



A REPORT  
TO THE  
MONTANA  
LEGISLATURE

FINANCIAL-COMPLIANCE AUDIT

# *Montana State Lottery*

*For the Fiscal Year Ended  
June 30, 2010*

MARCH 2011

LEGISLATIVE AUDIT  
DIVISION

10-30A

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# LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor  
Monica Huyg, Legal Counsel



Deputy Legislative Auditors  
Cindy Jorgenson  
Angie Grove

March 2011

The Legislative Audit Committee  
of the Montana State Legislature:

This is our financial-compliance audit report of the Montana State Lottery for the fiscal year ended June 30, 2010. Included in this report are recommendations related to noncompliance with state accounting law for two equipment purchases and several recommendations that focus on the Lottery's ineffective control system. The 2009 financial information was audited by our contract auditor and is included for comparative purposes.

The written response to the audit is included on B-1 of the audit report. We thank the former director and the current director and her staff for their assistance and cooperation throughout the audit.

Respectfully submitted,

*/s/ Tori Hunthausen*

Tori Hunthausen, CPA  
Legislative Auditor



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## COMMISSION MEMBERS AND ADMINISTRATIVE OFFICIALS

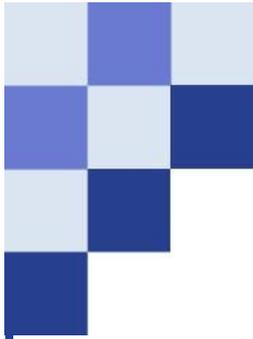
			<u>Term Expires</u>
<b>Montana State Lottery Commission Members</b>	Robert Crippen, CPA, Chairman	Butte	1/1/11
	Craig Anderson, Dawson County Sheriff	Glendive	1/1/13
	Thomas M. Keegan, Attorney at Law	Helena	1/1/14
	Beth O'Halloran	Missoula	1/1/14
	Wilbur Rehmann	Helena	1/1/13

<b>Administrative Officials</b>	Angela Wong, Montana State Lottery Director, effective 2/7/2011
	George Parisot, Montana State Lottery Director, through 12/30/2010
	John Tarr, Montana State Lottery Director of Security
	Armond Sergeant, Financial Services Director

For additional information concerning the Montana State Lottery, contact:

Armond Sergeant, Financial Services Director  
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 Helena, MT 59601  
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# MONTANA LEGISLATIVE AUDIT DIVISION

## FINANCIAL-COMPLIANCE

### Montana State Lottery

For the Fiscal Year Ended June 30, 2010

MARCH 2011

10-30A

REPORT SUMMARY

State law requires that a minimum of 45 percent of the money paid for tickets or chances must be paid out as prize money and that net revenue earned must be transferred to the General Fund quarterly. In fiscal year 2010, approximately \$10.6 million was transferred to the General Fund, which was approximately 22 percent of total revenue.

#### Context

The Montana State Lottery, created by the 1985 Legislature and approved by the Montana electorate in 1986, allows lottery games in which players purchase through a state lottery a chance to win a prize. A five-member Lottery Commission, whose members are appointed by the Governor, has certain powers and duties in law. State law also provides certain powers and duties to a director of the Montana State Lottery who is appointed by the Governor.

This audit is the first audit that the Legislative Auditor has conducted; all other audits since the Montana State Lottery's inception were performed by private CPA firms through contracts with the Legislative Audit Division. The prior audit of the Montana State Lottery did not include any recommendations.

#### Results

This audit report includes six recommendations to the Montana State Lottery. Five of the six recommendations relate to the Lottery's inadequate control system. The control issues relate to management override of controls for equipment purchases and contracts, contractor information used in financial reporting, prize payouts system, and payments for operating expenses. The other recommendation addresses two situations in which we determined the Lottery is not in compliance with the state law that requires it to record its financial activity on the state accounting system in accordance with generally accepted accounting principles.

Recommendation Concurrence	
Concur	6
Partially Concur	0
Do Not Concur	0
Source: Agency audit response included in final report.	

