

STATE OF CONNECTICUT

**AUDITORS' REPORT
CONNECTICUT LOTTERY CORPORATION
FOR THE FISCAL YEAR ENDED JUNE 30, 1999 and 2000**

**AUDITORS OF PUBLIC ACCOUNTS
KEVIN P. JOHNSTON ♦ ROBERT G. JAEKLE**

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January 17, 2002

**AUDITORS' REPORT
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FOR THE FISCAL YEAR ENDED JUNE 30, 1999 and 2000**

We have made an examination of the financial records of the Connecticut Lottery Corporation for the fiscal years ended June 30, 1999 and 2000.

Financial statements pertaining to the operations and activities of the Connecticut Lottery Corporation for the fiscal years ended June 30, 1999 and 2000, are presented and audited on a Statewide Single Audit basis to include all State agencies and funds. We have relied on the financial and compliance audits conducted by the Corporation's independent public accountant covering the fiscal years mentioned above, after having satisfied ourselves as to the firm's professional reputation, qualifications and independence, and verifying that generally accepted accounting principles and auditing standards were followed in the audits and in the preparation of the reports. Financial statements of the Corporation are included in the Corporation's Annual Reports for 1999 and 2000.

In addition to reviewing the audits and related working papers prepared by the independent public accountant, we reviewed State statutory compliance requirements, tested certain internal control procedures, and reviewed the minutes of the Corporation's meetings. We conducted our audit in accordance with generally accepted government auditing standards for financial related audits. This report on our examination consists of the following Comments, Condition of Records and Recommendations.

COMMENTS

FOREWORD:

The Connecticut Lottery Corporation operates primarily under Chapter 229a, Sections 12-800 through 12-818 of the General Statutes. Pursuant to Section 12-802 of those Statutes, it is a public instrumentality and political sub-division of the State. Also, pursuant to Chapter 12 of the General Statutes, it is classified as a quasi-public agency subject to various statutory requirements related to those agencies. As a quasi-public agency the Corporation's financial information is included as an Enterprise Fund in the State of Connecticut's Comprehensive Annual Financial Report (CAFR).

Sections 12-800 through 12-818 of the General Statutes established the Connecticut Lottery Corporation to take over the operation of the Lottery from the Division of Special Revenue. The Corporation was set up to operate and manage the Lottery in an "entrepreneurial and business-like manner." The purpose of the Corporation is to increase revenue from Lottery operations by being responsive to market forces. As a quasi-public agency, the Connecticut Lottery Corporation is free from budgetary and other constraints such as procurement regulations that affect State agencies.

By law the Connecticut Lottery Corporation is not allowed to sell the Lottery or to modify lottery games that would violate any agreement the State has with the Mashantucket Pequots, the Mohegans or any other Federally recognized Native American Tribes. Also, Section 12-818 of the General Statutes requires the Corporation to make an annual transfer from lottery sales to the chronic gamblers treatment and rehabilitation program account created pursuant to Section 17a-713 of the General Statutes. Public Act 98-250 increased the amount of the annual transfer from \$250,000 to \$500,000 for the fiscal year ending June 30, 1999. Public Act 99-173 further increased funding provisions to \$875,000 for the fiscal year ending June 30, 2000, and \$1,200,000 for the fiscal year ending June 30, 2001, and for each fiscal year thereafter.

The Connecticut Lottery Corporation provides two categories of game products: On-line games and instant tickets. Currently, there are eight different games offered by the Corporation within the two categories. They are as follows:

- Instant games are played by scratching off the latex covering of the play area on the ticket. A number of different instant games are in circulation during a given period, each with a determinate pay out. Instant tickets were introduced to the market in September 1975, and have become the largest contributor to total sales and resulting contributions to the State of Connecticut's General Fund.
- The Nightly Numbers is an on line game that is available to consumers on a daily basis. Players pick three numbers from a range and choose among different play options. This game has been in existence in similar form since 1977. This game accounts for the next largest amount of sales and contributions to the State of Connecticut's General Fund.
- The Play 4 on line, nightly game was introduced in 1980. Players select four numbers from a range and choose from different play options.

