, 2003 through January 31, 2005. The purpose of our audit was to review and analyze financial and administrative activities, update the status of prior audit results and review the corrective actions taken, review improvements relating to internal controls and revenue enhancements, assess the effectiveness of investigatory and oversight activities regarding sales agents, and determine compliance with applicable laws, rules, and regulations.

The MSLC has responded to certain of our audit result recommendations, and those responses are included throughout this report.

AUDIT RESULTS

5

1. PRIOR AUDIT RESULTS RESOLVED

5

During our follow-up review, we determined that MSLC has taken corrective action with regard to correcting special arrangements with one sales agent; complying with Chapter 647 reporting requirements; including the OSA audit authority clause in MSLC contracts;

complying with certain provisions of the open meeting law; enhancing revenues; and improving internal controls.

a. Special Arrangements with One Sales Agent Terminated **5**

Our prior audit disclosed that one sales agent had an exclusive arrangement with the MSLC to pay individual claims up to \$25,000. Our follow-up review found that the MSLC has taken corrective action and that this agent no longer has the privilege to pay claims of over \$600 and up to \$25,000.

b. Compliance with Statutory Requirements under Chapter 647 for Reporting Unaccounted-for Variances, Losses, Shortages, or Thefts of Funds or Property **5**

Prior reports have disclosed thousands of unreported incidents of thefts and losses involving instant game tickets, as well as shortages at various MSLC offices. Our follow-up review indicated that the MSLC has taken corrective action and was in compliance with Chapter 647 of the Acts of 1989, which requires agencies to immediately report all unaccounted-for variances, losses, shortages or thefts of funds or property to the OSA.

c. OSA Audit Authority Clause Included in MSLC Contracts **7**

Our prior audit disclosed that the MSLC Sales Agent Agreements did not contain the clause required by MGL Chapter 11, Section 12, that states that the OSA has the right to examine the accounts, books, records, and activities of a vendor that has a contract or agreement with the Commonwealth. Our follow-up review revealed that the MSLC has taken corrective action and now includes language in MSLC contracts and agreements with agents and vendors indicating that they are subject to audit by the OSA.

d. Compliance with Certain Provisions of the State's Open Meeting Law **7**

Our prior audit disclosed that the MSLC did not fully comply with the requirements of MGL Chapter 30A, Section 11A 1/2, commonly referred to as the Open Meeting Law, when convening meetings in executive session. Our follow-up review revealed that the MSLC has taken corrective action and is in compliance with the requirements of the law, including properly recording meeting minutes, the calling of the roll, a declaration of the executive session, and reconvening the regular session.

e. Revenue Enhancements for High-End Instant Game Tickets and Keno **8**

Our prior audit included recommendations to enhance revenue relative to Keno games and high-end instant game tickets. Our follow-up review indicated that the MSLC enhanced revenue on March 1, 2003 by reducing the interval between Keno Games from five minutes to four minutes. The modification resulted in a 10.4% increase in Keno revenue for fiscal year 2003 and an increase of 9.8% in fiscal year 2004. In addition, the MSLC followed our recommendation to design games with a matrix distribution of payouts with higher-level prizes (i.e., some mix of \$100 to \$1000 or more). Specifically, our follow-up review disclosed that MSLC products now include games with prize matrices that have both high- and low-tier prizes in order to attract the different types of players who purchase lottery products. Also, the MSLC is offering its customers a choice of two \$10 tickets and intends to have the tickets available throughout the year. The revenue from \$10 tickets within calendar year 2004 increased from \$366,953,030 in the first six months to \$613,790,190 in the second six months. During fiscal year 2004, \$10

ticket sales amounted to approximately 22% of all MSLC gaming revenue. The MSLC has achieved an overall increase of 4.21% in gaming revenue of \$178,118,000 for fiscal year 2004 (\$4,373,151,000) as compared with fiscal year 2003 (\$4,195,033,000). Total revenue, including annuities, fees, and investment income, was \$4,606,772,000 in fiscal year 2004 as compared to \$4,424,922,000 in fiscal year 2003.

f. Internal Control Improvements Implemented

8

Our prior audit report recommended that internal control improvements be implemented with regard to more frequent collections (sweeps) from sales agents to eliminate float and improve revenue cash flow, that late fees be assessed for sales agents where accounts could not be swept, that a reasonable application fee be charged for new sales agents, that regional advisory councils of sales agents and sales representatives should be established, and that all policies regarding employee benefits for union and non-union employees, as well as in-state and out-of-state travel policies, should be incorporated into its existing policies and procedures. We also recommended that the MSLC ensure that a telecommunications overbilling be adjusted and credited to future billing. Our follow-up review disclosed that the MSLC has taken corrective action on these issues. Specifically, sweeps are made more frequently in certain instances, a sliding scale of late fees has been established and implemented, new sales agent application fees have been increased to \$200, regional advisory councils meet at least once per year, policies regarding employee benefits and travel have been established and implemented, and \$1,518,641 was credited to the MSLC for the telecommunication overbilling.

2. PRIOR AUDIT RESULTS UNRESOLVED OR PARTIALLY RESOLVED

10

During our follow-up review, we determined that the MSLC had not yet adequately resolved certain issues identified in our prior audit. Specifically, the MSLC needs to improve oversight of winner identification and preclude the activities of so-called "professional" ticket cashers, develop an organization-wide risk assessment, enhance its internal audit function, enhance its collection of accounts receivables, continue to monitor sales agents ticket scanning, and identify and document quality control procedures over instant game ticket manufacturing.

a. Ineffective Controls Over "Professional" Ticket Cashers Results in Hundreds of Millions of Dollars in Unclaimed and Unreported Income and Lost Tax Revenue

10

Our prior audit reports disclosed numerous instances in which the same individuals were repeatedly claiming hundreds of prizes valued at millions of dollars over a period of several years. Our follow-up audit disclosed that this practice is ongoing and has become even more widespread. We noted the following:

- In calendar year 2004, 88 individuals cashed 5,332 winning tickets totaling \$10,065,427.
- In calendar year 2003, 71 individuals cashed 4,527 winning tickets totaling \$8,228,480.
- During calendar years 2002, 2003 and 2004, one individual cashed 1,588 winning tickets totaling \$2,840,000.

- One individual cashed 20 winning tickets totaling \$44,336 during 2003, and an additional 394 tickets totaling \$638,338 during 2004.
- In calendar year 2003, a sales agent cashed 21 winning tickets totaling \$243,483. In calendar year 2004, the same sales agent cashed 25 winning tickets amounting to \$36,500. These tickets were purchased at 10 different locations in 2004. On November 30, 2004, this sales agent cashed 14 \$1,000 winning instant game tickets at the Braintree Office. These tickets were purchased from eight different sales agents.

This practice appears to circumvent the federal and state tax codes and the Commonwealth's Intercept Program (tax liens, child support, etc.), as well as the potential for fraud against various government assistance programs. Also, during our prior audit we referred a number of these individuals who were identified as "professional" cashiers that claimed large numbers of lottery prizes to our Bureau of Special Investigations (BSI) for investigation. The BSI investigation resulted in the identification of seven individuals who were receiving medical assistance from MassHealth while collecting \$1,750,200 in lottery prizes. The potential recovery from these individuals totals approximately \$174,000.

In our prior audits we suggested that the MSLC reduce the threshold for withholding federal and state income taxes on winnings of \$5,000 and over to \$600 and over. The amount of potential federal income taxes which could have been withheld during calendar year 2004 on cumulative winnings between \$600 and \$5,000 (the federal withholding threshold) was approximately \$28 million. Our follow-up review disclosed that on December 1, 2004, MGL Chapter 62B, Section 2, of the General Laws was amended to require the withholding of Massachusetts income tax on all winnings of \$600 and over. We recommend that the MSLC encourage the Internal Revenue Service, Department of Revenue and other states' lotteries to have the federal government modify its regulations to require withholding taxes on all winnings of \$600 and over.

In response to our audit, the MSLC has reported that it provides a monthly report, which identifies individuals who have accrued lottery winnings of sufficient quantity and value to be professional cashers, to the Internal Revenue Service, Department of Revenue and the Office of the Attorney General. MSLC views the enforcement of claimant reporting failures to be the purview of those agencies, and does not believe it has the authority to decline payment for a legitimate prize based on the prior cashing history of the claimant. Also, MSLC indicated that it would support changes to the Federal Tax Code which would increase withholdings and adopt further measures to monitor and discourage the practice of professional cashing.

b. Internal Audit Function Needs Improvements**14**

Our prior audit disclosed that an independent internal audit function was needed at the MSLC. Our follow-up review revealed that on July 1, 2003, the MSLC established its Internal Audit/Compliance Department and created the position of Assistant Executive Director for Internal Audit/Compliance, which reports directly to the Treasurer of the Commonwealth. The Internal Audit/Compliance Department conducted some reviews limited to operating controls at the regional offices and game closure procedures. However, there were no audit reviews evaluating the overall internal controls and the

identification of risk of the MSLC's financial and programmatic operations. In fiscal year 2002, the MSLC retained an accounting firm to conduct an overall network security assessment. The MSLC has made improvements and should complete an evaluation of all MSLC functions based upon a risk assessment of its financial and programmatic operations and technology environment and the implementation of a plan for future reviews. Also, the MSLC indicated that it hired a private accounting firm to assist in the preparation of an audit plan. Such an internal audit function will greatly enhance the MSLC's operations, safeguard its assets, and mitigate the risk of fraud, waste, and abuse occurring. In response to the audit, the MSLC indicated that the newly created Internal Audit department is proceeding with a multiphase plan to establish a professional and meaningful method by which risk is identified and tested. Audits have been conducted for certain MSLC departments, and the findings have been used to develop a reporting template which will be issued to the Treasurer and Receiver General and the MSLC Executive Director on a quarterly basis, and will encompass all remaining departments.

c. Risk Assessment/Internal Control Plan Needs Improvements

16

Our prior audit disclosed that the MSLC had not developed an internal control plan as required by Chapter 647 of the Acts of 1989, and had not developed an organization-wide risk assessment in accordance with the Office of the State Comptroller's (OSC) guidelines. In the fall of 2001, the OSC directed all state agencies to prepare an organization-wide risk assessment. Also, in its Single Audit Internal Control Questionnaire Letter issued in the spring of 2002, the OSC re-emphasized that all departments should have prepared this department-wide risk assessments by July 1, 2002, and advised departments to use these risk assessments to focus on listing the control activities (policies and procedures) that mitigate the risks identified in organization-wide risk assessments. This process would become the basis for the development of an internal control plan to test the effectiveness of the internal controls over risks.

Our follow-up review disclosed that the development of an organization-wide risk assessment and internal control plan had not been accomplished. Therefore, on January 31, 2005, the MSLC retained the services of an outside accounting firm to complete an organization-wide risk assessment and internal control plan. The completion of this risk assessment and the implementation of an internal control plan, combined with the further development of the internal audit function, should improve and enhance the MSLC's internal control structure.

In response to our audit, the MSLC reported that the Internal Audit department is proceeding with a multi-phase plan to establish a professional and meaningful method by which risk is identified and tested. This task is scheduled to be completed by June 30, 2006.

d. Improvements Needed 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

17

Our prior audits found that the MSLC had written off \$13 million in bad debts representing funds owed by sales agents from fiscal years 1999 to 2002. Our follow-up review disclosed that the amounts written off as agent bad debts were \$1.8 million for fiscal year 2003 and \$700,000 for fiscal year 2004. We also found 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. Moreover, the MSLC has implemented a revised sliding scale fee structure for new and existing agents. The fees are intended to cover the MSLC losses as a result of the costs associated with delinquent or terminated sales agents. Also, our follow-up review disclosed that a new sales agent licensure procedure allows the MSLC to place liens on sales agents for any amounts owed when it becomes necessary to terminate them as sales agents. In addition, the new MSLC regulations allow for the collection of past-due accounts after a sales agent ownership changes.

The following chart of sales agent accounts receivable shows that current balances have been decreasing (\$1.4 million in fiscal year 2003, \$900,000 in fiscal year 2004, and \$400,000 for the first six months of fiscal year 2005) due to changes in MSLC policy. The chart shows that amounts owed over 90 days, net of the reserve for bad debts, have also decreased to \$1.5 million as of December 31, 2004 from \$1.7 million at June 30, 2003.

| Accounts Receivable | December 31, 2004 | June 30, 2004 | June 30, 2003 |
|-----------------------------|----------------------|------------------|------------------|
| Total (in Thousands) | \$5,000 | \$6,300 | \$5,700 |
| Less: Current | <u>400</u> | <u>900</u> | <u>1,400</u> |
| Over 90 Days | \$4,600 | \$5,400 | \$4,300 |
| Less: Reserve for Write-Off | <u>3,100</u> | <u>3,100</u> | <u>2,600</u> |
| Net at Risk | <u>\$1,500</u> | <u>\$2,300</u> | <u>\$1,700</u> |

The MSLC contracts with a collection agency to collect the delinquent amounts over 90 days past due. The MSLC has made a number of policy changes designed to minimize the potential risk of loss, however, the MSLC should continue to pursue all outstanding accounts receivable with every means at its disposal.

The MSLC responded to our audit by stating the rate of collection from delinquent sales agents has improved and will continue to be a management focus.

