

STATE OF CONNECTICUT

**AUDITORS' REPORT
CONNECTICUT LOTTERY CORPORATION
FOR THE FISCAL YEARS ENDED JUNE 30, 2001 and 2002**

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

Table of Contents

INTRODUCTION	1
COMMENTS	2
FOREWORD	2
Board of Directors and Administrative Officials	4
RÉSUMÉ OF OPERATIONS	5
State Accounts	5
Financial Operations	6
CONDITION OF RECORDS	10
Operations Controls/Business Resumption Plan	10
Other Examinations	12
RECOMMENDATIONS	13
CONCLUSION	14

October 1, 2003

**AUDITORS' REPORT
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We have made an examination of the financial records of the Connecticut Lottery Corporation for the fiscal years ended June 30, 2001 and 2002.

Financial statements pertaining to the operations and activities of the Connecticut Lottery Corporation for the fiscal years ended June 30, 2001 and 2002, 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 2001 and 2002.

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 12-834 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 12-834 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 99-173 increased the amount of the annual transfer from \$500,000 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 nine different games offered by the Corporation within the two categories. They are as follows:

- Scratch 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.
- Play 3 replaced Nightly Numbers and 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 Lottery 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.
- The Powerball Game Show was introduced by the Multi-State Lottery Association. The show aired for the first time in October 2000. The show airs each Saturday night and contestants are chosen based on the State’s Instant Powerball Ticket.

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, 2002, 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, 2002, 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.

Mr. George Wandrak was appointed President and Chief Executive Officer of the Connecticut Lottery Corporation on November 24, 1998. 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. Mr. Vance continues to serve as President and Chief Executive Officer.

RÉSUMÉ OF OPERATIONS:

The Connecticut Lottery Corporation has contracted with approximately 2,800 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 \$7,149,873 and \$6,216,418 as of June 30, 2001, and June 30, 2002, 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 \$252,002,987, and \$271,509,680, for the fiscal years ended June 30, 2001 and June 30, 2002, 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 \$451,339,288, for fiscal year ended June 30, 2001, to \$409,216,251, for the fiscal year ended June 30, 2002.

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 \$7,996,894 and \$9,225,165 for the fiscal years ended June 30, 2001, and June 30, 2002, 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, 2000, 2001 and 2002.

	<u>Fiscal Year Ended June 30,</u>		
	<u>2000</u>	<u>2001</u>	<u>2002</u>
Total sales	\$ 837,509,505	\$ 839,711,547	\$ 907,903,268
Prize expense	(502,494,275)	(507,863,928)	(546,095,390)
All other expenses	<u>(79,093,373)</u>	<u>(78,448,071)</u>	<u>(87,012,059)</u>
Excess of sales over expenses	255,921,857	253,399,548	274,795,819
Other non operating revenue	<u>1,659,850</u>	<u>1,656,183</u>	<u>1,003,638</u>
Subtotal	257,581,707	255,055,731	275,799,457
Subtotal Forward	257,581,707	255,055,731	275,799,457
Transfers to DSR and Gambler's Fund	<u>(3,135,903)</u>	<u>(3,370,102)</u>	<u>(3,422,470)</u>

Income Available	254,445,804	251,685,629	272,376,987
Transfers to the General Fund	<u>(253,598,048)</u>	<u>(252,002,987)</u>	<u>(271,509,680)</u>
Net(Loss) Income	<u>\$ 847,756</u>	<u>\$ (317,358)</u>	<u>\$ 867,307</u>

In accordance with Section 12-812 of the General Statutes, the President of the Connecticut Lottery Corporation transfers on a weekly basis the excess balance of the Lottery Fund to the General Fund. These weekly transfers represent an estimate of lottery sales revenues less operating expenditures. Weekly transfers totalled \$252,002,987, and \$271,509,680, for the fiscal years ended June 30, 2001 and June 30, 2002, respectively and represented 30 percent of total annual lottery sales for each of the fiscal years audited.

For the fiscal year ended June 30, 2002, instant tickets made up 60 percent of total sales by game, but, because of their higher prize pay out, contributed \$127,885,000 or 47 percent to General Fund transfers. However, all other expenses (which include commissions, advertising, production expenses and salaries and benefits) decreased as a percentage of sales from 9.4 percent to 8.3 percent over the same period.