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# Chapter I – Introduction

## Introduction

We performed a financial-compliance audit of the Montana State Lottery (Lottery) for the fiscal year ended June 30, 2010. The objectives of our audit were to:

1. Obtain an understanding of Lottery's control systems to the extent necessary to support our audit of the Montana Lottery's financial statements and, if appropriate, make recommendations for improvement in internal and management controls of the Lottery.
2. Determine if Lottery's financial statements present fairly the financial position and the results of operations for the fiscal year ended June 30, 2010.
3. Determine if Lottery complied with selected laws and regulations.

A separate report (#09C-01) for the financial-compliance audit of the Lottery for the fiscal year ended June 30, 2009, was issued by auditors under contract with the Legislative Audit Division. The report contained an unqualified opinion on the 2009 financial statements that are included in this report for comparative purposes.

Areas of concern deemed not to have a significant effect on the successful operation of the Lottery are not specifically included in the report, but have been discussed with management. In accordance with §5-13-307, MCA, we analyzed and disclosed the cost, if significant, of implementing the recommendations in this report.

Auditing standards require us to communicate, in writing, deficiencies in internal control we identified as a result of audit objective #1 above and considered to be significant or material. A deficiency in internal control exists when the design or operation of a control does not allow management or employees to prevent or detect and correct misstatements on a timely basis. A material weakness is one or more deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

The following table identifies material weaknesses we identified during this audit.

Table 1  
**Summary of Material Weaknesses in Internal Control**

Subject	Material Weakness	Page
Management Override of Controls	X	6
Inadequate Controls over Financial Information	X	9
Inadequate Segregation of Duties	X	10
Noncompliance with Expense Controls	X	12

**Source: Compiled by the Legislative Audit Division.**

## **Background**

The Lottery was created in November 1986 by a referendum vote of the people of Montana. The general purpose is to allow lottery games in which players purchase from the State, through the administration of the Lottery, a chance to win a prize. Disposition of revenue is a minimum of 45 percent for prizes. Lottery is required to transfer its net revenue to the General Fund. Members of the Montana Lottery Commission are appointed to four-year terms by the Governor and terms are staggered. The director of the Lottery is appointed by the Governor.

Lottery's operations are accounted for in an enterprise fund type, which means that its operations are financed and operated in a manner similar to private enterprise where the intent is to provide goods or services to the general public. The Lottery receives no funding from the state of Montana but rather generates money for the state General Fund. Games offered by the Lottery include scratch tickets, Powerball, Mega Millions, Montana Cash, Wild Card, Hot Lotto, 10 Spot, and Montana Millionaire.

The Lottery is a member of the Multi State Lottery Association (MUSL), a nonprofit association owned and operated by its member lotteries. MUSL is governed by a Board of Directors who develop rules and regulations for all participating state lotteries to follow.

The Lottery contracts with vendors for three crucial aspects of its operations: online gaming system, scratch ticket system, and advertising.

## **Prior Audit Recommendations**

The financial-compliance audit report for the fiscal year ended June 30, 2009, prepared by our contract auditors, did not contain any recommendations to the Lottery for improvements.

## Chapter II–Findings and Recommendations

### Noncompliance with GAAP Law

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#### **The Lottery was not in compliance with the GAAP law at June 30, 2010.**

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Section 17-1-102(4), MCA, mandates that, in accordance with generally accepted accounting principles (GAAP), all transactions necessary to present the receipt, use, and disposition of all money and property for which the agency is accountable must be entered into the state accounting system prior to fiscal year-end. Under GAAP and state accounting policy, the Lottery is required to use the full accrual basis of accounting. This basis of accounting requires increases and decreases in economic resources be recognized as soon as the underlying transaction or event occurs; revenues are recognized as soon as they are earned and expenses are recognized as soon as the related liability is incurred, regardless of the timing of cash flows.

### **Background**

In October 2005, the Lottery entered into its major gaming contract. The contract outlined specific equipment the contractor would provide as part of the base price of the contract. The contract also included a provision that allowed the Lottery to purchase optional equipment on a per unit fee. During the audit, we identified the following two instances, where the Lottery obtained optional equipment from the vendor but did not record the transactions in accordance with GAAP on the state's accounting records.