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

20

Prior reports have raised questions regarding the internal controls, policies, and procedures over sales agents' ability to scan instant game tickets. Our prior audit recommended that the MSLC should ensure that its compliance unit monitor sales agents for unusual, irregular, and questionable activities and patterns, and take appropriate action as warranted. Ticket scanning by a sales agent is the valid practice of placing sold tickets into the MSLC terminal to register a winning ticket into the MSLC system for redemption. "Peeking," however, is the invalid practice of scanning unsold tickets for the purpose of determining which ones are winning tickets. In order to control this improper activity, the MSLC investigates all instances in which a sales agent has scanned (or peeked at) eight or more losing tickets in a single day, an indication that a sales agent may be looking for unsold winning tickets. This practice has significantly reduced the instances of "peeking".

Also, our prior audit recommended that the MSLC consider, as in the case of MSLC employees, prohibiting agents (principals/owners) from purchasing tickets at their own stores. Our follow-up review determined that the MSLC has implemented policies and

procedures to reduce sales agents' "peeking" activity. In the first seven months of the implementation of the policies and procedures, "peeking" activity has been reduced significantly. Our follow-up revealed that the MSLC has issued an Agent Code of Conduct which, among other things, strongly discourages agents and their employees from playing MSLC games, including scratching instant tickets, at their location. We encourage the MSLC to continue these policies. In response to the audit, the MSLC indicated that pragmatically it would be impossible to enforce a ban against sales agent purchasing. The MSLC stated that the overall integrity of the MSLC is of paramount concern. The Executive Director sent a code of conduct letter to all sales agents strongly discouraging agents and their employees from purchasing tickets from the locations where they work. Regardless of enforcement practicality, the prohibition of agents and their employees from playing games would act as a deterrent, since most people tend to obey laws, rules and regulations. The MSLC should consider in repeat cases immediately suspending the agent's license and based upon the results of the investigation, revocation.

f. Improvements Needed in the Documentation of Quality Control Procedures over Instant Game Ticket Manufacturing

23

Our prior audit recommended that the MSLC recover costs associated with defective tickets purchased from the instant game ticket vendors. Our follow-up audit disclosed that the MSLC has established a threshold relative to the allowable number of defects prior to instituting cost-recovery efforts. During our audit period, there was an instance in which defects crossed the predetermined threshold. The MSLC identified and collected the amount due of \$49,532 as a cost reimbursement for this discovered defect; however, we found that the MSLC's documentation of quality control procedures needs to be improved. In response to the audit, the MSLC agrees that a more detailed description of instances of the defect will be helpful in determining when the threshold for acceptable defects has been passed.

3. MANAGEMENT OF RISK ASSOCIATED WITH INSTANT GAME TICKET MANUFACTURING NEEDS TO BE IMPROVED

25

The MSLC has contracted with three vendors for the production of instant game tickets; however, one vendor manufactures 80% of the MSLC's instant game tickets. Instant game ticket sales total approximately \$3 billion annually, of which 80% is \$2.4 billion. Based upon a 72% prize payout on the \$2.4 billion, a potential risk exists to the cities and towns, MSLC, General Fund, Massachusetts Arts Lottery Council, and sales agents of \$672 million, in the event of a disaster at the production location resulting in a shut down of 12 months. This risk could possibly be reduced by approximately 25% (\$168 million) assuming three months of inventory on hand, and stored at the same location, and were available to be sold, and not destroyed in the same potential disaster. Also, if one month's instant game ticket inventory (totaling approximately \$56 million in net revenue) at the MSLC storage locations is taken into consideration, the risk would be further reduced, decreasing the net potential risk to approximately \$448 million. Moreover, the MSLC may be able to obtain additional production capability from the other two vendors, thereby further reducing this risk. The MSLC has not recognized and considered this exposure of potential risk, and therefore should develop a plan to address the possible interruption of the instant game ticket supply. In response to the 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. To reduce the risk of loss, the MSLC maintains approximately a three month supply of instant tickets. Also, subsequent to our audit, the MSLC has 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.

4. INTERNAL CONTROL IMPROVEMENTS NEEDED TO ENSURE COMPLIANCE WITH ADVERTISING AGENCY CONTRACT PROVISIONS **28**

The MSLC entered into an agreement on July 1, 2003 with an advertising agency for the purpose of rendering advertising services. The contract, which may be renewed annually, provides for a maximum total obligation of \$14.5 million through June 30, 2005. The contract has a number of provisions intended to ensure that other services are passed along to the MSLC at "net out-of-pocket" cost. These services include media charges, production costs and related services.

Our audit disclosed that the advertising agency billings did not include sufficient documentation to support compliance with the administrative provisions of the contract. Specifically, the agency did not submit vendor invoices and cost estimates to support its billings to the MSLC. Also, the agency was paying for media services prior to the services being provided. As a result, the MSLC did not obtain sufficient evidential materials to determine compliance with the contract. In response to the audit, the MSLC reported that it currently receives and reviews copies of all vendor invoices and cost estimates that support advertising agency billings, and will implement additional procedures to ensure full contract compliance.

5. THE MSLC SUPPLIES PRIZE WINNERS OF BETWEEN \$600 AND \$9,999 WITH AN ACCOMMODATION LETTER THAT ENABLES THE HOLDER TO CASH THE MSLC CHECK AT THE MSLC'S BANK ON THE SAME DAY THE CHECK WAS ISSUED **29**

The MSLC has designed a letter of introduction addressed to its principal depository, requesting that it accommodate the holder of the letter to cash a prize-winning check 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 identification normally required by a bank. The letter, in effect, serves as the second form of identification. Approximately 70% to 80% of all prize winners cash their checks at the MSLC's bank on the same day that the MSLC issues the check to them. The MSLC issues approximately 500 checks per day in prize payouts, and on Mondays the number of checks could be upwards of 700, with a cash value in the \$1.5 million range. During our audit, we found that some professional cashers were taking advantage of this policy by using the MSLC letter to assist them in cashing their MSLC winning checks at a designated branch. Therefore, the MSLC's practice of supplying a letter to cashers enabled professional cashers to conduct their illegal activities. (See Audit Result No. 2a)

The MSLC's normal practice for prize winners is to supply its bank with a daily check-issued file on the next business day. Known as the Positive Pay system, this process is used by Commonwealth agencies to notify banks of valid checks issued, against which checks presented to the bank can be matched. This control system provides the MSLC and the bank protection against losses from altered checks.

In response to the audit, the MSLC stated that it views the accommodation letter as a convenience to its customers, and is not aware of an instance where a loss has occurred due to this practice.

6. INTERNAL CONTROL IMPROVEMENTS NEEDED OVER THE "INSTANT REPLAY" RECYCLING PROGRAM **31**

The MSLC initiated a pilot anti-litter program (the Instant Replay Recycling Program) at various fairs, events, and sites during fiscal years 2004 and 2005 (See Audit Result No. 7c). Under this program, individuals would receive one instant game ticket for every 20 non-winning tickets they return at selected community fairs and events throughout the state. Our review disclosed that internal control improvements are needed over this program. Specifically, the MSLC's Internal Audit/Compliance Department review of the program at three events disclosed that large numbers of live instant game tickets were transported by individual employees in order to expedite the MSLC operations at the fairs; non-MSLC employees were involved in the counting and handling of cash and instant tickets; night cash deposit duties were inadequately secured and segregated; cash proceeds were not counted and reconciled on all evening closings; initial cash banks of \$5,000 at the Marshfield Fair, \$5,000 at the Eastern States Exposition, and \$2,000 at the Topsfield Fair were kept overnight at an MSLC employee's residence; the practice of cashing lost, stolen, out-of-date, or out-of-state recycled tickets was inconsistent between employees and various shifts; and final reconciliations of cash and expenses were incomplete. In response to the audit, the MSLC reported that a new set of written internal control procedures has been developed and implemented for fair events to respond to the various operational issues that were experienced in running the new "Instant Replay" program.

7. REVENUE-ENHANCING OPPORTUNITIES **33**

During our audit, we identified some revenue-enhancing opportunities that the MSLC should consider with regard to stimulating growth in Bingo operations, licensing Keno operations at establishments that do not serve alcohol, expanding the sale of instant game tickets at fairs and carnivals, and establishing more kiosks in malls and other locations in order to sell more MSLC products and increase revenues.

a. Effects of Declining Revenue on Non-Profit Organizations Supported by Bingo Operations **33**

The steady decline in the ability of Bingo (on the order of 5% to 10% annually) and charitable games in general to produce revenue is having a negative effect on the community-based charitable fraternal non-profit organizations, educational institutions, food pantries, VA hospitals, etc. This situation has become a cause for concern to local groups. The MSLC has identified the reasons for this decline, which include an aging population, a decline in volunteering rates, a decline in social organization membership, a maximum prize of \$3,000 at charitable bingo games, the restriction that only volunteers can work at MSLC-sponsored games, and the statewide smoking ban. The MSLC should consider implementing or where required recommending and supporting legislation which allows some additional incentives, such as the following, to stimulate play:

- Providing a monetary incentive to the community groups that operate the games.

- Allowing organizations to pay a stipend or per diem for the work performed at the games that are currently being performed by volunteers to allow smaller organizations to conduct games.
- Consider authorizing for-profit agents to operate bingo halls with the proviso that a certain percentage of revenues received be distributed to local non-profit organizations.
- Raising the \$3,000 maximum prize.

In response to the audit, the MSLC indicated that it was supportive of changes that will stimulate growth in bingo operations.

b. Effects of Smoking Ban on Keno Operations

36

Keno revenues have declined after the introduction in July 2004 of the statewide smoking ban in all "pouring establishments" (places that serve alcohol). Our analysis of the seven months since the initiation of the ban compared to the previous seven months revealed that all but two months showed a decline in revenue. The aggregate amount of Keno revenue from the nine months prior to the smoking ban and the nine months after the smoking ban declined by \$34,476,490. The loss of business revenue to the affected establishments has not been calculated, but has also resulted in a loss of sales tax revenues to the Commonwealth. Because of the negative impact that the smoking ban is having on local business establishments and the cities and towns that depend on the Lottery, the MSLC should consider changes that would expand their base and also allow "non-pouring" agents to offer Keno. This would also generate additional sales from those people who would like to play Keno but do not frequent establishments that serve alcohol. In response to the audit, the MSLC indicated that in December 2005, it introduced a new Keno Bonus game option which gives players a chance to increase their Keno winnings exponentially, which has resulted in increased Keno sales. Through the first eight months of fiscal year 2006, Keno sales were up 4.3% over the prior year.

c. MSLC Operations at "Instant Replay" Recycling Events

37

The MSLC initiated a pilot anti-litter program at selected locations, including community fairs and other events and venues, during fiscal years 2004 and 2005. The primary goal of the program was to remove and recycle previously sold non-winning instant game tickets. In addition to this anti-litter program, the MSLC established a booth at these fairs and sold some of their products, including Keno, on-line games, pull tabs, and one-day bingo. Consideration should be given to expanding the program to other fairs and even carnivals around the Commonwealth, and include the sale of instant game tickets to enhance revenue. In response to our audit, the MSLC stated that it is planning to expand the "Instant Replay" recycling program. MSLC will add four new events, including fairs and other venues, in a geographically balanced way in fiscal year 2006 to bring the total number of recycling events across the Commonwealth to ten.

d. Evaluation of MSLC Kiosk Operations at Selected Malls and Other Locations **38**

The MSLC established a kiosk to service patrons in the Natick Mall. The kiosk, which sells instant game and jackpot tickets, Lottery apparel and other Lottery-themed items, and serves as a regional ticket-cashing location, generates \$20,000 in weekly sales. However, the MSLC has not conducted any financial analysis to determine whether the kiosk is a viable operation, or whether similar operations should be opened at malls throughout the state and operated by agents. Since shopping malls provide access for foot traffic and therefore appear to have the potential to stimulate the sale of MSLC products, the MSLC should consider developing a financial model for the operation of these kiosks and investigate other potential sites within the Commonwealth. In addition, the MSLC should consider introducing the ability to play Keno at such kiosks. The MSLC should also explore the potential of installing its vending machines at the various tourist information centers throughout the Commonwealth. The MSLC responded to our audit by stating that it is evaluating the cost/benefits associated with the kiosks at the Natick Mall and Logan Airport; however has no present plans to open additional kiosks.

8. OTHER ISSUES REGARDING GAME CLOSURE PROCEDURES, UNDERAGE GAMBLING, AND PROHIBITED GAME PARTICIPATION **39**

We examined other selected areas of the MSLC's operations to determine the extent of operational controls over these specific areas and evaluate their effectiveness. These areas include: (a) instant game closing procedures, (b) underage gambling and (c) game participation.

a. Instant Game Closure Procedures **39**

The MSLC's instant game closure policy requires a game to be closed when it has sold out or when its last grand prize is claimed. The MSLC prepares a report for every game closed summarizing the payout data for that game. Our examination indicated that the overwhelming majority of games with grand prizes sell out, the MSLC was in compliance with game closure procedures, and all grand prizes were paid.

b. Analysis of Underage Gambling **40**

The MSLC policy against underage gambling is 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 checks on licensed sales agents in an effort to determine whether the statutory prohibition against sales to minors is enforced. Beginning in 1994 and through 1998, the MSLC conducted by itself and in cooperation with the Attorney General's Office a series of undercover stings on various sales agents to identify those sales agents who conducted business with minors under the age of 18 years. From the years 1994 through 1998, the MSLC conducted a total of 464 individual sales agent stings, of which 97 sales agents, or 21% of those tested, were not in compliance with the Sales to Minors policies. There have been no such operations since 1998. The MSLC intends to test approximately 1% or more of sales agents each year during selected school vacation weeks, beginning in fiscal year 2005.

c. Prohibited Game Participation **41**

Our prior audit recommended that to better prevent MSLC employees and their family members in the same household from playing lottery games, the MSLC should require, as a condition of employment, the name, age, and Social Security numbers of all family members. Such a policy would demonstrate that the MSLC is taking additional measures to prevent insiders from playing lottery games. However, this policy has not been implemented. The MSLC responded that (a) random testing of employees and their family members would present problems because there is no way to constantly monitor the action of children, spouses, and employees from playing games, (b) children and spouses of MSLC employees could employ the aid of another to cash lottery winnings, and (c) winning tickets with a value of less than \$600 could be cashed anonymously by MSLC employees and their family. The MSLC stated, however, that when discovered, the MSLC would engage a vigorous investigation to determine if such employee participation in the Lottery games took place.

