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Department of Finance
State Capitol, Room 1145
Sacramento, CA 95814

**FISMA Report: DEPARTMENT NAME: California State Lottery
ORGANIZATION CODE: 0850**

INTRODUCTION:

In accordance with the Financial Integrity and State Manager's Accountability (FISMA) Act of 1983, the California State Lottery (Lottery) submits this report on the review of our systems of internal control for the biennial period ended December 31, 2011.

Should you have any questions please contact Roberto Zavala, Chief, Internal Audits, at (916) 822-8358 or rzavala@calottery.com.

BACKGROUND:

Creation and Purpose of the Lottery

The mission of the California Lottery is to provide supplemental funding to California schools while simultaneously supporting local communities. For every dollar spent on Lottery products, 94 cents is returned to the community in the form of player prizes, retailer compensation and contributions to education.

In 1984, voters passed Proposition 37 and created the California State Lottery (Lottery). The purpose of the Lottery is to provide supplemental funding for the benefit of public education without the imposition of increased taxes.

The Lottery Act (California Government Code Section 8880 et seq.) provides that net revenues of the Lottery shall not be used as substitute funds, but rather shall supplement the total amount of money allocated for public education in California. It also provides that the Lottery shall be operated to promote and ensure integrity, security, honesty, and fairness.

Since its inception, the Lottery revenues were distributed as follows: 50% must be returned to the public as prizes; at least 34% must be distributed to public education; and no more than 16% may be used for administrative expenses. The Lottery Act provides that none of its provisions may be changed *except to further its purpose* by a two-thirds vote of the membership of both houses of the Legislature and approved by the Governor.

The Lottery Act specifies that the Lottery is overseen by a five-member Commission appointed by the Governor and confirmed by the Senate. A director, who is also appointed by the Governor and confirmed by the Senate, serves as the chief administrator of the Lottery. The Commission is charged with the authority and responsibility to oversee the Lottery to ensure its integrity, security, honesty, and fairness. The Commission meets at least once a quarter and the meetings are open to the public.

The Commission expects the Lottery to:

- Increase our funding to education each year
- Improve our public image
- Grow in a socially responsible manner
- Utilize technological advances to improve product distribution
- Provide the best atmosphere for team members and partners
- Attract the types of employees that will move the business forward

In April 2010, the Legislature passed Assembly Bill (AB) 142 that allowed the Lottery to adopt best practices for the funding formula. AB 142 limits administrative expenses to 13 % of sales, while requiring that 87 % of sales go back to the public in the form of prizes and contributions to education. The law gives the Lottery flexibility to increase prize payouts in its games, but only if it does so in a way that increases the total amount of money that goes to public schools and colleges.

In conjunction with AB 142, the Lottery implemented the “Project RENEW” as an effort to reflect the Lottery’s desire to renew its innovation, drive, and commitment to maximizing funding for California’s public schools. The focus of this project is to make significant and strategic improvements in many areas of the Lottery’s operation. Major initiatives are:

- Corporate Social Responsibility – Identify and engage with all key stakeholders in the joint enterprise of building the Lottery.
- Jackpot Games – Consider the options for reversing the decline in the large jackpot games.
- Other Draw Games – Review the potential for Hot Spot game and examine the game development process with a view to having new games available when needed.

- Scratchers End-to-End – Replenish the stock of games at retail, review the end-to-end distribution of Scratchers by seeking efficiencies and cost saving, and institute weekly reviews of the performance of games in the marketplace.
- Advertising, Promotion and Player Communication – Promote and market games by introducing an econometric model that will assist in assessing the Return-On-Investment in marketing expenditure.
- Retailer and Sales Support – Improve the quality of retail network, segment the retailers by their relative sales and create the work of field staff more effectively.

The Lottery is organized into the following eight divisions which report to the Director: Executive, Finance, Operations, Human Resources, Corporate Communications, Security and Law Enforcement, Information Technology Services, and Sales & Marketing.

Control Environment

In the lottery industry, maintaining the public trust is the foundation of a successful lottery. It reassures players that games are operated fairly and winning tickets will be honored. Lottery management strives daily to demonstrate integrity, honesty and fairness in the operation and administration of the Lottery. Accordingly, the Lottery has a strong commitment to audit and compliance as referenced below.

The Lottery maintains a meticulous and comprehensive audit program. The Lottery not only employs internal auditing staff, but contracts with the State Controller's Office and independent firms to further ensure the integrity of all operations and transactions.