- In May 1999, the Wild Card Lotto game was replaced by “Classic Lotto”, the original lotto on line game that had been introduced on November 18, 1983. Two drawings are held each week. Players pick six numbers from a range of numbers. The minimum jackpot is \$1 million.
- Cash 5 is an on line game with a top prize of \$100,000 that was introduced in 1992 and is played seven days a week. Players pick 5 numbers from a range of numbers.
- Powerball is a multi-State, Lottery game that is played twice each week for a jackpot of at least \$10 million. Players select 6 numbers from a range of numbers. The game was introduced to Connecticut players in 1995.
- Mid-day 3 and Mid-day 4 on line games were introduced in February, 1998. These games are played on a daily basis at mid-day. They are played in a similar manner as the Nightly and Play 4 games.

Organizationally, the Connecticut Lottery Corporation is divided into three major areas:

Finance and Administration:

Responsible for disbursements, accounts payable, collections, revenue accountability, payroll and human resources.

Marketing and Sales:

Responsible for designing and promoting game products and the monitoring of vendors for compliance with sales, collections and game requirements.

Operations:

Lottery claims, purchasing services, information systems, receipt, control and disbursement of game products to vendors.

Board of Directors and Administrative Officials:

Pursuant to Section 12-802 subsection (b) of the General Statutes, the Connecticut Lottery Corporation is governed by a 13 member Board consisting of 11 appointees of various elected officials and two State office holders. The State Treasurer and the Secretary of the Office of Policy and Management, serve as ex-officio members of the Board of Directors by virtue of their office.

Of the 11 appointed members, five are appointed by, and serve at the pleasure of, the Governor. The Governor is required to appoint directors who have skill, knowledge and experience in the fields of management, finance or operations in the private sector. The six

remaining appointees are chosen by various legislative leaders. Appointed members serve at the pleasure of the appointing authority. Board members receive no compensation, but are entitled to reimbursement for expenses incurred in the performances of their duties.

As of June 30, 2000, the members of the Board of Directors were as follows:

Ex Officio:

MaryAnn Palmarozza, designee for the Secretary of the Office of Policy and Management

Howard G. Rifkin, designee for the State Treasurer

Governor Appointments:

Paul Corey, Chairman

Walter Scholtz

Ralph A. Carloni

Margaret Morton

Legislative Appointments:

John E. Calkins, Jr.

Steven Bafundo

Jerome Klein

Eugene Millerick

Martin E. Stauffer

As of June 30, 2000, there were two unfilled Board positions; one to be appointed by the Governor and the other by the Senate Majority Leader.

Subsection (c) of Section 12-802 of the General Statutes provides that the Chairperson of the Board shall be appointed by the Governor with the advice and consent of the Legislature. Robert W. Werner was appointed the first Chairman of the Connecticut Lottery Corporation (CLC) effective August 17, 1998. Prior to that appointment, Benson R. Cohen served as the Interim Chairman since the inception of the Corporation. In January, 2000, Mr. Werner resigned from his position as Chairman of the CLC. On January 3, 2000, Paul Corey was appointed Chairman of the CLC and continues to serve in that capacity.

Nicholas T. Manno was appointed Acting President of the Connecticut Lottery Corporation effective March 7, 1998. On November 24, 1998, George Wandrak was appointed to the position of President and Chief Executive Officer of the Connecticut Lottery Corporation. On April 20, 2000, Mr. Wandrak resigned from the position of President and Chief Executive Officer of the Connecticut Lottery Corporation. Retroactive to April 21, 2000, James Vance was appointed Acting President and Chief Executive Officer of the Connecticut Lottery Corporation.

On March 30, 2001, James Vance was appointed to the position of President and Chief Executive Officer of the Connecticut Lottery Corporation.

RÉSUMÉ OF OPERATIONS:

The Connecticut Lottery Corporation has contracted with approximately 3,000 licensed retailers throughout the State to offer lottery games for sale to the public. Only retailers who satisfy the Corporation's established criteria are recommended for licensure to the State of Connecticut's Division of Special Revenue. The Division of Special Revenue retained regulatory authority for such matters following the creation of the Connecticut Lottery Corporation.

On an ongoing basis retailers deposit revenues generated from the sale of lottery games to the public into fiduciary type bank accounts. Once a week, those deposits (less canceled tickets, prize payouts and retailer commissions) are "swept" into the Corporation's Operating Account held by a major bank. The Operating Account along with other Corporation bank accounts (i.e. Claim Account, Advance Account and Accounts Payable) are combined into a "Concentrator" account for overnight investment.