### **Lottery Vending Machines (Win Stations)**

In fiscal year 2010, the Lottery made two down payments totaling \$423,235 on 60 Win Stations. The total cost of the machines was \$838,200. At June 30, 2010, even though most of the machines had been placed into operation, the Lottery recorded only 30 of the Win Stations on the state's accounting system, understating the Lottery's assets and liabilities by \$414,875. Lottery management stated they did not record all 60 machines, because they did not have enough appropriation authority to pay for all of the machines. As a result, Lottery entered into a lease agreement with the vendor to pay for the remaining machines, purposely not dated until fiscal year 2011. As required by GAAP and state policy as discussed above, the Lottery is required to recognize increases and decreases in economic resources when the underlying event occurs. In this case, the underlying transaction, the obligation to purchase the Win Stations, occurred in fiscal year 2010, and the effective date of the subsequent lease agreement is irrelevant to the financial treatment.

The Lottery incurred a liability for all 60 of the Win Stations prior to June 30, 2010, and all of the associated transactions should have been recorded on the state's accounting records by fiscal year-end. See Table 2 for a summary of misstatements.

### Coronis MP Lottery Machines (MP)

In April 2010, the former Lottery Director signed a contract amendment in which the contractor agreed to provide and install 250 MP's (worth approximately \$1.6 million) as consideration for Lottery agreeing to the contractor's proposal to "consolidate the primary data-center operation from Helena, Montana with the Boise, Idaho data-center operation." Maintenance of a primary data-center operation in Helena was a provision in the original contract. The MP's were not part of the original base price of the contract, but were included on the optional list of equipment available to Lottery for purchase.

We believe the substance of the event occurred when the Lottery agreed to the change in contract terms in exchange for the donated assets. This exchange of economic resources is required by GAAP to be recorded as contributed capital revenue and, because the equipment would not arrive until after June 30, 2010, an accounts receivable. Lottery personnel believe the contract amendment constitutes an even, nonmonetary exchange between Lottery and its contractor and therefore, no transaction should be recorded on the accounting records. However, Lottery personnel could not provide any GAAP-based support for their position. Table 2 has a summary of the misstatements.

Table 2  
**Misstatements on SABHRS as of June 30, 2010**

Issue	Account	Amount of Misstatement over/(under) *
Win Stations	Lease Asset	\$(414,875)
Win Stations	Capital Lease Liability	\$(414,875)
Win Stations	Depreciation Expense	\$(104,383)
Win Stations	Accumulated Depreciation	\$(104,383)
MP	Accounts Receivable	\$(1,625,000)
MP	Capital Contribution	\$(1,625,000)

\*Lottery personnel adjusted the financial statements that are included in the report for these misstatements.

**Source: Compiled by the Legislative Audit Division from Lottery records.**

## Summary

Although both of the issues discussed above have some unique and unusual characteristics, we believe they indicate a need for Lottery personnel to increase their overall knowledge of state accounting policy and GAAP. In addition, as unusual transactions occur, research and consultation with others may be needed to ensure all relevant facts are considered and transactions properly recorded before the state's accounting records close each fiscal year.

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### ***RECOMMENDATION #1***

*We recommend the Lottery:*

- A. *Comply with state law and record transactions in accordance with generally accepted accounting principles.*
  - B. *Provide accounting personnel training in proper application of state accounting policy and generally accepted accounting principles.*
- 

## **Internal Control Structure**

The National Commission on Fraudulent Financial Reporting (the Treadway Commission) was created in 1985 by the joint sponsorship of five organizations which comprised the Committee of Sponsoring Organizations (COSO).

In 1987, the Treadway Commission recommended COSO develop a common definition of internal control and provide guidance to assist management to better control its organization. COSO subsequently issued a document titled Internal Control-An Integrated Framework. This framework developed by COSO was used by the Department of Administration when a guidebook was developed in fiscal year 2008 as a tool for agencies to use in performing internal control evaluations. The guidebook describes five components of internal control, which are necessary for an effective internal control structure.

1. Control environment sets the tone of an organization and influences the effectiveness of internal controls within the agency. It is an intangible factor, yet is the foundation for all other components.
2. Risk assessment is the process used to identify, analyze, and manage potential risks.
3. Control activities are designed to minimize the risks that have been identified through policies and procedures which ensure assigned directives are carried out.