APPENDIX I **43**

MSLC Sales by Cities and Towns vs. Distribution to Cities and Towns (Top 20)

APPENDIX II **44**

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

APPENDIX III **47**

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

INTRODUCTION

Background

The Massachusetts State Lottery Commission (MSLC) is authorized by Chapter 10, Sections 22 through 35, of the Massachusetts General Laws (MGL) 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, MGL, Chapter 10, Section 24, 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 MGL, Chapter 10, Section 26:

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.

The administrative office of the MSLC is located at 60 Columbian Street, Braintree. The MSLC also has five regional offices, which are located in Fairhaven, West Springfield, Woburn, Worcester, and Boston. In addition, there is a Canton warehouse facility that houses instant game tickets and other supplies, and a computer facility in Norwell. 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 to cover certain expenses. Operating expenses, such as salaries and administrative expenses, must be appropriated by the state 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.

During fiscal year 2004, the MSLC generated \$4.606 billion in revenue, of which \$3.358 billion was paid in prizes, \$248 million was used for commissions and bonuses to its sales agents, \$73 million was used for administrative and operating expenses, \$740 million was allocated to cities and towns, \$8 million was divided between the Massachusetts Arts Council and the Gamblers' Treatment Program, \$164 million was transferred to the Commonwealth's General Fund, and \$15 million was

added to the MSLC fund balance. Additionally, the prize money winnings result in 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 and effective internal controls to ensure that the Commonwealth's resources are safeguarded and losses are minimized, generating maximum net revenue to fulfill its mission and purposes.

Audit Scope, Objectives, and Methodology

In accordance with MGL, Chapter 11, Section 12, the Office of the State Auditor (OSA) conducted an audit of the MSLC in accordance with applicable generally accepted government auditing standards, and accordingly included such audit procedures and tests as we considered necessary under the circumstances. Our audit covered the period July 1, 2003 through January 31, 2005.

The objectives of our audit were to:

- Review and analyze financial and administrative activities of the MSLC in reference to our previously issued audit report (Audit No. 2003-0089-11S).
- Update the status of prior audit results and review the corrective actions implemented by the MSLC since our last audit.
- Review the MSLC's improvements relating to internal controls and revenue enhancements, including the appointment of an internal control officer, development of a comprehensive internal control plan, and a thorough department wide risk assessment.
- Assess the effectiveness of the MSLC's investigatory and oversight activities regarding sales agents, including the investigation of missing/stolen lottery tickets and monitoring sales agent compliance with licensing agreements and MSLC regulations.

To achieve these objectives, we reviewed applicable state and federal laws, rules, and regulations, as well as the MSLC's own internal policies and procedures. We interviewed selected MSLC personnel; tested and reviewed MSLC accounting records and transactions; and analyzed various administrative, personnel, and other agency documents, including sales agents contracts, various MSLC reports and records, and minutes of Commission meetings. In addition, we conducted various analyses of prize claim information maintained by the MSLC. The purpose of our testing in this area was to determine on a test basis the accuracy of the information being provided by prize winners to the MSLC and to identify any unusual patterns or instances involving claims that we believe may warrant further review and investigation.

Except as reported in the Audit Results section of this report, for the areas tested, we have concluded that the MSLC has taken corrective action on prior audit results, improved internal controls, and complied with applicable laws, rules, and regulations. The recommendations in this report are made to assist the MSLC in developing and implementing its internal control structure and financial and administrative functions to ensure that they are adequate to minimize the occurrence of errors, mistakes, or illegal acts and that the MSLC is operating in an economical, efficient, and effective manner in which assets and revenues are maximized and safeguarded and in compliance with all applicable rules, regulations, and laws.

The MSLC has responded to certain of our audit result recommendations and those responses are included throughout this report.

AUDIT RESULTS

1. PRIOR AUDIT RESULTS RESOLVED

During our follow-up review, we determined that the Massachusetts State Lottery Commission (MSLC) has taken corrective action to resolve issues revealed in our prior audit report regarding special arrangements with one sales agent; compliance with Chapter 647 reporting requirements, including the OSA audit authority clause in MSLC contracts; compliance with certain provisions of the state's open meeting law; revenue enhancement, and improved internal controls.

a. Special Arrangements with One Sales Agent Terminated

Our prior audit disclosed that one sales agent had an exclusive agreement with the MSLC to pay individual claims of up to \$25,000, whereas all other of the 7,300 sales agents were limited to paying claims of up to \$600, thereby allowing this agent to receive an unfair competitive advantage and greater commissions than other sales agents. Our prior audit recommended that the MSLC limit this sales agent's cash payments to \$600, and ensure that all of its sales agents abide by the same rules and regulations. Also, our review recommended that the sales agent's internal controls be evaluated to strengthen oversight and prevent "professional" cashers from shielding and evading the tax withholding system.

Our follow-up review disclosed that the MSLC's agreement with the sales agent in question was amended on September 23, 2003, so that the sales agent has the same sales agent arrangement that all other MSLC sales agents have. Our testing of cash payment transactions since the effective date of this amended agreement revealed that this sales agent has adhered to the \$600 claim payment limit.

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

Prior reports disclosed thousands of unreported incidents of thefts and losses involving instant game tickets, as well as shortages at various MSLC offices, that were not reported to the Office of the State Auditor (OSA), contrary to Chapter 647 of the Acts of 1989. Our prior audit report recommended that, since instant game tickets are Commonwealth property, missing, stolen, and unaccounted-for tickets must be reported to the OSA as required by Chapter 647 for an independent review of the circumstances, and to make recommendations to improve the internal controls over instant game tickets.

Our follow-up review disclosed that a cooperative effort between the OSA and the MSLC has resulted in the electronic transmittal of missing, stolen, and unaccounted-for instant game ticket incidents from the MSLC to the OSA. The MSLC has indicated that it is aware of and intends to comply with the requirements of Chapter 647 of the Acts of 1989 regarding the reporting of all unaccounted-for variances, losses, shortages, or thefts of funds or property to the OSA.

The Assistant Executive Director of Internal Control/Compliance explained that steps to comply had been taken prior to the submission of the Chapter 647 reports to the OSA. 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. The security person enters this information in the MSLC database and submits 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 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 and testing revealed that the MSLC is electronically transferring reports of unaccounted for variances, losses, shortages or thefts of funds or property to the OSA in compliance with the law and the agreed upon procedures and format. In addition, our testing of three cases in which instant games tickets were reported lost or missing indicated that the MSLC was adhering to its in-house investigatory procedures described above.

c. OSA Audit Authority Clause Included in MSLC Contracts

Our prior audit disclosed that the MSLC's Sales Agent Agreements did not contain the clause required by MGL Chapter 11, Section 12 that indicates the OSA has the right to examine the accounts, books, records, and activities of the contractor.

Our follow-up review disclosed that in the summer of 2003, Section 7.5 of the MSLC Sales Agent Agreement was amended to include the following clause:

The Agent agrees to authorize the Department of the State Auditor, and the Principal to inspect, review, or audit in conformity with generally accepted government auditing standards, accounts, books, records and activities of the Agent. This inspection, review or audit is limited to the Agents' accounts, books, records and activities with the Principal.

We reviewed several Sales Agent Agreements and updated sales agent contracts and found that they contained this amended language.

d. Compliance with Certain Provisions of the State's Open Meeting Law

Our prior audit disclosed that the MSLC did not fully comply with the requirements of MGL Chapter 30A, Section 11A 1/2, commonly referred to as the Open Meeting Law, when convening meetings in executive session. For example, the MSLC did not maintain minutes of any of the matters discussed in meetings held in executive session, and in four instances did not state the reasons for convening in executive session.

Our follow-up review disclosed that the MSLC is in full compliance with the provisions of the Open Meeting Law. This compliance includes strict adherence to recording minutes, the calling of the roll, a declaration of the commencing of the executive session, and a declaration of the reconvening of the regular session. Our review also revealed that the MSLC met 11 times during regular commission meetings and once in executive session during the audit period. We reviewed the minutes for both the regular commission and the executive session meeting and found that proper roll was taken and minutes were recorded for both the regular commission meetings and the executive session meeting.

e. Revenue Enhancements for High-End Instant Game Tickets and Keno

Our prior audit included recommendations to enhance revenue relative to Keno games and high-end instant game tickets. The MSLC implemented the following enhancements to the high-end instant game tickets and Keno:

- With respect to Keno games, we recommended consideration be given to expanding Keno into other venues in order to increase sales. Our follow-up review revealed that the MSLC enhanced Keno revenue by reducing the intervals between Keno games from five minutes to four minutes. The modifications resulted in a 10.4% increase in Keno revenue in fiscal year 2003 and an increase of 9.8% in fiscal year 2004.
- We recommended that the MSLC consider designing games with a matrix or distribution of payouts with higher-level prizes (i.e., some mix of \$100 to \$1,000 or more) to be offset from smaller prizes in order to generate more sales. Our follow-up review revealed that MSLC products now include games with prize matrices that feature both high- and low-tier prizes to attract the different types of players who purchase lottery products. Free bets are included in these prize matrices and contribute to additional sales. Upon reviewing the matrix/distribution of the MSLC's game payouts, we found that there was a 4.21% increase in revenue from fiscal year 2003 to fiscal year 2004. In addition, the MSLC introduced the Cash Winfall game to replace the Mass Millions game (which was experiencing revenue decreases) and a year-round \$10 instant game ticket. When the MSLC introduced a year-round \$10 instant game ticket during fiscal year 2004, there was a steady decline in revenue from the \$5 instant game ticket of \$3,609,290 per month, whereas the year-round \$10 instant game ticket increased by \$8,146,260 per month, indicating the desirability of high-tier prize games among MSLC customers.
- We recommended the MSLC consider introducing additional \$10 tickets and an additional \$20 ticket at key times during the year. Our review disclosed that MSLC offers its customers a choice of two \$10 tickets. During our follow-up audit we reviewed the amount of tickets introduced by the MSLC for the \$10 and \$20 instant game at key times during the year. The MSLC indicated that it has no imminent plans to issue a \$20 instant game ticket. However, we found that three \$10 instant game games were introduced, of which one game was discontinued in 2003 and replaced by a new game in 2004. The revenue from \$10 tickets within calendar year 2004 significantly increased from \$366,953,030 in the first six months to \$613,790,190 in the second six months.

f. Internal Control Improvements Implemented

Our prior audit recommended that the MSLC consider implementing certain measures to improve its system of internal controls, as follows:

- Since MSLC sales agents have the benefit of using MSLC funds (float) for anywhere between one and two weeks, depending on when revenue is swept, we recommended that the MSLC determine the cost-effectiveness of conducting more frequent collections

- (sweeps) from sales agents to eliminate the float and increase cash flow to the MSLC. In addition, we recommended that the MSLC ensure that, during the quarterly and annual fiscal year revenue cut-offs, all net revenue due to the Commonwealth is recorded as income in the proper period, accounts receivables are evaluated for accuracy and recovery, and any adjustments to revenue are made timely. Our follow-up review revealed that new sales agents who have historically proven to be a financial risk to the MSLC are placed on weekly sweeps to minimize the risk of loss. In addition, the MSLC records on an annual and quarterly basis the net revenue due to the Commonwealth, accounts receivable are evaluated for accuracy and recovery, and any adjustments to revenue are made timely.
- Our prior report recommended that the MSLC consider charging specific late fees or a percentage of the amount due, whichever is greater, to sales agents whose accounts cannot be swept because of insufficient funds. Our follow-up review revealed that the sales agents whose accounts cannot be swept because of insufficient funds are now charged fees in accordance with their first and second missed sweeps as detailed in Audit Result No. 2d. When a sales agent account cannot be swept for a third time, the sales agent's privileges are suspended, and a final settlement is completed. The sales agent must appear for a MSLC hearing in order to be reinstated. In each case of a missed sweep, the sales agent is charged a Not Sufficient Funds (NSF) fee of \$75 per missed sweep.
 - Our prior report recommended that the MSLC charge a reasonable application fee for new sales agents to cover the costs of processing, conducting background and credit checks, training, etc. Our follow-up review revealed that as of July 1, 2004 the MSLC has been charging new sales agents an application fee of \$200. Moreover, our audit testing disclosed that these application fees were being properly charged and collected.
 - Our prior report recommended that the MSLC establish regional advisory councils of sales agents and sales representatives to meet regularly to discuss issues and ideas to improve operations with representatives from each region, meeting periodically with the Executive Director and State Treasurer. Our follow-up review disclosed that, at least annually in each region an advisory panel meeting is held at which all sales agents are invited to attend to discuss issues and ideas to improve operations. Representing the MSLC at these advisory panels are the Assistant Executive Director/Sales, the regional managers, and a variety of MSLC department managers. In addition, field representatives may attend on a voluntary basis.
 - Our prior report recommended that the MSLC incorporate all policies regarding employee benefits for union and non-union employees, as well as travel policies for both in-state and out-of-state travel, into the MSLC's policies and procedures. During our follow-up review the MSLC provided a copy of the policy regarding employee travel. Changes were made to the travel and related policies and procedures. Also, the Executive Director recommended the adoption of a travel policy which would require following the federal meals and incidental expenses and mileage rates, reimbursing actual cost for lodging, rental cars and air fare, and paying those costs directly by the MSLC with the proper approvals.

