LEGISLATIVE
AUDIT
COMMISSION

Review of
Department of Lottery
Two Years Ended June 30, 2015

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REVIEW: 4473
ILLINOIS DEPARTMENT OF LOTTERY
TWO YEARS ENDED JUNE 30, 2015

FINDINGS/RECOMMENDATIONS - 8

ACCEPTED - 3
IMPLEMETED - 4
UNDER STUDY - 1

REPEATED RECOMMENDATIONS - 6

This review summarizes the auditors' reports on the Department of Lottery for the two years ended June 30, 2015 (compliance) and the year ended June 30, 2015 (financial), filed with the Legislative Audit Commission May 5, 2016. 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. 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. The Lottery continues to seek a private manager as required by law.

Mr. Michael Jones was Director of the Department for the majority of the two-year period under review. Mr. Jones left the position in March 2015, and Jayme Odom began as Acting Director. In April 2015, B.R. Lane took over the position of Acting Director and he resigned in June 2016. Tim McDevitt temporarily served as Acting Director until the former Director of the Vermont Lottery, Greg Smith, was appointed Acting Director in October 2016. Mr. Smith remains as Acting Director.

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

Division	FY15	FY14
Operations	54	50
Employee Use Agreement	71	71
Electronic Data Processing	15	17
Lottery Interagency Agreement	1	1
Shared Services Center	4	5
Total Department	**145**	**144**

Ticket Sales and Commissions

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

Performance Measures	FY15	FY14
Sales	$ 2,837,800,000	$ 2,802,300,000
Prizes Paid	1,743,000,000	1,699,600,000
Retailer and vendor commissions	161,600,000	159,100,000
Transfers to Common School Fund	678,600,000	668,100,000
Expense of operations	147,100,000	156,500,000

Expenditures From Appropriations

The General Assembly appropriated a total of $1,226,949,500 from the State Lottery Fund to the Department of the Lottery for the year ended June 30, 2015. Total expenditures were $988 million in FY15 compared to $787.3 million in FY14, an increase of $200.7 million, or 25.5%. Lottery prizes increased in FY15 due to a large Mega Millions winner from Illinois. Interfund cash transfers decreased in FY15 compared to FY14 and FY13 due to no chargeback of penalties to the private manager. Appendix A provides a summary of the appropriations and all expenditures for FY15 and FY14.

Financial Statements

The table appearing in Appendix B presents the statement of net position (deficit) for the Department. Total assets were $664.1 million in FY15 compared to $499.9 million in FY14 while total liabilities, which increased in almost every line for FY15, were $723.8 million in FY15 compared to $505.1 million in FY14. Net position was ($59,725,000) in FY15 compared to ($58,803,000), restated, in FY14.

Appendix C presents statements of revenues, expenses, and changes in net position (deficit) for FY15 and FY14.

Significant Account Balances

Appendix D presents a table of significant account balances for the Department for FY15 and FY14. Most of the large increases in FY15 are due to delayed payments to the private manager resulting from negotiations.

Accounts Receivable

Gross receivables stood at $51.7 million as of June 30, 2015 compared to $40.7 million at June 30, 2014. Most receivables, $31.7 million for FY15 and $22.7 million for FY14 were current. Of the total accounts receivable, $15.8 is estimated uncollectible for FY15 and $13.8 million was estimated uncollectible for FY14.

Property and Equipment

Equipment for which the Department was accountable during the period under review was $1,855,000 at June 30, 2015 and $1,935,000 at June 30, 2014.

Accountants' Findings and Recommendations

Condensed below are the eight findings and recommendations, six repeated, presented in the reports. Responses to the recommendations are classified on the basis of updated information provided by Darick Clark, Chief Internal Auditor, via email on August 4, 2017.

Accepted, Implemented, or Under Study

1. Improve preparation and review process of GAAP Reporting Packages and financial statements to ensure they are prepared in a complete and accurate manner. (Repeated-2012)

<u>Finding:</u> The Department's year-end financial statements, prepared in accordance with generally accepted accounting principles (GAAP) and submitted to the Illinois Office of the Comptroller, contained errors in certain accounts and disclosures, which are considered to be deficiencies in internal control over financial reporting.

