LEGISLATIVE AUDIT COMMISSION

Review of
Department of Lottery
Two Years Ended June 30, 2013

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REVIEW: 4438
ILLINOIS DEPARTMENT OF LOTTERY
TWO YEARS ENDED JUNE 30, 2013

FINDINGS/RECOMMENDATIONS - 7

ACCEPTED - 3
IMPLEMETED - 4

REPEATED RECOMMENDATIONS - 2

This review summarizes the auditors' reports on the Department of Lottery for the two years ended June 30, 2013 (compliance) and the year ended June 30, 2013 (financial), filed with the Legislative Audit Commission July 24, 2014. The auditors conducted a compliance examination and financial audit in accordance with *Government Auditing Standards* and State law. Auditors stated the financial statements were fairly presented.

The Lottery began its operations as part of the Department of Revenue in 1974. In 1986, the Lottery was separated from the Department of Revenue and established as the Department of the Lottery. In 2003, the Lottery was established as a Division within the Department of Revenue. In 2011, the Lottery operations transitioned to a private manager, Northstar Lottery Group, and effective October 15, 2011, the Department of Revenue transferred all functions, powers, duties, rights and responsibilities to the Department of the Lottery. As a means of easing and transitioning, management elected to use an effective date of July 1, 2011 for the financial accounting and reporting. In August 2014, Governor Quinn terminated the State's agreement with Northstar and the final termination deal was disclosed in December 2014. Attorney General Madigan blocked the deal in January 2015 saying the deal extends indemnification to Northstar in excess of the Lottery's statutory authority.

Mr. Michael Jones is Director of the Department now and for the two-year period under review. Mr. Jones became Director effective October 10, 2011. Mr. Jones ran the Illinois Lottery from 1981 to 1985.

The number of employees at June 30 of the following years was:

Division	**FY13**	**FY12**
Operations	56	56
Employee Use Agreement	77	82
Electronic Data Processing	17	18
Lottery Interagency Agreement	1	2
Shared Services Center	4	5
Total Department	155	163

Ticket Sales and Commissions

Unaudited information from the Department on various performance measures appears below:

Performance Measures	**FY13**	**FY12**
Sales	$ 2,832,600,000	$ 2,677,000,000
Prizes Paid	$ 1,728,300,000	$ 1,561,200,000
Retailer and vendor commissions	$ 164,000,000	$ 151,400,000
Transfers to Common School Fund	$ 655,600,000	$ 639,900,000
Expense of operations	$ 153,700,000	$ 152,200,000

Expenditures From Appropriations

The General Assembly appropriated a total of $1,042,044,300 from the State Lottery Fund to the Department of the Lottery for the year ended June 30, 2013. Appropriated expenditures for payment of prizes was $459 million in FY13 compared to $543 million in FY12 (not including prizes paid by retailers). Overall expenditures were $604.6 million in FY13 compared to $693.5 million in FY12, a decrease of $88.9 million, or 12.8%. Appendix A provides a summary of the appropriations and expenditures for FY13 and FY12.

Financial Statements

The table appearing in Appendix B presents the statements of net position for the Department. Total assets were $528 million in FY13 compared to $537 million in FY12. Net position was $375,000 in FY13 compared to $24,366,000 in FY12.

Appendix C presents statements of revenues, expenses and changes in net position for FY13 and FY12.

Significant Account Balances

Appendix D presents a table of significant account balances for the Department for FY13 and FY12.

Accounts Receivable

Gross receivables stood at $36.2 million as of June 30, 2013 compared to $30.5 million at June 30, 2012. Most receivables, $21.6 million for FY13 and $18.9 million for FY12 were current. Of the total accounts receivable, $11.3 is estimated uncollectible for FY13 and $8.4 million was estimated uncollectible for FY12.

Property and Equipment

Equipment for which the Department was accountable during the period under review was $2,421,000 at June 30, 2013 and $2,412,000 at June 30, 2012.

Accountants' Findings and Recommendations

Condensed below are the seven findings and recommendations, two repeated, presented in the reports. Responses to the recommendations are classified on the basis of updated information provided by Brett Finley, Finance Manager, via email on February 24, 2015.

Accepted or Implemented

1. **Implement procedures to ensure GAAP Reporting Packages and financial statements are prepared in an accurate and complete manner. Allocate sufficient staff resources and follow formal procedures to ensure financial information is prepared and submitted to the Illinois Office of the Comptroller in accordance with GAAP, and maintain supporting documentation in a contemporaneous manner to support the financial information being reported. (Repeated-2012)**

Finding: The Department of the Lottery's (Department or Lottery) year-end financial reporting in accordance with generally accepted accounting principles (GAAP) to the Illinois Office of the Comptroller contained numerous errors/inaccuracies and incomplete data.