- Our prior report recommended that the MSLC ensure that a disputed telecommunications over-billing is adjusted and credited to future billings. Also, the MSLC should consider taking advantage of the statewide contingent fee contract for the Telecommunications Audit Services to possibly identify current or past overcharges and/or improper tariff rates and to negotiate a refund on behalf of the MSLC. Our follow-up review disclosed that, as a result of extended negotiations with Verizon, the final outstanding accounts payable totaling \$1,518,641 was credited to the MSLC's account by Verizon in April 2003.

2. PRIOR AUDIT RESULTS UNRESOLVED OR PARTIALLY RESOLVED

During our follow-up review, we determined that the MSLC did not fully resolve certain issues identified in our prior audit report. Specifically, the MSLC needed to improve its (a) controls to deter the activities of professional ticket cashers, (b) internal audit function, (c) risk assessment/internal control plan, (d) controls over sales agent accounts receivable, (e) controls over unallowable sales agent ticket scanning and purchasing activities, and (f) documentation of quality control procedures in the manufacture of instant game tickets.

a. Ineffective Controls Over "Professional" Ticket Cashers Results in Hundreds of Millions of Dollars of Unclaimed and Unreported Income and Lost Tax Revenue

Prior audit reports illustrated numerous instances in which the same individuals were repeatedly claiming hundreds of prizes valued at millions of dollars over several years. Moreover, many of these claims occurred at one time on the same day, had little or no taxes withheld, and were from several agents from several locations, all of which indicates that that some or most of these claims represent the activities of so-called "professional" ticket cashers. Such individuals charge legitimate winners 10 percent of the winnings, while the real winners avoid up to 30 percent in taxes. Our follow-up audit disclosed that this practice was not only ongoing but occurring at an accelerated rate.

The MSLC produces a monthly and year-to-date report (20/20 Report) that identifies any individual who has cashed 20 or more winning tickets totaling \$20,000 or more. This report is provided to the Internal Revenue Service (IRS), the Massachusetts Department of Revenue (DOR) and the Massachusetts Attorney General (AG) on a monthly and a cumulative basis for the calendar year. During calendar year 2004 this report included 88 individuals who had cashed over 5,332 in prizes totaling \$10,065,427. This cashing practice is continuing, even though the MSLC terminated an exclusive arrangement to pay claims of up to \$25,000 at one sales agent

outlet (see Audit Result No. 1a) favored by these professional cashers. Specifically, our follow-up review disclosed the following issues regarding the activities of professional ticket cashers:

- The following exhibit illustrates the top 10 cashers in calendar year 2004 and their corresponding cashing activity in calendar year 2003.

| Rank | Residence | Calendar Year 2004 | | Calendar Year 2003 | |
|------|------------------|-----------------------|--------------------|-----------------------|--------------------|
| | | Number of Prizes | Amount | Number of Prizes | Amount (1) |
| 1 | Lynn | 666 | \$1,173,752 | 530 | \$ 940,000 |
| 2 | Waltham | 443 | 654,200 | 228 | 334,000 |
| 3 | Everett | 343 | 631,340 | 274 | 570,000 |
| 4 | Braintree | 394 | 638,338 | 20 | 44,000 |
| 5 | West Newton | 365 | 539,700 | 193 | 294,000 |
| 6 | Lynn | 47 | 318,000 | - | - |
| 7 | West Bridgewater | 190 | 266,000 | 20 | 27,000 |
| 8 | Fall River | 158 | 229,000 | 272 | 533,000 |
| 9 | Watertown | 118 | 205,000 | 65 | 90,000 |
| 10 | Braintree | 112 | 180,000 | 27 | 40,000 |
| | | <u>2,836</u> | <u>\$4,835,330</u> | <u>1,629</u> | <u>\$2,872,000</u> |

(1) Rounded to nearest thousand

- Further examples of individuals with a large number of claims and prize winnings include the following:
 - In calendar year 2003, 71 individuals cashed 4,527 winning tickets totaling \$8,228,480.
 - During calendar years 2002, 2003, and 2004, an individual cashed 1,588 winning tickets totaling \$2,840,000.
 - One individual cashed 20 winning tickets totaling \$44,336 in calendar year 2003 and an additional 394 tickets totaling \$638,338 in calendar year 2004.
- In calendar year 2003, a sales agent cashed 21 winning tickets totaling \$243,483. In calendar year 2004, the same sales agent cashed 25 winning tickets totaling \$36,500 that were purchased at 10 different locations. On November 30, 2004, this sales agent cashed 14 winning instant game tickets at the Braintree Office valued at \$1,000 each that were purchased from eight different sales agents. This individual is included in the MSLC's listing of licensed sales agents as of September 18, 2001, and the corporation that owns this sales outlet bears this individual's name. In addition, the corporate information filed with the Commonwealth's Secretary shows this same individual as a principal in the corporation, and the February 2005 list of agents obtained from the MSLC shows the same individual still involved in the corporation. Evidence of a sales agent participating in a ticket cashing scheme as a professional casher could cause doubt as to the integrity of the games, create an atmosphere of suspicion, and raise questions surrounding these practices.

- A cashier from Brockton redeemed 48 tickets in Braintree and 142 in Fairhaven for \$266,378 in 2004. Of these 190 tickets, only 12 were purchased in Brockton and the remaining 178 were purchased from agents as far away as Orleans, North Attleboro and Watertown.
- During the prior audit we referred a number of professional cashiers that claimed large numbers of lottery prizes to our Bureau of Special Investigations (BSI) for investigation to determine the potential for fraud against various government assistance programs. The BSI investigation resulted in the identification of seven individuals who were receiving medical assistance from MassHealth while collecting \$1,750,200 in lottery prizes. The potential recovery is approximately \$174,000, as follows:

| Case | Period | Lottery Winnings | | Prize Winner | Benefits Recoverable |
|------|---------------------|------------------|--------------------|----------------------|----------------------|
| | | | Amount | | |
| 1 | 02/01/02 – 08/31/02 | | \$ 200,000 | Professional Cashier | \$ 14,400 |
| 2 | 07/02/01 – 07/02/03 | | 280,000 | Professional Cashier | 39,500 |
| 3 | 04/20/01 – 04/06/04 | | 845,000 | Professional Cashier | 41,300 |
| 4 | 09/27/99 – 04/06/04 | | 171,000 | Large Winner | 46,100 |
| 5 | 04/20/01 – 04/06/04 | | 72,500 | Large Winner | 10,900 |
| 6 | 05/05/02 – 04/06/04 | | 135,000 | Large Winner | 10,000 |
| 7 | 03/23/01 – 03/31/03 | | 46,700 | Large Winner | 11,700 |
| | | | <u>\$1,750,200</u> | | <u>\$173,900</u> |

Also, in accordance with MGL Chapter 10, Section 28B, the MSLC is providing the Department of Transitional Assistance (DTA) a list of all persons (including their address and Social Security number) who were holders of any winning ticket in excess of \$600 in the prior month. However, the law does not require that this information be transmitted to the Department of Medical Assistance (MassHealth). Although the MSLC indicated that the DTA transmits this information to MassHealth, there is inadequate assurance that such information is transmitted monthly and on a timely basis.

The fact that professional ticket cashing activity occurs is well-known and indisputable, given the implausible mathematical probability that just 88 individuals were able to cash over 5,000 prizes totaling \$10,065,427 in one year. Audit Result No. 5 further demonstrates how professional cashier activity was enabled by obtaining letters of introduction for presentation to the payee bank from the MSLC. Additionally, the practice of allowing professional ticket cashier activity to occur results in the following inefficiencies and deficiencies:

- The issuance of thousands of separate W-2G income reporting forms to the taxing authorities instead of a summary form for the year for each cashier.
- Circumvention of both state and federal tax laws and regulations (the practice shields the real tax obligator).

- Filing of false claims, reports and tax returns on behalf of themselves and the true owners of prizes to federal and state tax authorities.
- Prevention of the Commonwealth intercept policies from the garnishment of potential amounts due for taxes, child support, etc.
- Prevention of the State and Federal Authorities from detecting the true individual winners who may be legally receiving public assistance.
- Cashier's ability to falsely assert status as a professional gambler and receive certain federal and state tax benefits that accompany such status.
- Large amount of cash is made available to individuals engaged in this illegal enterprise.
- Large amounts of federal and state taxes are being underwithheld and evaded.

Most importantly, the continuation of this situation could undermine public trust in the integrity of MSLC games.

Recommendation

The MSLC should take immediate action to mitigate the potential risks associated with professional ticket cashers by exercising its authority under MGL Chapter 10, Section 24, as follows:

- Immediately report any suspicious cashing activities to law enforcement officials.
- Implement a policy that prohibits the cashing of a winning ticket from any individuals, excluding annuity recipients, who have been identified by the MSLC on its 20/20 Report of frequent MSLC winners or any other individual appearing to be involved in suspicious activity.
- Establish and revise its rules and regulations to require the withholding of federal taxes on all prizes of \$600 or more. (On December 1, 2004, the Legislature amended Chapter 62B, Section 2, of the General Laws to require the withholding of Massachusetts income taxes on all winnings of \$600 or more.)
- Join with the Office of the Attorney General and the Department of Revenue in an effort to have the federal government modify its regulations to require withholding taxes on all winnings of \$600 and over.
- Encourage other state lottery commissions and the Internal Revenue Service to join in the effort to promote modification of the federal government's tax laws and regulations.

- Immediately terminate any sales agent found to have been participating as professional cashers in professional ticket cashing activities.
- Provide the OSA's Bureau of Special Investigations (BSI) with the monthly and annual 20/20 activity reports, so that BSI can monitor and investigate activities on an ongoing basis.
- Submit legislation to amend Chapter 10, Section 28B, of the General Laws to require that MassHealth receive a list of persons who were holders of any winning ticket in excess of \$600.

Auditee's Response

As your audit result noted, a monthly report has been issued from the MSLC to the Internal Revenue Service, Department of Revenue and the Office of the Attorney General since 1999. The report identifies individuals who have accrued Lottery winnings of sufficient quantity and value to be considered professional cashers. MSLC views the enforcement of claimant reporting failures to be the purview of those agencies. Currently, MSLC does not believe it has the authority to decline payment for a legitimate prize share based on the prior cashing history of the claimant.

Moreover, the MSLC took part in the December 2004 change to MGL Chapter 62B, Section 2 in the hope that it would curtail that type of conduct. As the result of that effort the threshold for withholding taxes at the point of prize redemption has been reduced from \$5,000 to \$600. MSLC would support changes to the Federal Tax Code which would similarly increase withholding. MSLC intends to adopt further measures to monitor and discourage the practice of professional cashing. Efforts to increase the liability of those who would attempt to avoid state and federal reporting obligations have been undertaken and will be implemented.

b. Internal Audit Function Needs Improvements

Our prior audit recommended that the MSLC immediately establish audit oversight and internal control functions to determine the efficiency, effectiveness, and benefit of retaining the internal audit function in-house or outsourcing it to a professional organization. In either case, our audit recommended that the MSLC conduct a comprehensive analysis of internal audit duties and responsibilities in order to develop a plan, based on an organization-wide risk assessment, for a series of scheduled reviews and tests of MSLC systems, functions, programs, activities, and operations. This internal audit oversight would be for all MSLC operations, including regional offices and sales agents, to ensure that the MSLC fulfills its responsibilities. This oversight should also include a review of the systems, policies, and procedures in place in order to ensure efficient and effective operations. The importance of the internal audit function in the MSLC's overall financial management and control process is essential and must be performed independent of ongoing operations and report directly to the Executive Director, the Commission, and the State Treasurer.

Our follow-up audit disclosed that on July 1, 2003, the MSLC established its Internal Audit/Compliance Department and created the position of Assistant Executive Director for Internal Audit/Compliance reporting directly to the Treasurer of the Commonwealth. Currently, there are four people assigned to the department. We examined several of the internal audit reports issued by the Assistant Executive Director for Internal Audit/Compliance since the position was filled. We noted that the scope of the reviews has been limited to regional offices, television drawing compliance, game closure procedures, operations at fairs, and physical inventories. There was no comprehensive plan and schedule of reviews for all functions and activities of the MSLC, and, in particular, there were no audits evaluating internal controls and risk assessment of the MSLC's financial and programmatic operations. In fiscal year 2002, the MSLC retained an accounting firm to conduct an overall network security assessment. Given the MSLC's responsibilities under MGL Chapter 10, Section 24, it should continuously evaluate its operations to determine where improvements are needed and have an effective and proactive internal audit function, as demonstrated throughout our report. The MSLC indicated that it has on January 31, 2005 contacted a private accounting firm to prepare a risk assessment and assist in the preparation of an internal audit plan. (See Prior Audit Results No. 2c.)

Recommendation

The Internal Audit/Compliance Department should place a high priority on and implement the following:

- Develop an internal audit plan based on a risk assessment of MSLC operations and submit this plan annually to the Treasurer, Executive Director, and Commission for review and approval.
- Assess staff capabilities, particularly in the information technology area, in order to effectively and efficiently complete the annual audit plan and risk assessment. In this regard, in order to fulfill the internal audit responsibilities effectively, consideration should be given to outsourcing specific tasks beyond current capabilities, augmenting staff, or having an Internal Audit Unit at the highest Office of the State Treasurer (OST) level covering all functions and responsibilities of the OST (i.e., the OST PRIM Board, State Retirement Board, School Building Authority, Water Pollution Abatement Trust Fund, and the Alcoholic Beverage Control Commission).