During the audit of the June 30, 2015 Department financial statements, auditors noted errors in the Department's GAAP Reporting forms submitted to the Office of the Comptroller and Department financial statements as follows:

During testing of the Department's accounts receivable, auditors identified the Department incorrectly recorded a transfer of $20.0 million to the Virginia Lottery to fund future multi-state lottery prize settlements in accounts receivable. This transfer was done at June 30, 2015 in order to fund Illinois' future financial obligations to the multi-state games (Mega Millions and Powerball) in the absence of a FY16 budgetary appropriation to pay game winners. The misclassification resulted in an overstatement of accounts receivable and an understatement of prepaid assets of $20.0 million. This was discussed with Department management and they subsequently made a correcting entry.

Accepted, Implemented, or Under Study – continued

During testing of the Department's financial statements, particularly the notes, auditors identified errors regarding the amounts disclosed, which included the following:

- The amount of annual compensation for reimbursement of operating expenses to the Private Manager under the PMA, was overstated by $8.8 million. This was discussed with Department management at which time they adjusted the disclosure.
- $3.8 million for the retroactive supply agreement reduction was overstated by $0.5 million. This was discussed with Department management at which time they adjusted the disclosure.

In discussing these conditions, Lottery management indicated the budget impasse at June 30 and certain unforeseen subsequent events resulted in the issues identified.

Response: Accepted. Will continue to review current procedures to ensure GAAP financial reporting and the financial statements are prepared completely and accurately.

Updated Response: Implemented.

2. Adhere to the Illinois laws prohibiting prepayment of future year obligations from the current year appropriation.

Finding: The Department inappropriately prepaid amounts from their FY15 appropriation to the Multi-State Lottery Association to fund FY16 Multi-State Lottery Association payment obligations in noncompliance with the State Finance Act (Act) and Illinois Lottery Law (Law).

During testing of 16 investment purchase expenditures (totaling $158,768,750), auditors noted that one expenditure item (totaling $10,000,000) was made to fund future Multi-State game prize payment obligations (Mega Millions and Powerball). Upon further testing, it was noted that another prepayment had been made. In total, two vouchers for $20,000,000 were processed on June 30, 2015 to pay for Multi-State game expenses for FY16.

In discussing these conditions with Department management, they indicated that due to the lack of a FY16 State budget, the Department sent additional funds to the multi-state clearing house to ensure the Department could continue to participate in the multi-state Lottery games. (Please note copies of correspondence on this Finding at the end of the review.)

Response: Accepted. The Lottery will continue to review procedures to ensure it is in compliance with the Lottery Law.

Updated Response: Under Study. The Department believes that it acted within the bounds of the law; however, the Department will continue to review procedures and communicate with the Auditor General to ensure it is in compliance with the Lottery Law.

3. Adhere to the provisions of the Lottery Law and enhance internal control procedures to ensure compliance. With regard to the transfer of amounts due to the Capital Projects Fund, work to improve the process of estimating amounts owed to the Capital Projects Fund prior to the end of each fiscal year to minimize amounts owed subsequent to June 30, or seek legislative relief to allow a transfer after finalizing accounting records.

Finding: The Department and Lottery Control Board (Board) did not comply with various provisions of the Illinois Lottery Law.

During testing, auditors noted the following:

- There was only one scheduled meeting of the Board during the year ended June 30, 2015, and there was no review of major media campaigns conducted during that meeting.
- The Department did not deposit funds into the Capital Projects Fund in accordance with the Lottery Law in a timely manner. Auditors noted the Department owed approximately $60 million to the Capital Projects Fund as of June 30, 2015.
- During testing, auditors noted the Department included an allocation for "Lottery Operating Expenses & Overhead" within the calculation of "net revenue" attributable to the "Go for the Gold" scratch-off game, as they do for all other scratch-off games. The Department does not have a system or process to capture administrative expenses solely related to a specific game.
- During testing of the executed contract for services to be performed by an independent accounting firm in relation to the compliance examination of the private manager, auditors found the Department was identified as the party to be billed for such services, not the private manager. Additionally, the Department did not provide documentation to demonstrate that the financial burden of the investigation was passed on to the private manager. Lottery paid the independent accounting firm approximately $147,000 for services related to investigation work in FY15.