State Accounts:

Section 3-27a of the General Statutes allows the Connecticut Lottery Corporation to deposit excess funds with the Treasurer in such fund or funds of the State as is considered appropriate. Excess funds represent the amount in cash accounts not immediately needed to meet current operating requirements. The "Concentrator" account, as described above, is evaluated weekly and available cash is invested with the Treasurer of the State of Connecticut in a short-term investment fund that offers a greater return on investment than its bank. Deposits with the State Treasurer's Short Term Investment Fund (STIF) were \$8,455,857 and \$10,233,121 as of June 30, 1999, and June 30, 2000, respectively.

On a weekly basis the Connecticut Lottery Corporation transfers net income to the Connecticut General Fund. Such transfers are based upon sales revenue less the cost of game prizes, retailer commissions and operational and administrative costs. Transfers to the General Fund from operations were \$271,308,023, and \$253,598,048, for the fiscal years ended June 30, 1999 and June 30, 2000, respectively.

The Connecticut Lottery Corporation incurs long-term liabilities as the result of game prizes that are paid out in the form of periodic payments. In order to meet those future obligations, the Corporation purchases annuities from insurance companies. This debt represents remaining periodic payments owed to Lotto and Instant game winners. Annuity contracts and related liabilities are reported at their discounted present value in the Financial Statements of the Corporation. The long-term liabilities decrease as annuity payments are made to winners. In addition, the recent decrease in Lotto sales has resulted in a decrease in game prizes being won. The liabilities decrease and game prize decrease combined with Lotto winners choosing the lump sum prize payment option (thus eliminating annuity purchases), resulted in a decrease of the annuities outstanding from \$514,375,083, for fiscal year ended June 30, 1999, to \$486,568,191, for the fiscal year ended June 30, 2000.

Connecticut Lottery Corporation employees are considered employees of the State of Connecticut per Section 12-802 subsection (e) of the General Statutes and are covered under the State Employees Retirement System. The Corporation's payroll is processed through a direct link with the State's automated payroll system. That system produces reports on the amount of salaries and fringe benefit costs incurred during the previous biweekly period. An amount equal to the costs incurred for salaries and fringe benefits is wire transferred by the Corporation into a State of Connecticut Treasurer's Account to cover those costs. The operating expenses for salaries and benefits were \$6,810,942 and \$7,333,541 for the fiscal years ended June 30, 1999, and June 30, 2000, respectively.

Financial Operations:

The Connecticut Lottery Corporation operates as an enterprise activity and is included in the State of Connecticut's Comprehensive Annual Financial Report within that category. The accrual basis of accounting is used in accordance with generally accepted accounting principles. The Corporation applies applicable pronouncements of the Financial Accounting Standards Board issued on or before November 30, 1989, unless those pronouncements conflict with or contradict the pronouncements of the Governmental Accounting Standards Board (per GASB #20).

The following is a comparative summary of operations. This financial information was obtained from the Connecticut Lottery Corporation's audited financial statements for the fiscal years ended June 30, 1998, 1999 and 2000.

	<u>Fiscal Year Ended June 30,</u>		
	<u>1998</u>	<u>1999</u>	<u>2000</u>
Total sales	\$ 805,612,669	\$ 870,916,802	\$ 837,509,505
Prize expense	(474,372,235)	(517,307,130)	(502,494,275)
All other expenses	<u>(74,813,323)</u>	<u>(80,107,149)</u>	<u>(79,093,373)</u>
Excess of sales over expenses	256,427,111	273,502,523	255,921,857
Other non operating revenue	<u>1,679,399</u>	<u>1,739,500</u>	<u>1,659,850</u>
	258,106,510	275,242,023	257,581,707
Transfers to DSR and Gambler's Fund	<u>(2,294,366)</u>	<u>(2,529,803)</u>	<u>(3,135,903)</u>
Income Available	255,812,144	272,712,220	254,445,804
Transfers to the General Fund	(255,812,144)	(271,308,023)	(253,598,048)
Transfer of prior years' unclaimed prizes	<u>(8,462,686)</u>	<u>0</u>	<u>0</u>
Net(Loss) Income	<u>\$ (8,462,686)</u>	<u>\$ 1,404,197</u>	<u>\$ 847,756</u>

Transfers to the General Fund as a percentage of sales of lottery game products was 31 and 30 percent for the fiscal years ended June 30, 1999, and June 30, 2000, respectively.

For the fiscal year ended June 30, 2000, instant tickets made up 62 percent of sales by game, but, because of their higher prize pay out, contributed 46 percent to General Fund transfers. Also, all other expenses (which include commissions, advertising, production expenses and salaries and benefits) increased as a percentage of sales from 9.2 percent to 9.4 percent over the same period.