During the audit of the June 30, 2013 Department financial statements, auditors noted errors in the Department's GAAP Reporting forms submitted to the Comptroller and Department financial statements and deficiencies in internal controls over financial reporting as follows:

- During testing of the estimate of the prizes payable, liability for instant games, auditors noted the prize structure utilized was inaccurate. The inaccuracies resulted in prize expense and the associated liability being understated by $18.5 million.

- During testing of the Department's accounts payable, an error in recording "vouchers in transit" as of June 30, 2013 was identified. The error resulted in Accounts Payable—General and Operating expenses at June 30, 2013 each being understated by $12.1 million.

- Auditors found an error in recording payments as of year-end. The Department made a journal entry to correct a previously identified error which inappropriately adjusted the wrong account resulting in operating expense and prizes payable each being overstated by $13.1 million.

Lottery management indicated that similar to the fiscal year 2012 audit, certain issues emerged during fiscal year 2013 with the financial data generated by the private manager's

Accepted or Implemented – continued

gaming system leading to certain inaccuracies. Lottery management also indicated that certain year-end processes did not detect the incorrect recording of certain vouchers.

<u>Response:</u> Accepted. The Lottery will continue to review current procedures to ensure they are up-to-date and implement any additional procedures, as necessary, to ensure GAAP financial reporting and the financial statements are prepared completely, accurately and timely with appropriate supporting documentation. The Lottery will also ensure sufficient staff resources are allocated to this process.

<u>Updated Response:</u> Implemented.

2. Implement and document adequate controls over the computing environment and ensure the controls provide sufficient protection. Specifically:

- **Review access rights to systems and applications on a periodic basis, and retain documentation of such reviews.**

- **Maintain documentation of access provisioning and termination, and timely terminate user access rights.**

- **Implement a process to create a system generated list of changes for applications. If a system generated list is not feasible, develop a method of logging and tracking all changes. Additionally, ensure all documentation related to changes is maintained.**

- **Ensure the segregation of development activities and migration activities.**

- **Maintain documentation for the security of the Drawing Room.**

- **Develop and document a monitoring process to determine the impact of noted deficiencies in the Service Organizations' Control Reports to the Department's environment. In addition, review the Complimentary User Controls identified in the Service Organizations' Control Reports to ensure they were in place and operating effectively. (Repeated-2012)**

<u>Finding:</u> The Department had not implemented controls over its computing environment to ensure the controls provided sufficient protection. Auditors noted a number of control deficiencies related to the various computer systems utilized by the Department. Specific areas where weaknesses were identified are as follows:

- **Access Reviews** - Although access was reviewed on an ad hoc basis, documentation was not maintained.

- **Access Provisioning and Termination** - Requests to grant one user's access to one application was not maintained. Additionally, access rights were not timely removed for eight terminated users.

- **Change Management** - A system generated list of changes was not available for one of the Department's applications. A change ticketing tool was not in use and there was not a logging feature within the application. The Department manually compiled a listing of four changes to the application, and testing documentation was not retained for all the changes implemented into the production environment.

- **Segregation of Duties** - From July 2012 through April 2013, one user was responsible for the development and migration of changes to the production environment. In April 2013, the Department implemented a control where the developer had to request access to the production environment once changes had been tested and approved.

- **Access to Drawing Room** - The Department could not provide documentation confirming the Drawing Room was locked at all times when Department staff was not present.

- **Monitoring of Service Providers** - The Department reviewed the two Service Organizations' Control Reports, but the documentation did not evidence the impact assessment of noted deficiencies on the Department's IT environment. In addition, the Department had not ensured the Complimentary User Controls identified in one Service Organizations' Control Report were in place and operating effectively.

Response: Accepted.

- Access Reviews – The Department continues to perform periodic access reviews of key systems. We have also begun to ensure proper related documentation is kept to track the reviews.

- Access Provisioning and Termination – The Department had one instance of lack of documentation for access provisioning and strives to have zero instances in the future. Access rights termination time frames have improved due to a tighter control over our user de-provisioning practice.

- System Change Control – The system in question as designed does not have a formal change logging capability nor can it produce a system generated list of changes. The Department instituted a manual process of tracking, managing and approving system changes for this system in late FY13 and has begun to fully implement the process that includes maintaining all test data produced to support approved changes. The process also serves as a compensating control to mitigate the risk associated with the Department's inability to segregate development activities and production migration activities by leveraging the Department's ability to control access to the

Accepted or Implemented – continued

production environment of the system. The system manager cannot make any system changes without getting access from the Department.