Auditee's Response

The MSLC's newly created Internal Audit department is proceeding with a multi-phase plan to establish a professional and meaningful method by which risk is identified and

tested. Phase 1 of the plan was completed in June of 2005. That phase consisted of the development of a mission statement, objectives, internal control procedures narrative, risk assessment, and risk control matrix for each department within the MSLC. Phase 2, which will be completed by June 30, 2006, establishes audit programs by which the internal controls that mitigate the risk identified within each department are tested. Audit programs have been applied to the internal controls for the MSLC's Human Resources, Licensing and Security departments. The findings have been used to develop a reporting template which will issue to the Treasurer and Receiver General and the MSLC Executive Director on a quarterly basis and will encompass all remaining MSLC departments.

c. Risk Assessment/Internal Control Plan Needs Improvements

Our prior audit disclosed that the MSLC had not developed an internal control plan and an organization-wide risk assessment as required by Chapter 647 of the Acts of 1989 and in accordance with the Office of the State Comptroller's (OSC) guidelines that should have been completed July 1, 2002. Also, in the spring 2002 letter to all Internal Control Officers (ICO) Single Audit Liaisons, the OSC distributed an internal control questionnaire re-emphasizing that:

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

In response to our audit, the MSLC indicated that they were in the process of developing an organization-wide risk assessment, as follows:

We are in the process of developing a Lottery-wide Risk Assessment Plan and editing the Internal Control documents for all our operations. Each department has been charged with conducting a Risk Assessment of their operations, ... and documenting the Internal Controls in place to address the issues raised in the Risk Assessment. This effort will be overseen by the Internal Auditor and is scheduled to be completed in this Fiscal Year.

In a May 3, 2004 letter of response to our prior audit, MSLC's management stated that they are on schedule in internally developing a risk assessment. Our follow-up review disclosed that the MSLC is still in the process of developing its organization-wide risk assessment on a department-by-department basis. The agency-wide risk assessment is needed in order to develop a comprehensive internal control plan and an effective internal audit function.

On January 31, 2005, the MSLC retained an outside accounting firm to complete the department-wide risk assessment and identify the control activities that will mitigate those risks. This effort remains a work in progress. This effort was scheduled to be completed by June 2005. We have reviewed the progress to date with the accounting firm and agree with both the

scope and approach to the development of the plan. Upon completion of the risk assessment, the firm will assist the internal audit department in the completion of the internal control plan.

Recommendation

The MSLC should prioritize the completion of the internal control plan, supported by an organization-wide risk assessment, and ensure that it is completed expeditiously in accordance with the requirements set forth by the OSA and the OSC, so that the internal audit department can implement the plan and conduct reviews in the various operations of the MSLC.

Auditee's Response

See response to Section 2b.

d. Improvements Needed on 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 ineffective debt collection procedures and was not adhering to its own internal policies and procedures relative to the collection of millions in outstanding sales agent accounts receivables. Our prior audit recommended the following:

- The MSLC should consider placing liens on those sales agents for amounts owed when it becomes necessary to terminate them as sales agents.
- The MSLC should conduct more extensive credit and background checks extending beyond their Massachusetts history on all new sales agents and annually thereafter for all sales agents.

Our follow-up review disclosed that the MSLC has implemented our prior audit recommendations, as follows:

- A new licensure procedure allows the MSLC to place liens on those sales agents for amounts owed when it becomes necessary to terminate them as sales agents. The new MSLC regulations allow for the collection of past-due accounts after the change of ownership of a sales agent. The annual licensure agreements that are being implemented include an individual guarantee for payment of the debt as the old agreements expired. Implementation began July 1, 2004, and all sales agents will be operating under this new licensure agreement.
- The MSLC now performs a more extensive credit and financial evaluation of all new agents and a more comprehensive annual licensing procedure, including a more detailed security background check and site evaluation, to mitigate risk.

In addition, a revised sliding scale bond fee structure has been implemented for new and existing agents. The fees are intended to cover potential MSLC losses as a result of the costs associated with delinquent or terminated sales agents. However, we found that sales agent accounts receivable over 90 days remains an issue. Specifically, our follow-up review disclosed the following accounts receivable balances over 90 days old:

| Fiscal Year | Accounts Receivable Balance | Amount under 90 Days | Amount over 90 Days |
|-------------|-----------------------------|----------------------|---------------------|
| 2003 | \$5.7 Million | \$1.4 Million | \$4.3 Million |
| 2004 | \$6.3 Million | \$900,000 | \$5.4 Million |
| 2005* | \$5.0 Million | \$400,000 | \$4.6 Million |

*First six months of fiscal year 2005

The following amounts were written off as sales agent bad debt expenses:

| Fiscal Year Ended | Amount Written Off |
|-------------------|--------------------|
| June 30, 2003 | \$1.8 Million |
| June 30, 2004 | \$700,000 |

The MSLC has instituted a program under which it bills its sales agents on either a weekly or a bi-weekly basis for funds owed the MSLC. Sales agents deposit funds from MSLC sales activity into a bank account, and the account is “swept” on a weekly basis for the on-line products and on a bi-weekly basis for the instant game tickets in order to allow the MSLC to collect the revenue. Sales agents that have one “bounced” or missed sweep as a result of insufficient funds deposited into the account are moved from a bi-weekly instant game ticket settlement period (the billing cycle for agents with a good collection history) to a weekly settlement period. If the sales agent bounces a third sweep, the sales agent’s privileges are suspended, a final settlement is prepared, and the sales agent must attend a hearing in order to be reinstated. In each of these cases the sales agent is charged a Non Sufficient Funds fee of \$75 per bounce. If the sales agent is successfully reinstated, the sales agent’s fee increases from \$.35 per day to \$2 per day after the third bouncing incident. All new sales agents, with whom the MSLC has had no prior experience, are assessed a fee of \$2 per day. All existing sales agents, however, remain assessed at the \$0.35 daily rate. As of February 2005, 1,342 of 7,460 sales agents were on a weekly billing schedule, with 38 sales agents suspended pending a review and a hearing for reinstatement.

There are five reasons that a sales agent’s license may be revoked for delinquent or unpaid sweeps, as follows:

- Three missed sweeps within a 12-month period;
- Two consecutive missed sweeps;
- An unpaid sweep outstanding for more than 30 days;
- Two nonconsecutive unpaid missed sweeps;
- A determination by the Finance Department that the sales agent is a “financial risk.”

Every effort is made by the MSLC to accommodate payment of the outstanding debt by the sales agent whose license has been revoked. Reminder notices are sent at 16, 31, and 46 days after the agent’s terminal is deactivated. Collection notices begin at 60 days, and the Revenue Recovery Unit of the MSLC is assigned to the sales agent for collection of the debt after the 16-day notice has been issued.

MSLC staff meet on a quarterly basis to review recently revoked agents that have not sufficiently paid the amount they owe the MSLC. MSLC officials indicate that every effort is made to assess and accommodate revoked sales agents that are making payment and whether they can make payments before finally turning the account over to one of the MSLC’s two collection agencies for satisfaction of the outstanding receivable that is deemed uncollectible by these means.

Generally, the sales agent that is not making payments on their outstanding accounts receivable will either have liens placed on their owner-operated agency or will have their account assigned to a collection agent for a non-owner-operated agent after 90-days or earlier, or after 60-days if the agent is considered to be a flight risk.

The revenue generated by the MSLC from sales agent bond fees from fiscal year 2002 through the first six months of fiscal year 2005 were as follows:

| Fiscal Year | Fees Received |
|-------------|--------------------|
| 2002 | \$ 961,000 |
| 2003 | 968,000 |
| 2004 | 990,000 |
| 2005* | <u>518,531</u> |
| Total | <u>\$3,437,531</u> |

*First six-months of fiscal year 2005.

MSLC officials believe that the revenue amounts from fees will eventually increase, with the ongoing addition of new sales agents, to meet the amounts needed to cover the allowances for write-offs in the \$1 million to \$2 million annual range. Although revenue from fees for the first six months of fiscal year 2005 are \$518,531, which is 5% higher on an annualized basis over fiscal year 2004, they still may not be sufficient to cover the potential losses from uncollectible accounts receivable that may occur in future years.

Recommendation

The MSLC should:

- Reduce the time limit before it hands over uncollectible accounts to its collection agencies or place a lien on the property, whichever is appropriate, to 60 days instead of the current three months.
- Increase its fees charged to sales agents to more accurately reflect the potential loss from uncollectible accounts receivable balances.
- Continue to pursue all outstanding accounts receivable with every means at its disposal for the prompt collection of accounts receivables.

Auditee's Response

Sales Agent account receivable balances continue to decline. As of June 30, 2005, the total sales agent receivable balance was \$5,581,000, down 11.4% from the prior year balance of \$6,300,000. The sales agent accounts receivable total as of June 2005 represents 1/10th of 1% of MSLC's total revenues in FY 2005. In short, the MSLC rate of collection from delinquent sales agents has improved and will continue to be a focus.

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

Prior audit reports have raised questions regarding the internal controls, policies, and procedures over sales agents' ability to scan unsold instant game tickets. Ticket scanning by a sales agent is the valid practice of placing sold tickets into the MSLC terminal to register a winning ticket into the MSLC system for redemption. "Peeking," however, is the invalid practice of scanning tickets prior to sale for the purpose of determining winning tickets. In order to control peeking activity by sales agents, the MSLC investigates all instances in which a sales agent has scanned eight or more losing tickets in a single day, which is an indication that a sales agent may be scanning unsold instant game tickets to find a winning ticket. This practice has significantly reduced the instances of peeking.

Our prior audit recommended that the MSLC ensure that its compliance unit monitor sales agents for unusual, irregular, and questionable activities and patterns, taking appropriate action as warranted. The report also urged that the MSLC institute controls and measures to offset or intercept prize money won from any active, suspended, delinquent, or terminated agent who owes any money. The MSLC responded by stating that the new MSLC administration has established new sales agent monitoring guidelines. These new guidelines include not only daily, weekly, and monthly reports of errors for review by the Compliance/Internal Audit Unit, but also on-line instant reporting of infractions.

Our follow-up review determined that during July 2003, the MSLC amended its policy with regard to these errors. Now, when a sales agent appears on a weekly printout indicating an unacceptable level of error, a member of the Compliance/Internal Audit Unit visits the sales agent in person immediately. The compliance officer shows the sales agent documentation indicating the date, time, and type of error; reinstructs the sales agent in the proper operation of the MSLC terminal; and serves the sales agent with a letter advising him or her that a second appearance on the weekly unacceptable error printout will result in a 30-day suspension of the auto-cash privilege subject to investigator discretion.

A second appearance on the unacceptable error printout warrants another in-person visit and a hand-delivered letter of suspension of the auto-cash privilege. The sales agent is advised of the date, time, and type of occurrence, and the auto-cash privilege is then disabled. The sales agent is given a date, at least 30-days hence, after which he or she may call the Compliance Unit for auto-cash reinstatement. A third appearance on the weekly printout of unacceptable error results in an indefinite suspension of the auto-cash privilege and requires a hearing administered by the MSLC Legal Department before auto-cash reinstatement is considered. Each instance of contact with a sales agent relating to auto-cashing is documented on a spreadsheet maintained by and shared among the Compliance Unit members.

Our follow-up review revealed that, in the seven months prior to the policy change specified above, the Compliance Unit responded to 164 first offenses and 15 second offenses. In the past seven months, the Compliance Unit responded to 68 first offenses and 10 second offenses. The totals for October 2003 were 17 first offenses and six second offenses, significantly higher than the other months in the post-policy change group due to a quality control issue for the \$640

Million Jubilee game (See Audit Result 2f). Additionally, the prior audit recommended that the instant ticket cashing be rolled back from a daily error combination of 11 to six incidents. The MSLC, after much consideration, set that figure at eight, and implemented that decision on December 4, 2003.

The MSLC implemented these changes to its policies and procedures and significantly reduced the number of infractions that a sales agent can perform without remedial action taking place. We acquired and reviewed the Auto-Cash Report, which lists all “peeking” infractions since December 2002 and the corrective action for those infractions, and noted the following:

- During calendar years 2003 and 2004 a total of 360 peeking infractions occurred for the entire sales agent population. This represents a significant decrease in occurrences and an improvement in the system, since prior audits noted infractions of 700 per year. Moreover, we found that the MSLC notified all sales agents as outlined in the corrective action plan.
- There were 32 second warnings during the same two-year period, and 30-day auto-cash suspensions were administered to all of these offenders.
- There was only one third-time offender, for whom a hearing was scheduled with the MSLC’s Legal Department concerning the matter as outlined by the corrective action plan.

The MSLC complied with their corrective action plan as outlined by administering warning letters, suspending auto-cash privileges, and scheduling an administrative disciplinary hearing for a third time offender.

Our prior audit also emphasized that strong oversight, monitoring, and enforcement be exercised over sales agents in order for the public to have confidence in the fairness of games, and we further recommended that the MSLC place a prohibition on sales agents purchasing tickets from their own stores.

Recommendation

The MSLC should continue to monitor the instances of agent infractions with the goal of the elimination of agent “peeking” activities.

Auditee's Response

Pragmatically, it would be impossible to enforce a ban against sales agent purchasing, since; a) the MSLC is not required to keep an active database of agent employees beyond those employees of significant authority; b) prizes awarded under \$600 are cashed without the need for identification, and c) enforcement at 7,500 agent locations would be logistically untenable.

Given that the overall integrity of the MSLC is of paramount concern to the organization, the Executive Director sent a code of conduct letter to all sales agents of the MSLC. In that correspondence, the Executive Director strongly discouraged agents and their employees from purchasing tickets from the locations where they work.