We noted that the Connecticut Lottery Corporation contracted with a law firm in the 2000 – 2001 fiscal year to provide lobbying services for a two year period ending December 31, 2002, for a fee of \$40,000 per year. Expenditures associated with this contract were \$20,000 and \$40,000 for the fiscal years ended June 30, 2001 and 2002, respectively.

As presented in its audited financial statements, the Corporation's Statement of Net Assets for June 30, 2000, June 30, 2001 and June 30, 2002, was as follows:

	<u>June 30,</u> <u>2000</u>	<u>June 30,</u> <u>2001</u>	<u>June 30,</u> <u>2002</u>
ASSETS			
Current Assets			
Cash and cash equivalents	\$ 23,977,171	\$ 28,274,228	\$ 19,276,208
Accounts receivable net of allowance	11,162,841	10,011,243	9,510,705
Prepaid annuities for prizes	57,250,066	59,875,896	61,239,119
Accrued interest receivable	20,218,353	18,973,355	17,421,202
Ticket inventory	1,541,382	1,147,010	1,651,173
Prepaid expenses	<u>231,334</u>	<u>320,395</u>	<u>518,799</u>
Total Current Assets	<u>114,381,147</u>	<u>118,602,127</u>	<u>109,617,206</u>
Noncurrent Assets			
Investments for prize payments at present value	486,568,191	451,339,337	409,216,300

Auditors of Public Accounts

Prize reserve held by Multi-State Lottery Association	5,441,077	4,751,040	4,686,780
Advances to high tier claim centers	0	200,000	200,000
Property, plant and equipment, net	<u>3,371,178</u>	<u>2,657,761</u>	<u>1,991,608</u>
Total Noncurrent Assets	<u>495,380,446</u>	<u>458,948,138</u>	<u>416,094,688</u>
Total Assets	<u>\$609,761,593</u>	<u>\$577,550,265</u>	<u>\$525,711,894</u>
LIABILITIES AND NET ASSETS			
Current Liabilities			
Annuities payable	\$ 60,436,655	\$ 62,842,581	\$ 64,666,312
Prizes Payable	31,731,922	24,235,247	23,952,378
Accrued interest payable	20,218,353	18,973,355	17,421,202
Accounts payable and accrued expenses	7,538,287	5,797,026	6,993,476
Due to Multi-State Lottery Association	344,298	789,993	257,026
Deferred revenue	623,461	384,301	394,825
Due to the General Fund		<u>11,245,357</u>	
Total Current Liabilities	<u>120,892,976</u>	<u>124,267,860</u>	<u>113,685,219</u>
Long Term Liabilities			
Long-term annuities payable	486,568,142	451,339,288	409,216,251
Retailer Bond	<u>40,000</u>		
Total Long-Term Liabilities	<u>486,608,142</u>	<u>451,339,288</u>	<u>409,216,251</u>
Total Liabilities	<u>607,501,118</u>	<u>575,607,148</u>	<u>522,901,470</u>
NET ASSETS			
Invested in capital assets		2,657,761	1,991,608
Reserved for unclaimed prizes	2,260,475	1,943,117	2,810,424
Unrestricted		<u>(2,657,761)</u>	<u>(1,991,608)</u>
Total Net Assets	<u>2,260,475</u>	<u>1,943,117</u>	<u>2,810,424</u>
Total Liabilities and Net Assets	<u>\$609,761,593</u>	<u>\$577,550,265</u>	<u>\$525,711,894</u>