4. Information and communication provides for the identification, capture and exchange of information both within the agency and with external parties, including financial reporting.
5. Monitoring is assessing the quality of a control structure over time and making adjustment as necessary.

The following five report recommendations address specific control issues we found during the audit. These issues focus on two of the five components of internal control discussed above; control environment and control activities. These issues indicate, when aggregated, that Lottery's control structure is deficient.

The Lottery should develop and implement an effective internal control structure, addressing all five components, over its key business processes. Effective controls require not only appropriately designed controls but adherence to them.

## **Management Override of Controls**

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### **Management bypassed payment and appropriation controls to buy equipment.**

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Because agency management is primarily responsible for the design, implementation, and maintenance of internal controls, agencies are always exposed to the risk of override or by-pass of those controls. We found several instances, as discussed below, where the former director did not follow established control policies and procedures.

#### **Down Payment on Equipment**

Multi-State Lottery (MUSL) rules require that participating lotteries contribute to reserve funds maintained by the MUSL. The reserve amounts fluctuate from month to month so at times the Lottery has unreserved cash held by the MUSL.

In October 2009, Lottery made a down payment of \$348,000 to purchase equipment by transferring excess cash reserve funds held by MUSL directly to the vendor. Except for specific exceptions outlined in state law (§17-8-101, MCA), payments made by the Lottery are normally paid from the state treasury through an entry on the state's accounting system that charges an expense account and appropriation. This payment however, was made using cash held by MUSL without recording expenses or the use of an appropriation on the state's accounting system. This payment clearly did not follow the Lottery's established control procedures and is in violation of state law which subjects these Lottery payments to appropriation because state law requires Lottery to transfer its net revenue to the General Fund.

The payment exceeded the Lottery's total appropriation authority for equipment by approximately \$306,000. It was not until June 2010, nine months after the cash was transferred, that the payment was recorded as an expense and charged against an appropriation on the accounting records. This occurred after the Lottery asked for, and received, authorization from the Governor's Office of Budget and Program Planning (OBPP) under §17-7-301, MCA, to make expenditures during the first year of the biennium from appropriations for the second year of the biennium. The condition under which this type of request is supposed to be granted by the OBPP is for an "unforeseen and unanticipated emergency". The Legislative Finance Committee (LFC) role under statute is to report to the OBPP whether, in the committee's view, the request meets statutory conditions and necessary compliance requirements. The LFC staff report to the committee stated the "statutory requirements of being an unforeseen and unanticipated emergency appears to be difficult to defend". The LFC passed a motion to approve the request, but added "address concerns" to the motion for the equipment. We do not believe the equipment purchase was unforeseen or unanticipated by Lottery officials.

---

**RECOMMENDATION #2**

*We recommend the Lottery:*

- A. *Comply with applicable appropriation laws for all payments.*
  - B. *Follow established control procedures for all payments.*
- 

## **Authority for Contracting**

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**The former Lottery Director agreed to substantive amendments to the major gaming contract without concurrence of the Lottery Commission in violation of state law and Lottery's control procedures.**

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State law, §23-7-211, MCA, provides specific powers and duties to the director of the Lottery. The law allows the director to enter into contracts with the "concurrence of the commission or pursuant to commission rules." The commission has not adopted any rules regarding this authority. During our audit we noted two instances in which the director amended the terms of the contract with the Lottery's gaming operator without formal concurrence by the Lottery Commission.

- ◆ In August 2008 the director signed the first amendment, which extended the length of the contract by three years and added the Montana Sports Action (SPA) games. In Commission meetings for July 2008 and September 2008,

no discussion occurred related to this amendment. Extending the duration of the contract by three years and addition of the SPA are substantive changes to the contract. Lottery officials did provide us two agreements between the Lottery and the Board of Horse Racing regarding the SPA's that were signed by the chair of the Lottery Commission. This indicates the Commission was aware of the SPA's, however it does not demonstrate the Commission's concurrence with the amendment.