Auditor's Reply

Regardless of enforcement practicality, the prohibition of agents and their employees from purchasing tickets from their own stores would act as a deterrent since most people tend to obey laws, rules and regulations. The MSLC should consider immediately suspending the agent's license in repeat cases, and based upon the results of the investigation, revoking their licenses.

f. Improvements Needed in the Documentation of Quality Control Procedures over Instant Game Ticket Manufacturing

Our prior audit recommended that the MSLC determine and recover any additional costs incurred as a result of defective lottery tickets and that the MSLC keep its business dealings simple and straightforward. Further, this report stated that the MSLC should obtain reimbursement for any future costs or losses caused by contractor error or deficiencies in the product. In addition, we recommended that the MSLC make public notification that some tickets are defective and void, reprint and replace defective tickets, and ensure that the reprinted tickets contain the same prizes as the original tickets.

After our last audit, the MSLC was notified that individuals purchasing tickets within certain \$640 Million Jubilee instant game books were experiencing difficulty removing the protective latex covering from the tickets. As a result, on November 3, 2003, MSLC management announced the formation of new instant ticket quality control procedures. The procedures included:

- Establishment of a permanent Quality Control Committee composed of members of MSLC senior management to monitor defective tickets.
- Maintenance of a watch list to track identified defective tickets.

- Reporting of patterns and concerns regarding defective tickets to the Executive Director with suggested course of action.

Each contract between the MSLC and its individual instant ticket manufacturers identifies unacceptable quality conditions. If a game contains substantial manufacturer error pursuant to that contract, such as a difficulty in removing the protective latex covering from the ticket, a notification shall be sent to all media outlets, MSLC sales agents, and MSLC field representatives advising them of the scope of the problem and remedial options, and a message will be posted on the MSLC website. If the range of flawed tickets is identifiable, MSLC sales agents in possession of these particular books will be instructed to send these books back to the MSLC. The MSLC will then forward these books to the manufacturer for reprint, the cost of which will be borne by the manufacturer.

Our follow-up review found that the Quality Control Committee meets if a problem is identified with the potential to reach the defective ticket threshold level (typically the threshold is .01% of total tickets manufactured for the game) stipulated in the contract. As of our follow-up audit, two instant games were on the watch list (i.e., a spreadsheet that is maintained to monitor the level of identified defects and identify patterns and concerns) for reporting to the Quality Control Committee and the Executive Director. The only information recorded on the watch list is the name of the game, the number of defective tickets identified within each book of tickets, and the applicable defect threshold level for tickets. However, the watch list should also include a reason for the defect, the total number of defects, and the number of defective tickets required to reach the threshold level so that the MSLC can determine whether the threshold has been reached and if reimbursement from the vendor that produced the ticket is applicable. The two games currently on the watch list have not reached the defective threshold for reimbursement from the vendor as indicated in the contract.

In addition, the MSLC has implemented a quality control program that consists of a series of tests for each new instant game to identify any printing defects prior to distribution for sale. Although the specific tests to be performed are documented, there is no record maintained to report that all the required tests were actually performed or completed for each new instant game.

Lastly, on April 8, 2004, the MSLC received a reimbursement check for \$49,532 from the manufacturer for damaged tickets under the \$640 Million Jubilee for returned damaged tickets. Our prior audit suggested that this method of reimbursement is preferable to a credit, and thus the MSLC has kept its business dealings simple and straightforward, as suggested in our report.

Recommendation

- The MSLC should ensure that it has the ability to monitor and identify potential instances of defective instant game tickets that would result in ticket reimbursements from the vendor. The watch list that documents the identified instant game ticket defects should include the reason for the defect, the total number of defects, and the number of defective tickets required to reach the threshold level.
- The MSLC should maintain records to document that the required in-house quality control procedures were fully performed for each instant game.

Auditee's Response

MSLC agrees that a more detailed description of instances of defect will be helpful in determining when the threshold for acceptable defect has been passed.

3. MANAGEMENT OF RISK ASSOCIATED WITH INSTANT GAME TICKET MANUFACTURING NEEDS TO BE IMPROVED

The MSLC has entered into contracts with three qualified and experienced instant game ticket manufacturers. These contracts, which cover fiscal years 2005 and 2006, can be renewed for up to three one-year periods, which in itself constitutes a potential risk. The majority (80%) of instant ticket purchases is from one primary vendor. The MSLC did not recognize this potential risk and, therefore, has no plan in place to address any potential long-term interruption of the instant game ticket supply from this major supplier. Given the reliance placed on a single supplier as their principal provider of instant game tickets and that supplier's position in the marketplace, sound business practices would advocate a strategy that ensures continuous ticket production and sales in the event of a major disaster or disruption at the primary vendor's production facility.

The primary vendor is a publicly traded company (NASDAQ) with stockholder's equity in excess of \$300 million as of December 31, 2004, based upon information contained within its annual report pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934 (Form 10K). Based on its revenue, the primary vendor is a leading worldwide provider of services, systems, and products to both the lottery and parimutuel wagering industries. The primary

vendor's sales of instant game tickets and related service businesses with a market share of approximately 67%, based on retail sales in 2004, makes it the industry leader in the United States. Their customers include 29 of the 40 United States' state lotteries. In addition to ticket design and manufacturing, the company provides lotteries with related value-added savings, including game design, sales, marketing support, inventory management, and warehousing.

The contractual arrangements with the MSLC's instant ticket manufacturers include compliance with certain specifics relating to the quality of stock, packaging, shipping schedules, marketing assistance, storage, and security. The primary vendor has several months of printed inventory on hand awaiting shipping orders from the MSLC. In addition, the company has a disaster recovery plan and emergency plan in place and, in response to a request from the OSA, has supplied an outline of that plan to the MSLC.

The primary vendor has estimated that total production capacity of instant game tickets in North America to be between 40 and 45 billion ticket units, divided between the primary vendor and the other two MSLC vendors. Current demand has been estimated at 20 billion tickets.

Given the reliance placed on the primary vendor and its position in the marketplace, sound business practices would advocate a strategy that guarantees continual ticket production and sales in the event of a major (9-11 type) disaster at this production facility. The MSLC does not have adequate internal controls with regard to a business continuity plan to ensure the adequacy of the security system, disaster recovery plan, and internal controls at the manufacturing facilities and to ensure the integrity of the game and the continuous flow of production. Business continuity planning is a methodology used to create a plan for how an organization will resolve partially or completely interrupted critical function(s) within a predetermined time after a disaster or disruption.

The MSLC did not recognize and consider this potential risk, and should develop a plan to address the issue. Instant game ticket sales at the MSLC total approximately \$3 billion annually, 80% of which, or \$2.4 billion, are manufactured by the primary vendor. Based on a prize payout of 72% on the \$2.4 billion, there is a potential risk of approximately \$672 million to the cities and towns, MSLC, General Fund, Massachusetts Arts Lottery, and sales agents, based on 12 months of lost production in the event of a major disaster at the primary vendor. This risk

could possibly be reduced by approximately 25% (\$168 million), assuming the three months of inventory on hand and stored at the same location, were available to be sold by the MSLC and not destroyed in the same potential disaster. Also, if one month's instant game ticket inventory (totaling approximately \$56 million in net revenue) at the MSLC storage locations is taken into consideration, the risk would be further reduced, decreasing the total potential risk to approximately \$448 million. Additionally, we recognize that the MSLC may be able to obtain additional production capability from the other two vendors, thereby further reducing this risk.

Recommendation

The MSLC should determine, with the assistance and collaboration of its ticket suppliers, the best solution to ensure a continuous flow of instant game tickets. There are a number of ways to accomplish this, including:

- The manufacturer could offer an insurance product that protects customers from loss of revenue in the event of an extended interruption of production.
- The MSLC should coordinate a back-up production plan for instant game tickets among the manufacturers of their instant game tickets.
- The MSLC could disperse the production of instant game tickets to spread the risk among the major manufacturers.
- The MSLC should obtain a thorough understanding of the disaster recovery plans of the ticket manufacturers to evaluate the risk from an informed practical perspective.
- The MSLC, as part of its internal control plan, should develop a program to test the adequacy of security systems, disaster recovery plans, and internal controls at the manufacturing facilities in order to ensure both the integrity of the games and the continual flow of production. Routine site visits should be scheduled. Consideration should be given to collaboration with other state lotteries, to limit the cost of the visits and benefit from the practices that may have already been established.

Auditee's Response

A fundamental reason that the MSLC contracted with three vendors was to insure the continued production of instant tickets should the primary vendor suffer a catastrophic loss. The MSLC has received correspondence from the primary Instant Ticket Vendor that they are unable to secure insurance for the MSLC for this type of loss.

To reduce the risk of loss, the MSLC maintains approximately a three-month supply of instant tickets in back inventory. Further, the MSLC has contacted other vendors, and they have informed the MSLC that they could handle the excess capacity should an event

occur. The MSLC agrees with the value of testing the adequacy of security systems, disaster recovery plans, and internal controls at the instant ticket manufacturing facilities.

4. INTERNAL CONTROL IMPROVEMENTS NEEDED TO ENSURE COMPLIANCE WITH ADVERTISING AGENCY CONTRACT PROVISIONS

We reviewed the MSLC contract with its advertising agency to provide advertising services from July 1, 2003 through June 30, 2005, totaling \$14.5 million, and noted the following provisions:

- *All invoices submitted to the MSLC for payment shall be itemized and include appropriate back-up materials supporting each invoice. Back-up materials may include a signed copy of the cost estimate for the job, other supplier invoices for outside services and/or written explanations or justifications for any overages that may have occurred.*
- *For any production expenditure with a value estimated to be \$10,000 or more, the Contractor must also furnish the MSLC with copies of at least three (3) solicited bids for production of all expenditures in connection with all the services or projects recommended by the Contractor or requested by the MSLC.*

In addition, the contract specifies that all media, production, and miscellaneous expenses will be billed at net cost (i.e. no commission/mark-up). MSLC management estimates that these expenses will total \$7 million for fiscal year 2005.

We conducted interviews with selected MSLC officials and reviewed a sample of invoices totaling approximately \$2.5 million during fiscal year ended June 30, 2004. Our review revealed the following:

- Charges from the agency for media and production services paid by the advertising agency did not include copies of invoices from subcontractors in support of the amount billed to MSLC.
- The charges for production services did not include copies of costs estimates (bids) received by the advertising agency in support of the selection of the production vendor.
- The June 2004 payment to the agency included approximately \$460,000 in pre-paid media charges.

The MSLC policies and procedures do not require original invoices from subcontractors supporting costs incurred on behalf of the MSLC through the agency. In the absence of copies of invoices supporting costs received on behalf of the agency, there can be no assurances that these costs are being passed along at “net out-of-pocket cost” as required by contract. Similarly, the lack of original cost estimates (bids) in support of production costs in excess of \$10,000 does

not ensure that the best value was obtained at the most reasonable cost. The prepayment of services under 801 Code of Massachusetts Regulations (CMR) 21:00, "Procurement of Commodities or Services," requires that the contractor be compensated for performance delivered to and accepted by the department in accordance with the specific terms and conditions of a properly executed contract.

Recommendation

- The MSLC and its advertising agency should ensure that the billings to the MSLC contain the supporting documentation necessary to ensure compliance with the contractual arrangement.
- While the prepayment of media costs is a common business practice in the advertising industry with private sector clients, the MSLC should comply with 801 CMR 21:00, "Procurement of Commodities or Services".
- Establish a policy that requires original subcontractor invoices be submitted with the agency's billings to MSLC, and that the MSLC review for conformity before paying.

Auditee's Response

The MSLC now receives and reviews copies of all vendor invoices and cost estimates that support advertising agency billings. Additional procedures to insure full contract compliance are also being implemented.

5. THE MSLC SUPPLIES PRIZE WINNERS OF BETWEEN \$600 AND \$9,999 WITH AN ACCOMMODATION LETTER THAT ENABLES THE HOLDER TO CASH THE MSLC CHECK AT THE MSLC'S BANK ON THE SAME DAY THE CHECK WAS ISSUED

A check cashing arrangement between the MSLC and its principal bank allows the individual winners of MSLC game prizes to cash their prize checks at a designated bank branch location the same day the check was issued by MSLC to the winner. The MSLC winners can receive up to \$9,999 in cash, a bank policy, when they redeem their checks at the designated bank branches with a second form of identification, namely a letter of introduction from the MSLC to the bank.

During the initial claim process at the MSLC's regional offices, prize winners are asked by the MSLC claim personnel if they would like to cash their checks at their own bank or at the MSLC bank. The MSLC employee asks the prizewinner if they have a second form of identification, a bank requirement in order to receive any cash from the bank. In the event the prizewinner only has one form of identification, which is sufficient to receive a check from the MSLC but not to

cash the check, the MSLC will issue a standard letter of introduction or accommodation which instructs the designated branch to honor the check on the same day.

Approximately 70% to 80% of all prizewinners cash their checks at the MSLC's bank on the same day that the MSLC issues them the check. The MSLC issues approximately 500 checks per day in prize payouts, and on Mondays the number of checks could be upwards of 700, with a cash value in the \$1.5 million range.

The MSLC's normal practice is to supply its bank with a file of daily checks issued on the next business day. This is known as the Positive Pay system and is used by Commonwealth agencies to notify banks of valid checks issued, against which checks presented to the bank can be matched. The system provides the MSLC and the bank protection against losses from altered checks.