As presented in its audited financial statements, the Corporation's Balance Sheet for June 30, 1999 and June 30, 2000, was as follows:

	<u>June 30,</u> <u>1999</u>	<u>June 30,</u> <u>2000</u>
ASSETS		
Current Assets		
Cash and cash equivalents	\$ 23,930,926	\$ 23,977,171
Accounts receivable net of allowance	13,193,769	11,162,841
Prepaid annuities for prizes	57,189,933	57,250,066
Accrued interest receivable	19,525,267	20,218,353
Ticket inventory	2,007,422	1,541,382
Prepaid expenses	219,852	231,334
Total Current Assets	<u>116,067,169</u>	<u>114,381,147</u>
Long-Term Assets		
Investments for prize payments at present value	514,375,083	486,568,191
Prize reserve held by Multi-State Lottery Association	5,114,737	5,441,077
Property, plant and equipment, net	3,942,826	3,371,178
Total Long-Term Assets	<u>523,432,646</u>	<u>495,380,446</u>
Total Assets	<u>\$ 639,499,815</u>	<u>\$ 609,761,593</u>
LIABILITIES AND RETAINED EARNINGS		
Current Liabilities		
Annuities payable	\$ 59,144,830	\$ 60,436,655
Prizes payable	34,823,716	31,731,922
Accrued interest payable	20,289,867	20,218,353
Accounts payable and accrued expenses	4,707,738	7,538,287
Due to Multi-State Lottery Association	4,094,261	344,298
Deferred revenue	551,601	623,461
Total Current Liabilities	<u>123,612,013</u>	<u>120,892,976</u>
Long-Term Liabilities		
Long-term annuities payable	514,375,083	486,568,142
Retailer bond	100,000	40,000
Total Long-Term Liabilities	<u>514,475,083</u>	<u>486,608,142</u>
Total Liabilities	<u>638,087,096</u>	<u>607,501,118</u>

RETAINED EARNINGS

Reserved for unclaimed prizes	<u>1,412,719</u>	<u>2,260,475</u>
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Total Liabilities and Retained Earnings	<u>\$ 639,499,815</u>	<u>\$ 609,761,593</u>
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The Connecticut Lottery Corporation's assets, equaling its liabilities and retained earnings, decreased from \$651,367,560 for fiscal year ended June 30, 1998 to \$639,499,815 and \$609,761,593 for fiscal years ended June 30, 1999 and 2000, respectively. The primary cause for this decrease was a reduction in the investments for prize payments at present value and the corresponding decrease in long-term annuities payable.

CONDITION OF RECORDS

Operations Controls/Business Resumption Plan:

Background: On a weekly basis the Connecticut Lottery Corporation transfers revenue to the Connecticut General Fund. The Lottery revenue represents a significant part of the State of Connecticut's annual revenue.

Criteria: A disaster recovery plan that addresses resumption of Lottery business operations and protection of revenue in the event of an emergency is a necessary planning element in the efficient operation of the State of Connecticut's government.

Condition: The Connecticut Lottery Corporation does not have a well-documented disaster recovery plan which addresses all aspects of prompt business resumption.

Effect: If an emergency situation should arise, there is no formal disaster recovery plan that details how to resume all business operations of the Connecticut Lottery Corporation, thus protecting this significant source of State revenue.

Cause: We were unable to determine why a detailed disaster recovery plan has not been completed.

Recommendation: The Connecticut Lottery Corporation should complete a disaster recovery plan that addresses prompt business resumption in the event of an interruption of operations. (See Recommendation 1.)

Auditee Response: "The Connecticut Lottery Corporation agrees with this recommendation and is giving utmost priority to the completion of a fully documented business resumption and disaster recovery plan that addresses every aspect of our business.

The Connecticut Lottery Corporation has had a Disaster Recovery Plan in place for its on-line and instant games for several years. This plan is complete, fully-documented and tested on a regular basis. In the event of a disaster at the vendor site, all telephone lines and circuits would be immediately transferred to our hot backup site located at the Division of Special Revenue in Newington. This transfer would enable all 3000 lottery terminals to remain in operation should the Rocky Hill facility be rendered inoperable. The central computer system accounts for all on-line

and instant sales and, therefore, represents the greatest vulnerability to General Fund transfers.

We are currently in the process of documenting a disaster recovery plan for the packaging and distribution of our instant tickets and for the resumption of full and/or modified operation of our business. In May of 2001, after a very lengthy search of nearly two years for a qualified candidate, the Lottery hired a Data Security Specialist whose foremost responsibility is the planning and oversight of this project. This initiative is expected to take two years to full completion, although we will have a workable plan in place within a year which addresses all critical business functions.