- Drawing Room Security – The Department has relocated and instituted procedures to fully secure its Draw Room in early FY14.

- Monitoring of Service Providers – The Department will improve its process of review of the Service Organization Control reports of its service providers to determine the impact to its environment.

Updated Response: Implemented.

3. Develop policies and procedures to ensure timely compliance with the requirements outlined in the Personal Information Protection Act in the event of a breach of confidential information.

- **Develop and approve an Identity Protection Policy as required in the Identity Protection Act.**
- **Perform a comprehensive risk assessment to identify all forms of confidential or personal information and ensure adequate security controls, including adequate physical and logical access restrictions, have been established to safeguard data and resources.**

Finding: During the review of the Department, the following weaknesses were noted in regard to the Department's security and control of confidential information:

- Failure to perform a risk assessment of the Department's computer resources.
- Lack of a formalized breach of security procedures.
- Lack of a formal Identity Protection Policy.

Department management indicated that after it deconsolidated from the Department of Revenue during FY12, it continues to create and/or update all of its policies.

Updated Response: Accepted. The Department will continue its efforts to complete its risk assessment, finalize its identity protection policy and develop policies and procedures to ensure prompt notification of security breaches. The Confidential Personal Information Policy required under the Illinois Identity Protection Act has been issued.

4. Review and update the disaster recovery plan at least annually or when significant changes occur. Perform and document tests of disaster recovery plan at least once a year. In addition, work with the third parties to ensure the

third parties' disaster recovery plans have been developed, approved, and tested.

Finding: The Department does not have adequate disaster recovery procedures in place. Auditors noted the Department had not updated its disaster recovery plan since August 2004. The recovery plan did not reflect the separation from the Department of Revenue and the consolidation of the Information Technology infrastructure into the Department of Central Management Services. The auditors also noted the plan has not been tested in recent years.

The Department utilizes third party applications to receive financial, gaming, and winner information; however, the third parties' recovery plans had not been developed. Additionally, the auditors noted two of the three third party applications had not been tested.

Department management stated that while during FY13 it continued efforts to deconsolidate from the Department of Revenue as well as define and stabilize its environment and operations, it had yet to physically or logically separate. This complicated efforts to make substantial progress on updating and testing its overall agency Disaster Contingency plan. Updating the Disaster Contingency plan will also require additional resources to help facilitate its completion.

Response: Accepted. The Department will continue its efforts to update and test its agency Disaster Contingency plan by fully completing the physical and logical separation from the Dept. of Revenue and procuring the necessary resources to assist in drafting and finalizing the plan. It has received finalized plans from its third party vendors and will formally test the plans as required.

5. Comply with required provisions of the Fiscal Control and Internal Auditing Act.

Finding: The Department has not complied with the Fiscal Control and Internal Auditing Act. During testing auditors noted the following exceptions:

- The Department's internal audit function did not perform internal audits of all of their major systems of internal accounting and administrative control during the period under audit.
- The Department did not certify its internal controls at May 1, 2012 as required by the Act.
- The Department drafted but had not approved or implemented internal policies and procedures related to Revenues, Refunds & Receivables.

Department management indicated the Department did not become its own agency until October 2011 and the Internal Audit function was not established until September 2012 with the hiring of the Department's first Chief Internal Auditor.

Accepted or Implemented – concluded

Updated Response: Accepted. The Chief Internal Auditor position is currently vacant in the Department of the Lottery. The Department is in the process of filling the vacancy and will then resume implementation of the required provisions of the Fiscal Control and Internal Auditing Act (FCIAA).

6. Comply with the applicable statutory requirements and submit required reports, documents and policies as required.

Finding: The Department failed to submit, or timely submit certain required reports, documents and policies to the required oversight entities. The auditors noted the following exceptions:

- There were no quarterly reports on activities and actions of the private manager submitted to the Governor or the General Assembly during the period under audit as required by the Illinois Lottery Law.
- The Department submitted the findings and recommendations of the Internet Lottery Study to the members of the Internet Lottery Study Committee approximately nine months late.
- The Department did not file their required Agency Workforce Report due January 1, 2013.
- The Department failed to submit their vehicle use policy to the Department of Central Management Services.
- The Department failed to submit their required Travel Headquarter Reports (TA-2) to the Legislative Audit Commission during the period under audit.