The United States Treasury Department currently requires banks to be more vigilant, exercise stronger banking controls, and report suspicious persons and/or activities. It is therefore inconsistent for the MSLC to encourage a breakdown in controls over bank check cashing procedures, which require two forms of identification. This issue is particularly critical, considering that these letters of introduction enable "professional cashers" to immediately access ready cash for their enterprise. In fact, our audit found that some professional cashers were taking advantage of this policy by using the MSLC letter to assist them in cashing their MSLC winning checks at a designated branch. Therefore, the practice of supplying a letter to cashers can be interpreted as enabling these cashers to conduct their illegal enterprise. During calendar year 2004 alone, these professional cashiers processed 5,332 checks totaling \$10,065,427. (See Audit Result No. 2a). This practice also exposes the MSLC to financial risk from a potentially altered check, given that the bank lacks a "checks issued" file to match the check against because the issued file is transmitted the next day to the bank.

Recommendation

The MSLC should immediately discontinue providing a letter addressed to banks as a second form of identification for winners to cash MSLC prizes on the same day the prizewinning check is issued by the MSLC and instead support compliance with banking practices to obtain two

proper forms of identification. The MSLC should consider discontinuing the same-day check cashing policy because of the exposure to potential loss from fraud.

Auditee's Response

MSLC views the accommodation letter as a convenience to its customers. MSLC is not aware of an instance where a loss has occurred due to this practice.

6. INTERNAL CONTROL IMPROVEMENTS NEEDED OVER THE REPLAY RECYCLING PROGRAM

The MSLC initiated a pilot anti-litter program (the Instant Replay Recycling Program) at various fairs, events, and sites during fiscal years 2004 and 2005 (See Audit Result No. 7c). Our review disclosed that internal control improvements are needed over this program.

We examined the compliance reviews done by the MSLC Compliance and Internal Audit Department for the Replay Recycling Program at the Marshfield Fair, the Eastern States Exposition, and the Topsfield Fair. The compliance reviews disclosed the following issues where improvements and corrective action is needed:

- Large numbers of instant game tickets were transported by individual employees in order to expedite the MSLC operations at the fairs.
- Non-MSLC employees were involved in the counting and handling of cash and instant tickets.
- Night cash deposit duties were inadequately segregated and secured.
- Cash proceeds were not counted and reconciled on all evening closings.
- Initial cash banks of \$5,000 at Marshfield, \$5,000 at the Eastern States Exposition, and \$2,000 at the Topsfield Fair were kept overnight at an MSLC employee's residence, subjecting it to possible loss.
- The practice for cashing lost, stolen, out-of-date, or out-of-state recycled tickets was inconsistent between employees and various shifts.
- Final reconciliation and accounting of cash and expenses was not complete.

In response to the Compliance and Internal Audit Department review of the three regional fairs, the former Chief Financial Officer issued a memorandum dated January 21, 2005, which contained the following statement:

The Marshfield Fair was the first of the regional community fairs and probably the most successful in terms of controls of all of the other events, with the Topsfield Fair a close second. The banking operation was never left unoccupied by Lottery personnel and two (2) or more Lottery personnel made all cash transport and deposits. The manager/banker often times counted cash by herself without anyone else present. However, the risk associated by this procedure was fully mitigated by the fact that daily cash balancing of all the terminals, pull tabs and Instant Game ticket dispensing machines provided independent records of what the total cash needed to be.

The report further stated that the control issues at the Eastern States Exposition were due to inadequate training of personnel.

The Chief Financial Officer offered two specific recommendations to improve controls and mitigate the risk to the MSLC: (1) assign a security detail for all events and (2) establish a core team responsible for training and coordinating all key functions at the events.

The Office of the State Comptroller's Internal Control Guide, Volume II, Chapter Three, Part c, Fiscal Controls – Revenue, requires adequate internal controls, as follows:

Collected revenues are those that are paid to the department at the point where a service/good has been provided. The department should develop internal controls to ensure that staff who collect or process revenue understand the requirements of state finance law as well as governing policies and procedures issued by the Office of the Comptroller and/or the department. The staff responsible for recording collected revenue should carefully document all revenue activity in accordance with sound management practices and all governing policies. Collected revenue should be deposited into a Commonwealth account on a daily basis. Deposits should be reconciled daily by an individual independent of the collection process. Collected revenue should be reconciled monthly to the state accounting system records and to the monthly bank statement.

Also, Chapter 647 of the Acts of 1989, an Act Relative to Improving Internal Controls Within State Agencies, requires that (1) all transactions and other significant events be promptly recorded, clearly documented, and properly classified; (2) transactions and other significant events are to be authorized and executed only by persons acting within the scope of their authority; (3) access to resources and records be limited to authorized individuals as determined by the agency head; and (4) periodic comparison shall be made between the resources and the recorded accountability of the resources to reduce the risk of unauthorized use or loss and protect against waste and wrongful acts. A lack of adequate controls, such as separation of duties, reconciliations, and accountability, could result in undetected losses.

Recommendation

We recommend that the MSLC:

- Establish written policies and procedures for the conduct of each event.
- Develop an internal control plan and conduct a risk assessment for fair operations in order to identify and mitigate the potential risk of loss at these events.
- Prepare and report an accounting for each event.
- Ensure adequate security for each event.
- Develop a training program for personnel that are assigned to work these events.
- Develop policies and procedures for non-MSLC employees who are hired to work at these events. The policy and procedures should be in compliance with all applicable federal and state laws, rules, and regulations. In addition, the MSLC should ensure that non-employees are covered under its bond or insurance to cover losses or injury.

Auditee's Response

Since its introduction in 2004, the "Instant Replay" Recycling Program has resulted in the collection of more than 100 tons of instant tickets. Despite the success of the program, the MSLC recognized that changes were needed to improve management control. A new set of written internal control procedures have been developed and implemented for fair events to respond to various operational issues that were experienced in running the new "Instant Replay" program. Some of the changes include: the activation of tickets as needed only on-site at each fair, the setting up of an initial cash bank of not more than \$1,000, and mandatory end-of-day cash reconciliation and deposit of cash proceeds.

7. REVENUE-ENHANCING OPPORTUNITIES

During our audit, we identified some revenue-enhancing opportunities that the MSLC should consider with regard to stimulating growth in Bingo operations, licensing Keno operations at establishments that do not serve alcohol, expanding the sale of instant game tickets at fairs and carnivals, and establishing more kiosks in malls and other locations in order to sell more MSLC products.

a. Effects of Declining Revenue on Nonprofit Organizations Supported by Bingo Operations

Bingo was legalized in the Commonwealth of Massachusetts on September 29, 1971. Effective January 1, 1978, Chapter 219 of the Acts of 1977 transferred responsibility for the collection of

the five percent Bingo and Raffle/Bazaar (Casino Functions) Tax from the Department of Revenue to the MSLC.

Our review of Bingo gaming activities in the Commonwealth of Massachusetts extended from calendar year 2001 through calendar year 2004. Bingo games, which represent the largest share of the revenue generated in the MSLC Charitable Gaming Division, produce nearly two-thirds of the revenue of the four types of charitable games offered: Bingo, Charity Game Tickets, Raffles, and Bazaars (Casino Functions). Bingo payouts to winners were approximately three-quarters of Bingo revenue for these four years. Gross revenue for Bingo for the four years are as follows:

| Calendar Year | Gross Charity Gaming Revenue | Bingo Revenue | Net Charitable Revenue (Gross Revenue Less Expenses) Available to Community-Based Nonprofit Groups |
|---------------|------------------------------|----------------------|--|
| 2001 | \$161,105,888 | \$101,935,825 | \$ 27,152,744 |
| 2002 | 154,511,560 | 97,225,586 | 26,757,162 |
| 2003 | 141,268,704 | 88,208,825 | 24,786,149 |
| 2004 | <u>127,753,346</u> | <u>78,993,536</u> | <u>21,697,391</u> |
| Total | <u>\$584,639,498</u> | <u>\$366,363,772</u> | <u>\$100,393,446</u> |

The steady decline in the ability of Bingo specifically (on the order of 5% to 10% per year as noted in our review of the last four years' activity) and charitable games in general to produce revenue is having a negative effect on the community-based elderly and youth programs, scholarships, charitable fraternal nonprofit organizations, educational institutions, food pantries, VA Hospitals, etc., which is a cause for concern to these local groups. The net revenue available to the local groups has a direct effect on the quality of life in the local communities in which these charities lend their patronage. The further decline in these sources of support will erode the good work performed by these various and diverse groups, and could bring an end to their existence and the programs they support, since this revenue in some cases is a significant and/or primary source of funds.

The issue of declining revenue is cultural and fundamental. The aging of the population and the decline in volunteering and community spirit of joining social organizations and the impulse to volunteer during the operation of Bingo games within that social organizational structure are some of the cultural reasons for the decline in Bingo.

According to the MSLC, the reasons for the decline in revenue are as follows:

- The law only allows a maximum prize of \$3,000 for any charitable bingo game, whereas Bingo halls at casinos have no restriction on the maximum prize offered, thereby putting them at a competitive advantage over MSLC-licensed bingo games.
- Only volunteers can work at MSLC-sponsored games. None of the volunteers are allowed payment for their services, and Bingo is generally for these organizations, requiring a weekly commitment for the volunteers. As noted, service to and membership in these nonprofit charitable fraternal organizations for these functions is on the decline.
- The statewide smoking ban has discouraged playing due to the need to interrupt the games for breaks, allowing players to leave the hall to smoke, thereby interrupting the continuity of the games.

The reduction in the number of smaller organizations led to a decline in the number of games, with only the very large games with large halls thriving because of their ability to offer multiple prizes with larger player turnout.

Recommendation

The MSLC should look into ways of stimulating growth in enlarging this segment of its responsibility including recommending and supporting legislative change to permit,

- Increasing the maximum payout for any Bingo game to above \$3,000.
- Allowing organizations to pay a stipend or per diem for the work performed at the games that are currently being performed by volunteers to allow smaller organizations to conduct games.
- Providing monetary incentives to the community groups that operate these games.
- Authorizing for-profit agents to operate bingo halls and requiring a certain percentage to be directed to local nonprofit organizations.

Auditee's Response

The MSLC is supportive of changes that will stimulate growth in Bingo operations; however, Bingo, as regulated under Chapter 10 Sections 37 – 40 of the General Laws of Massachusetts, does not permit the proposals suggested in this audit report.

b. Effects of Smoking Ban on Keno Operations

Our review of monthly Keno sales from September 2003 to March 2005 revealed that Keno revenues were declining after the introduction in July 2004 of the statewide smoking ban in all “pouring establishments” (places that serve alcohol). We compared Keno data from September, October, November, and December 2003 with September, October, November, and December 2004, along with January, February, and March of 2004 with January, February, and March of 2005.

In our review of the seven months of comparative information, all but two of the months showed a decline in revenue from one year to the next after the introduction of the statewide smoking ban. The one month that showed an increase was October of 2004, when Keno sales increased by 19.1% from the totals in October 2003. One month (December) showed no statistical change from 2004 to 2003. The other five months we reviewed after the ban showed declines in revenue from one year to the next, as follows:

| Comparative Monthly Data | First Year | Second Year | Increase/Decrease | Percentage Increase/Decrease |
|-----------------------------------|--------------|--------------|-------------------|------------------------------|
| September 2003 vs. September 2004 | \$59,941,854 | \$54,190,212 | \$ (5,751,642) | (9.6%) |
| October 2003 vs. October 2004 | 57,959,770 | 69,022,808 | 11,063,038 | 19.1% |
| November 2003 vs. November 2004 | 73,408,013 | 55,901,338 | (17,506,675) | (23.8%) |
| December 2003 vs. December 2004 | 57,076,817 | 57,142,177 | 65,360 | 0.1% |
| January 2004 vs. January 2005 | 71,769,459 | 67,547,568 | (4,221,891) | (5.9%) |
| February 2004 vs. February 2005 | 61,890,684 | 59,700,979 | (2,189,885) | (3.5%) |
| March 2004 vs. March 2005 | 63,788,206 | 60,856,168 | (2,932,038) | (4.6%) |

Also, the aggregate amount of Keno revenue from the nine months prior to the smoking ban and nine months after the smoking ban declined by 6.0%. Revenue received for the nine months October 2003 to June 2004 (before the ban) was \$583,812,992, and the revenue received for the nine months of July 2004 to March 2005 (after the ban) was \$549,336,502, demonstrating both a loss of revenue totaling \$34,476,490 to the MSLC, but also a loss of business revenue to the effected establishments.

Recommendation

Because of the negative impact that the smoking ban is having on local business establishments and the cities and towns that depend on lottery revenue, the MSLC should consider changes that would expand their customer base, and also allow more “non-pouring” agents to offer Keno.

This would also generate sales from people who would like to play Keno, but who do not play because they are avoiding pouring establishments that serve alcohol.

Auditee's Response

In December of 2005, the MSLC introduced a new Keno Bonus game option. Keno Bonus gives players a chance to increase their Keno winnings 3, 4, 5 or 10 times. For those who choose to play the Keno Bonus, the cost of the wager doubles. Since its introduction, Keno sales have increase dramatically. Through 8 months of FY06, Keno sales were up 4.3% over the prior year.

c. MSLC Operations at Instant Replay Recycling Events

As discussed earlier, the MSLC initiated a pilot anti-litter program (the Instant Replay Recycling Program) at the following events during fiscal years 2004 and 2005:

| Event | Dates |
|----------------------------------|-----------------------|
| Marshfield Fair | August 20-29, 2004 |
| Eastern States Exposition (Fair) | September 17-23, 2004 |
| City Hall Plaza | September 18, 2004 |
| Taste of Boston | September 18, 2004 |
| Topsfield Fair | October 2-11, 2004 |
| Boston Home Show | January 28-30, 2005 |
| Bayside Exposition Center | January 28-30, 2005 |
| Radio Station WBOS Earth Day | April 30, 2005 |
| Boston Hatch Shell | April 30, 2005 |

The primary goal of the program was to remove and recycle previously sold non-winning instant game tickets. The incentive for individuals to redeem non-winning lottery tickets was to offer one free \$1 instant game ticket for every 20 non-winning lottery instant game tickets presented for redemption. In addition to this anti-litter program, the MSLC established a booth at these fairs and sold other MSLC products, including Keno, on-line games, instant game tickets, pull tabs, and one-day bingo.