Based on the Corporation's commitment to protecting the revenue stream and to maximizing transfers to the Connecticut General Fund, we will continue our progress to complete a comprehensive business resumption and disaster recovery plan in a timely and efficient manner."

Other Examinations:

As previously noted, an independent public accountant audited the Connecticut Lottery Corporation during our audited period. Those audits attested that, the combined financial statements presented fairly, in all material respects, the financial position of the Connecticut Lottery Corporation for the years under review, and the results of its operations and cash flows for those years in conformity with generally accepted accounting principles.

As part of these examinations, the independent public accountant provided compliance reports and reports on the internal control structure. The compliance reports relate to the requirements of Section 1-122 of the General Statutes. This section requires organizations, including the Connecticut Lottery Corporation, to comply with certain requirements concerning affirmative action, personnel practices, the purchases of goods and services, the use of surplus funds and the distribution of loans, grants and other financial assistance. The compliance reports disclosed no instances of noncompliance concerning these requirements. The reports on the internal control structure indicated that no material weaknesses in internal control were identified. The independent public accountant became aware of several matters that presented opportunities for strengthening internal controls and operating efficiency, and made recommendations in a management letter to the Corporation's Board of Directors. Those recommendations are presented below along with the current status based upon discussions with management concerning efforts to address them.

Independent Public Accountant Audit Recommendations:

- Management should consider using a data base program to track annuity transactions. When each annuity is set up, the amortization schedule could be entered and the data base would then be able to track not only the nominal payments (consisting of both principal and interest), but the interest from the amortization of the discount and the current principal balance (present value).

A software package named "T-Value" was purchased and installed by the CLC's Information Technology Unit. This software is being used as a data base program to track annuity transactions.

- Changes are needed for the Lawson accounting software (that posts high-tier claims and prize annuity transactions) to eliminate the need for manual correcting entries. Redundant postings of the claims transactions are made from the claims systems.

The required changes have been made to the Lawson software.

- Retail agreements should be modified to explicitly state the requirement that accounts be maintained in qualified public depositories.

The language has been amended in the retail agreements to state that separate accounts should be maintained in qualified public depositories.

- While the operating procedures and controls in place at the CLC and the on-line vendor were sufficient to ensure accurate financial reporting, opportunities exist in certain areas that would further strengthen general information systems controls. At the CLC these areas include access controls for data security policies and procedures documentation and operation controls to develop a business plan. At the on-line vendor these areas include systems program and development controls with regard to system documentation and access controls for data security administration, data security policies and procedures, TXE console security, the NT administrator account, and physical security administration and policies.

The CLC has reviewed the operating procedures and controls in place concerning general information systems controls as recommended by the Independent Public Accountant. Comprehensive procedure manuals have been developed for a major portion of the existing systems concerning system access controls and the documentation for the remaining systems is ongoing. The business plan project is in process.

The on-line vendor has completed a review of operating procedures and controls. Substantial improvements have been implemented by the on-line vendor concerning access controls, system documentation and system security. An ongoing program has been established between the on-line vendor and the CLC to monitor further progress.

RECOMMENDATIONS

Status of Prior Audit Recommendations:

There were no recommendations presented in our prior report.

Current Audit Recommendations:

As a result of our current examination, we present one recommendation to the Connecticut Lottery Corporation.

The Connecticut Lottery Corporation should complete a disaster recovery plan that addresses prompt business resumption in the event of an interruption of operations.

Comment:

The Connecticut Lottery Corporation does not have a disaster recovery plan which addresses prompt business resumption. A disaster plan that addresses resumption of Lottery business and protection of revenue in the event of an emergency is a necessary planning element in the efficient operation of State of Connecticut government, as the Lottery revenue represents a significant part of the State's annual revenue.

CONCLUSION

This report is intended for the Governor, the State Comptroller, the Appropriations Committee of the General Assembly and the Legislative Committee on Program Review and Investigations. However, this report is a matter of public record and its distribution is not limited.

In conclusion, we wish to express our appreciation for the courtesies and cooperation extended to our representatives by the officials and employees of the Connecticut Lottery Corporation during our examination.

Josepha M. Brusznicki
Principal Auditor

Approved:

Kevin P. Johnston
Auditor of Public Accounts

Robert G. Jaekle
Auditor of Public Accounts

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