In discussing these conditions with Department management, they indicated that the Lottery Control Board was unable to hold meetings due to not enough sitting board members to satisfy a quorum. The Department is currently seeking legislation to codify the current practice for the transfer to the Capital Projects Fund. The Department interpreted the specialty ticket legislation to recover all costs and transfer the net proceeds. The Department had not yet recouped the cost of the required investigation from the private manager due to staffing changes resulting in an oversight.

Updated Response: Accepted: The Department has corrected three of the four items noted in the finding. Regarding the transfer amounts owed to the Capital Projects Fund, the Department is still seeking legislative relief in an effort to codify the Department's current practice.

Accepted, Implemented, or Under Study – continued

4. Enhance internal control procedures to ensure policies such as those regarding the protection of confidential information are prepared in a complete and timely manner. (Repeated-2013)

Finding: A weakness was noted at the Department related to security and control over confidential information.

During testing, auditors noted the Department has several computer systems that contained confidential or personal information including employee and customer names, addresses, Social Security numbers, and credit card numbers; however, as of June 30, 2015, the Department had not completed its risk assessment of its computing resources to identify confidential or personal information to ensure such information is protected from unauthorized disclosure. The Department began the risk assessment process in March 2015, but did not finalize its initial risk assessment process until October 1, 2015.

The Department did not have formal policies in place relative to Personal Identity Information Protection or Data Breach Notification during the entire examination period. Specifically, auditors noted the Department did not have a Personal Identity Information Protection policy in place prior to September 8, 2014, or a Data Breach Notification policy prior to June 26, 2015.

In discussing these conditions with Department management, they indicated the delay in finalizing its risk assessment prior to June 30, 2015 was due to the scope of the assessment, which involved physical inspections at all Department offices and a comprehensive review of all of its systems. This newly implemented assessment process took six months to complete and made it difficult to finalize a report prior to June 30, 2015.

Updated Response: Implemented.

5. Update the disaster contingency plan such that it addresses not only the Department's IT environment but also business operation continuity plans at least annually or when significant changes occur. In addition, perform and document tests of the disaster contingency plan at least once a year. (Repeated-2013)

Finding: The Department does not have comprehensive disaster contingency procedures in place.

During the examination, auditors noted the Department had not updated its disaster contingency plan since August 2004. The contingency 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 had not been tested in recent years. Since the last examination, the

Department has focused on remediating a number of the disaster contingency plan shortfalls as they relate to the Department's IT environment. However, disaster contingency plans should be comprehensive and not only include procedures to ensure information technology is addressed but also business operation continuity plans.

In discussing these conditions with Department management, they indicated that during the review period they implemented and completed the first phase of their disaster contingency remediation strategy that focused on remediating weaknesses found related to their IT Infrastructure and third party contingency plans to ensure the recovery of its financial, gaming and winner information. Phase 1 was an important first step in enabling Phase 2 which focuses on a comprehensive update of its overall Department disaster contingency plan that ties together system recovery as well as overall business operations recovery. Phase 2 also requires additional specialized resources the Department has yet to procure to help facilitate the completion and testing of the plan.

Updated Response: Accepted. The Department is in the process of finalizing an overall disaster recovery plan that addresses business operation continuity and plans to conduct a test of the plan in the current fiscal year.

6. Comply with the required provisions of the Fiscal Control and Internal Auditing Act as well as other required reporting, and implement internal control procedures to ensure compliance. (Repeated-2013)

Finding: The Department, including its Internal Audit function, did not comply with the Fiscal Control and Internal Auditing Act or timely perform other required reporting and follow-up.

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. Auditors noted that Administrative Support Services; Purchasing, Contracting, and Leasing; Property, Equipment, and Inventories; Petty Cash and Local Funds; and Electronic Data Processing were not audited as required.
- The Department did not timely certify its internal controls for 2015 as required by the Act. This certification, which was due on May 1, 2015, was submitted on January 4, 2016, or 248 days late.

The Department did not maintain a full-time program of internal auditing during the examination period as required by the Act. The Department did not employ a Chief Internal Auditor or any internal audit staff from the period January 16, 2015 through May 31, 2015. The Department's internal audit function failed to perform follow-up on all internal audit findings to verify management's implementation of corrective action for two of four internal audits tested.

- The Department failed to submit their required annual audits of the GAAP package and financial statement process to the Financial Reporting Standards Board in a timely manner.

Accepted, Implemented, or Under Study – concluded

In discussing these conditions with Department management, they indicated that the exceptions noted were due to unanticipated vacancies within the Internal Audit Division.