Recommendation

We encourage this initiative by the MSLC, and recommend that consideration be given to expanding the program to other fairs and carnivals around the Commonwealth, and include the sale of instant game tickets to enhance revenue.

Auditee's Response

The MSLC is planning to expand the "Instant Replay" Recycling Program. Four new events (including fairs and other venues) will be added in a geographically balanced way in FY06 bringing the total number of recycling events across the Commonwealth to 10.

d. Evaluation of MSLC Kiosk Operations at Selected Malls and Other Locations

The MSLC established a kiosk to service patrons in Natick Mall. This 100 square foot satellite office provides the same service as the other five regional offices that the MSLC has statewide. These offices provide the MSLC customer with payments on winnings of up to \$49,999. The Natick office does not have Keno service operating out of the kiosk.

The facility was established in the fall of 2004, and is staffed by two MSLC employees. However, the MSLC has not conducted a financial analysis to determine whether the kiosk is a viable addition to the regional offices, or whether the \$20,000 in weekly sales it generates justifies its existence. Also, no studies were conducted to determine whether similar installations throughout the state in various underserved locations would be viable. The Assistant Executive Director/Internal Auditor indicated that this financial analysis would soon be scheduled. There are no current plans to open any new kiosk locations throughout the Commonwealth.

Recommendation

The MSLC should undertake demographic and marketing studies to determine whether similar installations throughout the state in various clustered retail locations underserved by the current number of regional offices would be viable. The MSLC study should also determine whether it would be cost beneficial to solicit agents to operate at mall locations to increase sales revenue. Finally, the MSLC should investigate whether a Keno service operating out of the kiosk like the Natick kiosk is a viable operation. Additionally, the MSLC should explore the potential of installing its vending instant ticket machines at various tourist information areas throughout the Commonwealth.

Auditee's Response

The MSLC continues to explore new opportunities that would increase revenues and profits for the benefit of the Commonwealth. In October 2005, the MSLC opened its second kiosk to service customers at Logan International Airport in Boston. During its first six months of operation, this location averaged approximately \$15,000 in weekly sales. The MSLC is evaluating the cost/benefits associated with the kiosks at the Natick Mall and Logan Airport; however, there are no plans to open additional kiosks at this time.

8. OTHER ISSUES REGARDING GAME CLOSURE PROCEDURES, UNDERAGE GAMBLING AND PROHIBITED GAME PARTICIPATION

During our audit, we identified other issues to examine as part of our review of the MSLC's operational and regulatory activities. These issues included MSLC's game closure procedures for their instant game tickets, an analysis of underage gambling, and prohibited game participation.

a. Instant Games Closure Procedures

The MSLC prepares a report for every game closed that summarizes the payout for that game. We reviewed a number of these reports and noted that the overwhelming majority of games with what the MSLC deems to be "Grand Prizes" (prizes of \$1 million or more) are completely sold out prior to closure. We reviewed the closing of Game No. 92, "Bonus for Life," and the procedures the MSLC had undertaken to close the game and record the results of the game. On October 22, 2002, the MSLC, through its network of on-line terminals, notified the sales agents that: "The final grand prize has been claimed in Game #92, Bonus for Life. Please remove #92 tickets from your selling area. Hold for your Lottery rep." A public notice is also posted in relevant newspapers and other outlets identifying the impending closing of the game, with the last date of prize redemption noted. The MSLC's legal department sets the last date of redemption after the closing of the game.

The process included notifying the agents of the termination of the game, removing the terminated game from distribution by clearing the inventory, if any, from the agents and its warehouses, and resolving all stolen or lost game tickets. As noted above, the majority of games we examined were sold out, and the Grand Prizes were distributed or paid upon game termination. Also the inventory of tickets was accounted for or sold. Notification of game termination was also placed in the major newspapers, the Boston Globe and the Boston Herald.

The games with "Grand Prizes" are terminated when completely sold out, or at the time the final Grand Prize has been collected by the winner of the ticket. Each MSLC instant game ticket has "Grand Prize" defined on the reverse side of the ticket. The smaller denomination games of \$1 and \$2 have several very large prizes, but not Grand Prizes as defined by the MSLC, and in some cases are closed before the inventory is sold out because of a lack of player interest in games without a Grand Prize.

We examined the closing statistics for a game which indicated that 95.04% of winning prize tickets were claimed, representing a 94.52% payout of available prize money. All of the million dollar Grand Prizes, (\$50,000 per year for 20 years) were claimed, but many large prizes went unclaimed. We found that a total of five out of 35 \$20,000 prizes went unclaimed, and a total of 54 out of 706 \$10,000 prizes were unclaimed at the time the game was closed. These prizes could still be claimed if they were sold up to the final redemption date. The MSLC only knows the number of prizes paid; there is no way of knowing whether an unpaid prize was sold. The remaining prizes, \$5 to \$1,000, were paid out in ratios above 94% of the available money at the close of the game, but 100% of the Grand Prizes were indicated as paid. Therefore, the closure procedures employed by the MSLC appeared to be in order.

b. Analysis of Underage Gambling

The MSLC policy for underage gambling is promulgated under 961 CMR 2.13, “Denial, Revocation, Suspension or Non-Renewal of License,” which states, in part:

A Sales Agent's license may be revoked, suspended or an application may be denied or its renewal rejected by the Director, or Sales Agent's privilege to sell tickets or shares in one or more of the Lottery games operated by the Commission may be revoked or denied by the Director, for one or more or all of the outlets listed thereon for any one or more of the following reasons. (11) If the Sales Agent sells tickets to individuals under the age of eighteen years of age (see 961 CMR 2.50)

This statement sets forth the policies by which the MSLC, through its Security Department, conducts periodic, unannounced, and random checks on licensed sales agents in an effort to determine whether the statutory prohibition against sales to minors is enforced. Under the Massachusetts General Laws, minors are prohibited from purchasing any MSLC products. As a form of enforcement, the MSLC provides signage informing the public that these products are sold only to those who are of 18 years of age and older. During our audit review, we examined the signage at selected sales agent locations and found the information concerning the prohibition of underage gambling omnipresent at the point of sale.

Beginning in 1994 and through 1998, the MSLC conducted, by itself and in cooperation with the Attorney General's Office, a series of undercover stings on various sales agents to identify those sales agents who conducted business with minors (those under the age of 18 years). The goal of these stings was to isolate those sales agents who either sold instant game tickets or allowed wagering on Keno or the purchase of other lottery products. These stings involved one or more

security officers who accompanied a minor to a preselected sales agent location in an effort to have the minor purchase a lottery ticket. From the years 1994 through 1998, the MSLC conducted a total of 464 individual sales agent stings, in which 97 sales agents, or 21% of those tested, violated the sales to minors prohibition. There have been no such operations since 1998. The MSLC intends to test approximately 1% or more of those sales agents each year, during selected school vacation weeks, beginning in the current fiscal year.

Recommendation

The MSLC should reactivate the sting operations to determine whether sales agents are selling MSLC products to minors. This program should be a permanent part of the MSLC operations.

c. Prohibited Game Participation

Our prior audit recommended that, to better prevent MSLC employees and their family members in the same household from playing lottery games, the MSLC should require, as a condition of employment, the name, age, and Social Security number of all family members. Such a policy would demonstrate that the MSLC is taking additional measures to prevent insiders from playing lottery games. Our audit recommended that the MSLC periodically crosscheck this data against the winners because of the statutory prohibition against MSLC employees participating in MSLC games.

Our review revealed that this policy has not been implemented. The MSLC responded that random testing of employees and their family members would present problems because there is no way to constantly monitor the action of children, spouses, and employees from playing games. Furthermore, children and spouses could employ the aid of another to cash lottery winnings. Finally, due to the nature of the MSLC, tickets cashed under \$600 by family members of or MSLC employees themselves will remain anonymous. It would be difficult to discover prohibited MSLC gaming activities of employee family members.

The MSLC stated, however, that when discovered, the MSLC would engage a vigorous investigation to determine if such employee participation in the Lottery games took place.

Recommendation

The MSLC should stipulate as a condition of employment that random checks of employee activity in the lottery will be performed, including crosschecking employee name and Social Security data against payment lists of MSLC game prizewinners. We recognize MSLC's stated position; however, MSLC should understand that instituting a prohibitive rule will go a long way in achieving compliance, as well as public confidence in the integrity of the game.

APPENDIX I

**MSLC Sales by Cities and Towns vs. Distribution to
Cities and Towns
(Top 20)**

| City and Towns | Fiscal Year 2004 | | | Fiscal Year 2003 | | |
|--------------------------------|------------------------|----------------------|--------------------------------|------------------------|----------------------|--------------------------------|
| | Amount Wagered | Lottery Aid | Lottery Aid Per Amount Wagered | Amount Wagered | Lottery Aid | Lottery Aid Per Amount Wagered |
| Boston | \$480,664,314 | \$58,603,602 | 12.19% | \$480,428,744 | \$57,555,789 | 11.09% |
| Brockton | 73,463,391 | 17,404,211 | 23.69% | 72,050,192 | 16,676,576 | 23.15% |
| Cambridge | 47,967,016 | 7,315,127 | 15.25% | 47,297,514 | 7,273,615 | 15.38% |
| Chicopee | 49,834,292 | 9,703,998 | 19.47% | 47,484,890 | 9,102,673 | 19.17% |
| Fall River | 62,671,975 | 21,747,477 | 34.70% | 59,541,580 | 20,691,928 | 34.75% |
| Haverhill | 45,096,448 | 7,639,101 | 16.94% | 42,952,377 | 7,281,553 | 16.95% |
| Lowell | 64,265,816 | 19,812,272 | 30.83% | 61,525,396 | 18,638,151 | 30.29% |
| Lynn | 84,211,187 | 14,538,966 | 17.26% | 82,761,542 | 13,706,031 | 16.56% |
| Malden | 54,759,348 | 8,250,922 | 15.07% | 52,430,014 | 7,950,134 | 15.16% |
| Methuen | 53,743,170 | 5,211,675 | 9.70% | 51,447,428 | 4,909,434 | 9.54% |
| New Bedford | 81,751,536 | 22,628,784 | 27.68% | 79,097,519 | 21,620,327 | 27.33% |
| Peabody | 46,823,398 | 4,674,247 | 9.98% | 45,695,970 | 4,557,888 | 9.97% |
| Quincy | 98,710,042 | 9,917,818 | 10.05% | 95,172,120 | 9,634,228 | 10.12% |
| Revere | 46,975,920 | 5,979,963 | 12.73% | 46,790,895 | 5,670,009 | 12.12% |
| Somerville | 58,568,152 | 11,642,703 | 19.88% | 55,022,264 | 11,403,360 | 20.72% |
| Springfield | 98,126,341 | 33,159,295 | 33.79% | 94,715,308 | 30,900,045 | 32.62% |
| Taunton | 45,876,353 | 8,461,467 | 18.44% | 43,845,666 | 8,102,749 | 18.48% |
| Waltham | 54,878,276 | 5,177,423 | 9.43% | 52,498,350 | 5,080,700 | 9.68% |
| Weymouth | 53,846,063 | 7,024,536 | 13.05% | 52,001,436 | 6,850,560 | 13.17% |
| Worcester | <u>147,934,891</u> | <u>30,565,502</u> | <u>20.66%</u> | <u>142,666,721</u> | <u>28,744,919</u> | <u>20.15%</u> |
| Subtotal | \$1,750,167,929 | \$309,459,089 | | \$1,705,425,926 | \$296,350,669 | |
| Other Cities and Towns | <u>2,597,740,657</u> | <u>426,919,074</u> | | <u>2,479,465,942</u> | <u>408,989,685</u> | |
| Total for all Cities and Towns | <u>\$4,347,908,586</u> | <u>\$736,378,163</u> | <u>16.94%</u> | <u>\$4,184,891,868</u> | <u>\$705,340,354</u> | <u>16.85%</u> |

APPENDIX II

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

H 5

Chapter 647

THE COMMONWEALTH OF MASSACHUSETTS

In the Year One Thousand Nine Hundred and Eighty-nine

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

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

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

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

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

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

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

H 5

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

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

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

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

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

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

H 5

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

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

House of Representatives, December 21, 1989.

Passed to be enacted, *George Luvaan*, Speaker.

In Senate, December 22, 1989.

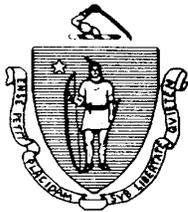
Passed to be enacted, *William W. Budge*, President.

January 3, 1990.

Approved, *Richard H. Kiah* Governor.

APPENDIX III

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



The Commonwealth of Massachusetts

Office of the State Auditor
State House
Boston, MA 02133

Office of the Comptroller
One Ashburton Place
Boston, MA 02108

September 19, 2000

Legislative Leadership
Judicial Branch Administrators
Elected Officials
Secretariats
Department Heads

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

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

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

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

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

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

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

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

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

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



A. JOSEPH D'ANNUNZIO
Auditor of the Commonwealth



MARTIN J. BENISON
State Comptroller