- ◆ In April 2010 the director signed a second amendment that allowed the gaming contractor to "consolidate the primary data-center operation from Helena, Montana with the Boise, Idaho data-center operation." In exchange, the contractor agreed to provide and install 250 MP's (worth \$1.6 million) free of charge to the Lottery. The contractor's maintenance of a data-center operation in Helena, employing approximately 30 staff, was significant to the Lottery Commission's decision to award it the contract. We reviewed the commission minutes for December 2009, and March and June 2010, and found no specific discussion or commission action related to this amendment. This amendment was a substantive change to the contract.

Lottery officials communicated to us that presentation of major contracts for approval by the Commission in a public meeting is means by which they mitigate financial risk and establish internal control. However, the amendments discussed above were not presented to or voted on by the Commission; the former director stated the commission members were made aware of the amendments, but provided no documentation to support this statement. The former director stated he did not believe the Commission's concurrence was necessary. Since the amendments to the contract were substantive in nature, we believe not having the Commission's formal concurrence to be noncompliance with state law regarding the director's powers and an override of controls that increases the Lottery's financial risks.

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### **RECOMMENDATION #3**

*We recommend the Lottery comply with state law by following its established procedures to obtain Commission concurrence for major contracts and reduce its financial risks.*

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## Inadequate Control over Financial Information

### **The Lottery does not have adequate controls to ensure accuracy of financial information obtained from its contractor used in financial reporting.**

The Lottery's current control procedures are deficient in preventing or detecting and correcting misstatements that could be material to its financial reporting. The Lottery relies exclusively on financial information it obtains from its gaming contractor for recording most of its scratch ticket activity on the state's accounting system.

As shown in the following table, scratch ticket activity is material to the Lottery's financial operations.

**Table 3**  
**Fiscal Year 2010 Scratch Ticket Activity and Balances**

Financial Statement Line	Amount	Percent of Subtotal
Accounts Receivable	\$1,786,398*	23% of total assets
Estimated Prize Liability	\$2,570,063*	33% of total liabilities
Scratch Ticket Game Revenue	\$14,274,286	30% of total operating revenue
Scratch Ticket Prize Expense	\$9,361,059	29% of total direct game costs
Retailer Commission Expense	\$2,338,036*	7% of total direct game costs
Cost of Ticket Sold Expense	\$1,193,018	4% of total direct game costs

\* Includes both scratch and on-line retailer balance and activity.

**Source: Compiled by the Legislative Audit Division from the Lottery's 2010 financial statements.**

A critical component missing from the Lottery's control system is a control that identifies, on a timely basis, errors or irregularities in the financial information it obtains from the contractor's system. This type of control is a detection control because it is used to detect errors in information already processed, rather than preventing errors from being recorded.

Detective controls the Lottery could implement include: trend analysis; analytic tests based on the individual games' winning tickets and sales performance; and confirmation of information with retailers. For trend information and analytic tests, the Lottery would need to establish expectations of trends and relationships between sales and winning tickets to be able to identify when the financial information from the contractor should be questioned. Adequate follow-up and resolution when financial information is not as expected is a necessary component of control design for these controls to be effective.

Alternatively, the Lottery could contract for, or require the contractor to procure, a review or audit of its computer system. We contacted three states that use the same gaming contractor as the Lottery; two of them now require the contractor to receive a Statement of Auditing Standards (SAS 70) service center audit. The other state we contacted does not require a service center audit but does contract for an information system review of the contractor.

Lottery personnel stated they believe the retailers serve as a control over the accuracy of the financial information provided from the contractor's system, as well as the contractor, because the retailers would not want to remit more money to the Lottery than they are obligated to remit, and the contractor is paid by the Lottery based on sales. Personnel also indicated their Internal Control System (ICS) serves as an additional control because information from that system is reconciled to the contractor's system. ICS is developed and maintained by a different contractor than the gaming contractor. However, the contract for the ICS is between the gaming contractor and the ICS contractor and the Lottery is not a party to that contract. As such, ICS provides no independent assurance over the gaming contractor information. Although we do agree these other parties may mitigate the risks of certain errors not being detected, this risk reduction is limited and ultimately the Lottery is responsible for its own controls over financial reporting, as required by state policy.