Updated Response: Implemented.

7. Comply with the applicable statutory requirements and submit the required reports, and documentation as required. Implement internal control procedures to ensure compliance. (Repeated-2013)

Finding: The Department failed to submit, or failed to submit timely, certain required reports and documentation to oversight entities.

During testing of the statutes applicable to the Department, the auditors noted the following exceptions:

- There were no quarterly reports or an annual report on activities and actions of the private manager submitted to the Governor or the General Assembly during the fiscal year ended June 30, 2015.
- The Internet Lottery Study Committee (Committee) failed to timely submit to the Department written changes, additions, or corrections to the proposed findings and recommendations of the Internet Lottery Study in a timely manner. The auditors noted that the Committee's written changes, additions, or corrections to the proposed findings were submitted November 8, 2013, which was 22 calendar days after the Committee met on October 17, 2013 to discuss the proposed findings and recommendations of the Internet Lottery Study.
- The Department failed to file their required 2013 Agency Workforce Report due January 1, 2014 (filed on March 28, 2014) in a timely manner. Also, the Department did not accurately prepare their 2014 Agency Workforce Report.
- The Department failed to submit their required 2014 and 2015 Agency Fee Imposition Reports to the Office of the Comptroller.
- The Department failed to submit annual reports for 2014 and 2015 regarding the work of the Lottery Control Board.

In discussing these conditions with Department management, they indicated that the exceptions were due to ineffective oversight.

Updated Response: Implemented.

8. Follow the applicable statutes, administrative rules, and SAMS procedures in maintaining and reporting property and equipment records. (Repeated-2013)

Finding: The Department did not have adequate internal 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:

- During testing over five property addition transactions (totaling $16,074), auditors noted that two transactions (totaling $5,775) were not reported in the appropriate fiscal year. Both transactions were identified to have occurred in the fiscal year prior to when they were reported.
- During testing over five property disposals/transfers (totaling $101,411), auditors noted that two transactions (totaling $16,757) were reported as disposals, when in fact the two transactions were to remove and then re-enter the items so new property tags could be issued/recorded. The resulting effect of the transactions was an overstatement of disposals reported during the examination period.
- During testing of one multi-year lease contract (total contract value of $93,161), auditors noted that the Department did not prepare and submit to the Comptroller's Office, Form SCO-560 "Accounting for Leases-Lessee."

In discussing these conditions with Department management, they indicated that the conditions identified were a result of limitations of the inventory system utilized by Lottery, employee oversight, and inventory and lease management practices that don't align with statutory requirements.

Updated Response: Accepted: The Department has transitioned to a new inventory system which should enable the controls that were not in place before. In addition, the Department is also working on formal policy and procedures which should be completed in the current fiscal year.

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 5 calendar 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 calendar 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.

The Department filed no affidavits for emergency purchases during FY14 and FY15.

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 reported in July of 2015 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, 2015

APPENDIX A

Appropriations and Expenditures

	FY15	FY14	FY13
Appropriations	**1,226,949,500**	**$ 1,229,925,800**	**$ 1,042,044,300**
Expenditures			
Regular Payroll	10,000,468	9,910,280	9,826,420
Contractual Payroll Employees	17,271	3,825	-
Other Personal Services	200	900	800
Personal Services Retirement	4,244,368	3,969,654	3,741,045
Social Security	728,438	715,060	722,028
Social Security - contractual	1,321	156	-
Group Insurance	2,722,483	2,933,574	3,432,739
Contractual Services	134,396,883	61,228,223	127,831,130
Travel	42,845	61,226	56,510
Purchase of Investments	120,469,111	151,652,907	134,843,471
Printing	11,624	11,568	8,548
Commodities	36,991	26,762	36,356
Equipment	5,114	9,392	5,600
Electronic Data Processing	14,567	17,536	23,560
Telecommunications	216,755	259,648	198,226
Operation of Auto Equipment	172,695	240,625	257,367
Interest Penalty - Prompt Payment Act	-	25	-
Lottery Prizes	667,111,928	361,861,026	323,682,854
Refunds	47,191	10,506	17,567
Total appropriated funds	**$ 940,240,253**	**$ 592,912,893**	**$ 604,684,221**
Non-appropriated Funds Expenditures			
Interfund Cash Transfers	8,000,000	145,000,000	135,000,000
Lottery Prizes	39,773,619	49,389,494	57,839,434
Total non-appropriated funds	**47,773,619**	**194,389,494**	**192,839,434**
GRAND TOTAL - ALL FUNDS	**$ 988,013,872**	**$ 787,302,387**	**$ 797,523,655**