Annually, an independent audit firm performs financial audits of the Lottery's financial statements. Since the inception of the Lottery, the annual financial statements have cited unqualified opinions. Further, in recognition of our financial reporting, the Government Finance Offices Association of the United States and Canada has awarded a Certificate of Achievement for Excellence in Financial Reporting to the Lottery for the past eight consecutive fiscal years (the most recent award was fiscal year 2009/2010). In addition, an independent audit firm witnesses and reviews every lottery draw to ensure accurate completion of the draw procedures, including the verification of technology systems, draw machinery, and draw items such as lotto balls.

Every two years, the Lottery contracts with an independent audit firm to conduct an audit of Lottery security. The audit includes a comprehensive study and evaluation of all aspects of security in the operation of the Lottery. Additionally, the State Controller's Office conducts quarterly and annual post-audits of all accounts and transactions of the Lottery including quarterly transfers to education, vendor claim schedules, and all prize payments.

RISK ASSESSMENT:

Methodology

The Lottery's Internal Audits Office is responsible to assist and facilitate the review process to conduct a risk assessment on behalf of the Lottery. Therefore, the Internal Audit staff attends the State Internal Auditors Quarterly Meetings hosted by the Department of Finance, Office of State Audits and Evaluations (OSAE). This ensures continued understanding including relevant changes for the FISMA reporting requirements. Discussions presented at meetings included an overview of the FISMA process, the Corrective Action Plan (CAP) components and guidelines, FISMA report evaluations and tools to design risk and control matrices.

The Lottery's control self-assessment was performed using a risk based format. Staff from the Internal Audits Office met with Senior Management Staff during the summer of 2011 to facilitate the process, determine a timeline and establish an understanding of expectations regarding the control self-assessment. In addition, risk assessment questionnaires were provided for their input on enterprise-wide risks. During interviews with Lottery management we discussed prior audit findings, and associated action plans related to their division.

The control self-assessment did not focus in one specific area but considered input of management's observations of risk areas that could severely impact our mission. Questionnaires completed by the Lottery's Senior Management identified individual division's business objectives that align with the Lottery's key business objectives. Assessment and identification of significant risks were based on the Lottery-wide impact and how often the same issue was raised in different interviews.

External/Internal Audits issued during calendar years 2010 and 2011:

LPAS Contract	October 2011
Asset Management Audit	September 2011
Samuel Ramirez & Company Contract	August 2011
Implementation of SCO Audit Recommendations	June 2011
Camelot Global Services Contract Audit	June 2011
3 Ball Productions & Milestone Entertainment Contract	May 2011
Alcone Marketing Group Contract	May 2011
Delehanty GPC GTECH Printing	March 2011
Delehanty SGI Scientific Games	March 2011
Annuity Investment Process	September 2010

Findings cited in the audits performed during 2010 and 2011 have either been corrected or are in the process of correction. High risk uncorrected weaknesses have been included in the Evaluation of Risks and Controls.

EVALUATION OF RISKS AND CONTROLS:

The results of the control self-assessment are based on data gathered from management interviews and a review of documentation that supports many of the Lottery's key processes. Using this method, the Lottery management identified three significant vulnerabilities critical to the Lottery's success:

1. Policies and Procedures: The Lottery has completed updating its policies since the last FISMA report. Plans are underway to update procedures at the divisional level. However, because procedures remain outdated this may negatively impact its operations.
2. Asset Management: The Lottery's plans for effective asset management intended to safeguard its assets is underway. This will provide Lottery staff with comprehensive and uniform processes to ensure that assets are identified, inventories taken and tracked. Inadequate asset management could result in theft, misuse, and inefficiencies to the organization's activities.
3. Data Classification: A formal cataloguing of sensitive and confidential Lottery information has yet to be performed. Currently, the Lottery has drafted and is formalizing its information classification procedures for guidance when cataloguing begins. In the meantime, without a comprehensive listing of sensitive and confidential data, this reduces the quality of management decision-making regarding access to such data.

Corrective Action Plan

Corrective action has been initiated on all three vulnerabilities. The Lottery is currently preparing a separate Corrective Action Plan to address these vulnerabilities, due to the Director of the Department of Finance by January 31, 2012.

VACANT POSITIONS:

The Lottery has reviewed Government Code Section 12439. At the inception of the Lottery, the Department of Finance exempted the Lottery from its budgetary review. Accordingly, the Lottery budget and related positions are established through the Lottery's budget process and approved by the Lottery Commission. Therefore, the Lottery self-monitors its vacant position control accordingly.

CONCLUSION:

I certify that our systems of internal controls are adequate to mitigate potential threats identified in the Evaluation of Risks and Controls Section above.



Linh Nguyen
Acting Director

cc:

Governor's Office
Legislature
State Controller's Office
State Treasurer's Office
Attorney General
State Auditor
State Library
File