Department management stated the delay in submitting the findings and recommendations of the Internet Lottery Study were due to the procurement process slowing down the Committee's activity. The Committee was tasked with reviewing the feasibility of a shared value card. Department management also stated that several workforce analysis reports were timely filed but one was inadvertently omitted. Department management indicated they could not verify the vehicle use policy had or had not been submitted to CMS.

Response: Accepted. The Department has subsequently filed all required reports, documents and policies, and implemented processes to ensure future filings are timely.

Updated Response: Implemented.

7. Follow the applicable statutes, administrative rules and SAMS procedures in maintaining and reporting property and equipment records.

Finding: The Department does not have adequate controls over the recording and monitoring of property and equipment. During testing of the Department's property and equipment, the auditors noted the following exceptions:

- Two vehicles assigned to the Department as part of the Department of Central Management Services (CMS) vehicle usage program were incorrectly reported as Department purchases to the Office of the Comptroller in the Department's quarterly property reporting during FY13. The two vehicles were valued at $31,834.

- During fiscal year 2013 the Department incorrectly removed two vehicles from their property records that had been sent to CMS for disposal. Documentation provided by the Department to the auditors supporting acceptance of the vehicles by CMS was dated subsequent to June 30, 2013. The two vehicles were valued at $31,273.

- One piece of equipment, a ball-drop machine valued at $5,100, was not properly tagged.

Department management stated the vehicles noted in the first bullet exception were reported on the C-15 in the quarter they were received but, as the vehicle usage program was new, it was not clear that vehicles "received" as part of the vehicle usage program from CMS were to be excluded. Department management also stated the two pieces of equipment disposed of subsequent to June 30, 2013 were vehicles that had been taken to CMS garages for disposal prior to June 30, 2013 and were removed from the Department's fleet at that time. The documentation requesting their formal disposition was not returned by CMS prior to June 30, 2013. Department management noted the piece of equipment missing a tag must have been the result of the tag coming off during its transport from a Springfield location to a Chicago location. A replacement tag will be issued.

Response: Accepted. A replacement tag will be issued for the ball drop machine and new reconciliation steps will be performed to ensure better alignment with the Department of Central Management Services' vehicle usage program and inventory tracking practices.

Updated Response: Implemented.

Emergency Purchases

The Illinois Procurement Code (30 ILCS 500/) states, "It is declared to be the policy of the State that the principles of competitive bidding and economical procurement practices shall be applicable to all purchases and contracts...." The law also recognizes that there will be emergency situations when it will be impossible to conduct bidding. It provides a general exemption when there exists a threat to public health or public safety, or when immediate expenditure is necessary for repairs to State property in order to protect against further loss of or damage to State Property, to prevent or minimize serious disruption in critical State services that affect health, safety, or collection of substantial State revenues, or to ensure the integrity of State records; provided, however that the term of the emergency purchase shall not exceed 90 days. A contract may be extended beyond 90 days if the chief procurement officer determines additional time is necessary and that the contract scope and duration are limited to the emergency. Prior to the execution of the extension, the chief procurement officer must hold a public hearing and provide written justification for all emergency contracts. Members of the public may present testimony.

Notice of all emergency procurement shall be provided to the Procurement Policy Board and published in the online electronic Bulletin no later than 3 business days after the contract is awarded. Notice of intent to extend an emergency contract shall be provided to the Procurement Policy Board and published in the online electronic Bulletin at least 14 days before the public hearing.

A chief procurement officer making such emergency purchases is required to file an affidavit with the Procurement Policy Board and the Auditor General. The affidavit is to set forth the circumstance requiring the emergency purchase. The Legislative Audit Commission receives quarterly reports of all emergency purchases from the Office of the Auditor General. The Legislative Audit Commission is directed to review the purchases and to comment on abuses of the exemption.

During FY12, the Department filed three affidavits for emergency purchases totaling $86,038.37 for specialized computer personnel. During FY13, the Department filed two affidavits for emergency purchases totaling $127,340.00 to verify audit services for midday drawings.

Headquarters Designations

The State Finance Act requires all State agencies to make semiannual headquarters reports to the Legislative Audit Commission. Each State agency is required to file reports of all of its officers and employees for whom official headquarters have been designated at any location other than that at which their official duties require them to spend the largest part of their working time.

The Department of the Lottery did not provide reports for FY12 and FY13 as noted in Recommendation #6. The Department reported in April of 2014 that no employees spent more than 50% of their working time away from their official headquarters.