The Connecticut Lottery Corporation's assets, equaling its liabilities and net assets, decreased from \$609,761,593 for fiscal year ended June 30, 2000 to \$577,550,265 and \$525,711,894 for the fiscal years ended June 30, 2001 and 2002, 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:* The major business operations of the Connecticut Lottery Corporation include transfers of revenue to the Connecticut General Fund on a weekly basis, monitoring of on line ticket sales, distribution of scratch off tickets and administration of periodic payments to lottery game winners. Lottery revenue consists of deposits of online and scratch off ticket sale proceeds and represents a significant part of the State of Connecticut's annual revenue. Gross weekly revenue averaged \$17 million dollars a week during the audited period.
- Criteria:* A disaster recovery plan that addresses resumption of Lottery business operations including 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 has formulated and written a disaster recovery plan. However, the plan has yet to be fully accepted, adopted and implemented. Specifically, the plan that has been written includes the assumption that an alternative site to the current Connecticut Lottery Corporation headquarters will be required to carry out business operations in the event of an emergency. The Connecticut Lottery Corporation has identified one possible alternative site and has prepared a list of expenditures that would be required to prepare the site for emergency occupancy. However, there are other alternatives to the site that are still in the process of being investigated by the Connecticut Lottery Corporation.
- Effect:* The Connecticut Lottery Corporation can not fully implement the disaster recovery plan until a suitable alternative site is chosen and prepared for an emergency occupancy.
- Cause:* It appears that the complexities and lengthy preparation time of the disaster plan has contributed to the delay in its implementation.
- Recommendation:* The Connecticut Lottery Corporation should complete, accept, adopt and implement a disaster recovery plan that addresses prompt business resumption in the event of an interruption of operations. (See Recommendation 1.)

Auditee Response: “We agree that the Connecticut Lottery Corporation, needs a completed Disaster Recovery Plan to resume operations as soon as possible in the event an emergency interrupts lottery functions. Toward that end, a project team was assembled in June 2001 to develop such a plan. This project proceeded forward and substantial efforts were expended by the Connecticut Lottery Corporation over the last year and a half. Critical business functions were defined, essential personnel required to effect an efficient recovery were identified, emergency response procedures were developed, and a recovery team structure was established. The project leader of this effort was a data security specialist who compiled the data into a three-volume set, approximately 450 pages in length that documents the results of the department examinations. This documentation is comprehensive in scope and will be the manual used to guide recovery operations in the event of an emergency.

The Disaster Recovery Plan includes the assumption that an alternative site to the current Connecticut Lottery Corporation headquarters will be required in the event of an emergency. We have identified one site as acceptable and have prepared a list of expenditures that would be required to prepare the site for emergency occupancy. However, there are other alternatives to the site that are still in the process of being investigated. Until all relevant data on these alternatives is gathered and such preparatory expenditures authorized, the plan cannot be considered final. The IT and Security Departments are coordinating efforts to gather the remaining information. When the information is accumulated, management will prepare its recommendation to the Board of Directors as to the preferred alternative and, once final decisions are made, the Disaster Recovery Plan will then be completed. Following the initial completion of the plan, there will be an on-going requirement to maintain and update the plan as systems, personnel, and circumstances continue to evolve.

We would also emphasize, as we have previously advised, that we have had in place for several years a Disaster Recovery Plan and redundant hardware, software, and communications capabilities that would protect against a disaster or catastrophic occurrence at our satellite office/vendor site in Rocky Hill, where the lottery on-line system is located. This capability consists of a “hot back-up” site located in Newington that is equipped with a central system that receives a live feed of all system transactions that occur throughout the wagering day. This system is capable of taking over central system operation, with virtually no downtime, in the event of a disaster at the primary site.”

Other Examinations:

As previously noted, an independent public accountant audited the Connecticut Lottery Corporation during the 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. Corporation management informed us, that the independent public accountants did not issue a formal management letter. The independent public accountant made reports to the Board of Directors on October 4, 2001 and September 26, 2002. In the reports to the Board it was stated that there were no reportable conditions related to the internal controls or procedures of the audited financial statements and that the SAS 70 report did not have a negative impact on the audit.

RECOMMENDATIONS

Our prior audit contained one recommendation that we have restated below to reflect current conditions.

Status of Prior Audit Recommendation:

The Connecticut Lottery Corporation should complete a disaster recovery plan that addresses prompt business resumption in the event of an interruption of operations. We have restated this recommendation to reflect current conditions. (See Recommendation 1.)

Current Audit Recommendation:

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

- 1. The Connecticut Lottery Corporation should complete, accept, adopt and implement a disaster recovery plan that addresses prompt business resumption in the event of an interruption of operations.**

Comment:

The Connecticut Lottery Corporation has written a disaster recovery plan which addresses prompt business resumption. However, it has not been fully accepted, adopted and implemented.

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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