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DEPARTMENT OF THE LOTTERY

YEAR ENDED JUNE 30, 2015

APPENDIX B

Statement of Net Position (Deficit)

Current assets	**FY15**	**FY14**
Cash and cash equivalents	$ 16,205,000	$ 17,945,000
Cash equity in State Treasury	245,963,000	108,497,000
Prepaid assets	20,000,000	-
Investments, short term	36,428,000	39,348,000
Accounts receivable	35,861,000	26,858,000
Private Management contract	32,618,000	37,129,000
Other receivables	-	12,697,000
Total current assets	**387,075,000**	**242,474,000**
Noncurrent assets		
Investments	265,231,000	257,335,000
Capital assets being depriciated, net	93,000	151,000
Total noncurrent assets	**265,324,000**	**257,486,000**
Deferred outflows of resources - pension	**11,718,000**	**-**
TOTAL ASSETS	**664,117,000**	**499,960,000**
Current liabilities		
Prizes payable	235,017,000	168,026,000
Accounts payable and accred liabilities	82,259,000	37,533,000
Due to other Government - Federal	72,000	184,000
Due to other State funds	60,803,000	6,930,000
Unearned revenue	2,789,000	1,650,000
Provision for private management contract dispute	-	21,776,000
Other liabilities	1,222,000	1,259,000
Current portion of long-term annuity prizes payable	34,409,000	37,622,000
Total current liabilities	**416,571,000**	**274,980,000**
Noncurrent liabilities		
Noncurrent portion of long-term annuity prizes payable	238,318,000	229,207,000
Net pension liability	65,780,000	-
Noncurrent other	828,000	929,000
Total noncurrent liabilities	**304,926,000**	**230,136,000**
Deferred inflows of resources - pension	**2,345,000**	**-**
TOTAL LIABILITIES	**723,842,000**	**505,116,000**
Net Position		
Invested in capital assets	93,000	151,000
Unrestricted	(59,818,000)	(5,307,000)
TOTAL NET POSITION	**$ (59,725,000)**	**$ (5,156,000)**
Restatement of FY14		(5,156,000)
Restatement of pension resources/liability		(53,647,000)
Net Deficit, July 1, 2014, restated		**$ (58,803,000)**

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YEAR ENDED JUNE 30, 2015

APPENDIX C

Statement of Revenues, Expenses, and Changes in Net Position (Deficit)

Operating Revenues	**FY15**	**FY14**
Charges for sales and services	$ 2,837,805,000	$ 2,802,310,000
Private management contract fee	10,000,000	35,713,000
Other	6,487,000	4,484,000
Total Operating Revenues	**2,854,292,000**	**2,842,507,000**
Operating Expenses		
Cost of sales and service	161,607,000	159,124,000
Prizes and claims	1,823,572,000	1,749,177,000
General and administrative	147,078,000	156,486,000
Recovery of private management contract fee	(21,776,000)	-
Depreciation	55,000	73,000
Total Operating Expenses	**2,110,536,000**	**2,064,860,000**
Operating Income	743,756,000	777,647,000
Nonoperating revenues (expenses)		
Investment income	11,533,000	7,406,000
Interest expense	(12,298,000)	(13,124,000)
Other	(8,000)	(20,000)
Total nonoperating revenues (expenses), net	(773,000)	(5,738,000)
Change in net positions before transfers	742,983,000	771,909,000
Tranfers to other State funds	(743,905,000)	(777,440,000)
Change in net position	(922,000)	(5,531,000)
Net position (deficit), at beginning of year, restated	(58,803,000)	375,000
Net position (deficit) at end of year	$ (59,725,000)	$ (5,156,000)

Restatement of FY14	
Net Deficit, June 30, 2014	(5,156,000)
Restatement - deferred outflow of resources - pension	4,125,000
Restatement - net pension liability	(57,772,000)
Net Deficit, July 1, 2014, restated	**$ (58,803,000)**

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YEAR ENDED JUNE 30, 2013

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 (Fund 711)	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