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DEPARTMENT OF THE LOTTERY

YEAR ENDED JUNE 30, 2013

APPENDIX A

Appropriations and Expenditures

	FY13	FY12
Appropriations	**$ 1,042,044,300**	**$ 949,184,900**
Expenditures		
Personal Services	$ 8,545,914	$ 8,943,086
Retirement	3,251,843	3,063,770
Social Security	626,781	659,682
Group Insurance	3,040,436	2,475,989
Contractual Services	2,349,307	1,761,690
Travel	56,510	56,224
Commodities	36,356	12,219
Printing	8,548	4,387
Equipment	5,600	76,087
Electronic Data Processing	3,375,980	3,418,290
Telecommunications	196,258	263,916
Operation of Auto Equipment	257,367	490,470
Expenses of Lottery Games	123,493,310	128,710,000
Expenses of Lottery Boards	1,165	-
Payment/Winning Lottery Tickets	459,033,855	543,154,031
Refunds	17,567	47,813
Shared Services	387,424	451,025
	$ 604,684,221	**$ 693,588,679**

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APPENDIX B

Comparative Balance Sheets at June 30

Assets	**FY13**	**FY12**
Cash and cash equivalents	$ 18,279,000	$ 13,024,000
Cash equity in State Treasury	117,608,000	141,986,000
Investments, short term	48,667,000	58,064,000
Accounts receivable	24,910,000	22,106,000
Private Management contract	40,000,000	-
Other receivables	13,710,000	-
Total assets	**$ 263,174,000**	**235,180,000**
Noncurrent assets		
Investments	264,600,000	302,031,000
Capital assets being depriciated, net	238,000	229,000
Total noncurrent assets	**$ 264,838,000**	**302,260,000**
TOTAL ASSETS	**528,012,000**	**$ 537,440,000**
Liabilities		
Current Liabilities		
Prizes payable	150,698,000	151,565,000
Accounts payable and accred liabilities	52,454,000	34,679,000
Due to other Government - Federal	109,000	27,000
Due to other State funds	44,449,000	18,624,000
Unearned revenue	4,769,000	5,427,000
Other liabilities	1,193,000	1,113,000
Current portion of long-term annuity prizes payable	47,917,000	57,110,000
Total Current Liabilities	**301,589,000**	**268,545,000**
Noncurrent Liabilities		
Noncurrent portion of long-term annuity prizes payable	225,166,000	243,609,000
Noncurrent other	882,000	920,000
Total Noncurrent Liabilities	**226,048,000**	**244,529,000**
Total Liabilities	**527,637,000**	**513,074,000**
Net Position		
Invested in capital assets	238,000	229,000
Unrestricted	137,000	24,137,000
TOTAL Net Position	**$ 375,000**	**$ 24,366,000**

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APPENDIX C

Statements of Revenues, Expenses, and Changes in Net Position

Operating Revenues	**FY13**	**FY12**
Charges for sales and services	$ 2,832,576,000	$ 2,676,996,000
Private management contract fee	61,776,000	-
Other	8,006,000	5,378,000
Total Operating Revenues	**2,902,358,000**	**2,682,374,000**
Operating Expenses		
Cost of sales and service	163,966,000	151,421,000
Prizes and claims	1,743,686,000	1,620,405,000
General and administrative	153,731,000	152,210,000
Provision for private management contract fee	21,776,000	-
Depreciation	99,000	107,000
Total Operating Expenses	**2,083,258,000**	**1,924,143,000**
Operating Income	819,100,000	758,231,000
Nonoperating revenues (expenses)		
Investment income	$ (9,354,000)	$ 37,633,000
Interest expense	(14,347,000)	(17,192,000)
Total nonoperating revenues (expenses), net	$ (23,701,000)	$ 20,441,000
Change in net positions before transfers	795,399,000	778,672,000
Tranfers to other State funds	(819,390,000)	(758,236,000)
Change in net postion	(23,991,000)	20,436,000
Net position at beginning of year	24,366,000	3,930,000
Net position at end of year	$ 375,000	$ 24,366,000

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APPENDIX D

Significant Account Balance

	FY13	FY12
Prizes and Claims Expense (Fund 711)	$ 1,743,686,000	$ 1,620,405,000
Transfers-Out (Fund-711)	819,390,000	758,236,000
Cost of Sales and Services	163,966,000	151,421,000
Accounts Payable-General	52,454,000	34,679,000
Cash Equity in State Treasury	116,847,000	141,435,000
Investments (Fund 978)	312,785,000	359,564,000
Due to/from Other State funds (Fund 711)	44,449,000	18,624,000
Ticket sales, Instant	1,768,382,000	1,622,545,000