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**RECOMMENDATION #4**

*We recommend the Lottery implement effective controls to prevent or detect and correct errors or irregularities in the financial information it obtains from the contractor's system.*

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## **Inadequate Segregation of Duties over Prize Payouts**

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**The Lottery does not have adequate segregation of duties to ensure all prize payments are valid.**

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The Lottery does not have adequate segregation of duties in place to ensure prize payment checks or electronic funds transfers made for less than \$10,000 are for valid lottery prizes, for the proper amounts, and paid to the proper persons.

State policy and the internal control guidebook suggests that the four kinds of functional responsibilities: authorization, recording, custody, and reconciliations should be performed by different work units, or at a minimum, by different persons

within the same unit. State policy requires that the person who reconciles a revolving cash fund be different than the custodian and check signer and not be involved in the revolving fund operations. We found that all four functions for prize payments processing, including the reconciliations, are performed within the four-person accounting staff at the Lottery. The accounting staff's ability to adequately segregate these duties is limited by the small number of staff, high turnover during the audit period, normal employee absence, and high frequency of prize payments.

Those who win more than \$600 in Lottery prizes are required to come to the Lottery office in Helena to collect their prizes. After Lottery personnel verify the winning ticket, the winner can elect to receive the prize payout through electronic funds transfer (EFT) or a check from the revolving cash fund. During fiscal year 2010, the Lottery disbursed over \$6 million in prize payments through checks and EFT's. Checks are paid out of a cash revolving fund, which is a checking account approved under state policy to allow state agencies to make immediate payments.

### **Check Disbursement**

Lottery personnel indicated they rely extensively on the gaming contractor's claim that its system will only produce a check after a winning ticket has been validated. However, access to the check stock and signature plate is available to all accounting staff. As a result, accounting staff could manually prepare a check without a winning ticket validated in the gaming contractor's system and not be detected in a timely manner.

The Lottery has a control procedure to periodically reconcile the activity processed through the revolving cash fund from valid prize tickets in the gaming contractor's system to the bank statements. The control procedure includes an independent review of each reconciliation. The reconciliation process is a key control that can compensate for situations where the other three functions described above are not always adequately segregated. Although the control procedure is adequately designed, we found it was not functioning during the audit period. We found only one month in fiscal year 2010 where support existed that someone had completed an independent review of the reconciliation. In some cases, the person preparing the reconciliation had custody of the checks, access to the signature plate, and the ability to process checks, which negates the benefits of the reconciliation as a means of identifying errors or irregularities.

Because the Lottery has not adequately segregated the duties related to disbursing monetary prizes, it has unnecessarily placed employees in a position where they could perpetrate and conceal errors or irregularities in the normal course of their work and not be detected in a timely manner.

## Electronic Funds Transfers (EFT)

In September 2010, the biennial Montana Lottery Security audit (10DP-06) was issued. This report identified a control deficiency in the process Lottery uses to disburse prize money to Lottery winners who elect to receive their payments through EFT. The security audit report includes a recommendation that the Lottery strengthen controls over the electronic funds transfer process by:

- ◆ Recording electronic fund transfers in the game management system.
- ◆ Conducting ongoing reconciliation of all payment via electronic funds transfers.

Lottery officials concurred with the recommendation and have requested the contractor develop software changes needed to address the deficiency. As of February 2011, the contractor has developed software modifications to address the issue but the modifications are still being tested.

## Summary

In addition to complete implementation of the recommendation from the security audit discussed above, Lottery should segregate its reconciliation process from the prize payment disbursements. To be effective, the reconciliations should be performed by someone not otherwise involved with the prize payment process and should include ties back to validated prizes in the gaming system.

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### ***RECOMMENDATION #5***

*We recommend the Lottery adequately segregate authorization, recording, custody, and reconciliation responsibilities over its prize payment process to ensure all prize payments are valid and accurate.*

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## Noncompliance with Expense Controls

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**The Lottery did not consistently follow its established controls over operating expense transactions that totaled over \$2.0 million in fiscal year 2010.**

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The Lottery's control procedures specify each expense transaction will be manually approved for payment by the appropriate division director and reviewed by accounting personnel to ensure it is a valid obligation of the Lottery, in the correct amount, to the appropriate person or vendor, and coded correctly on the state's accounting system.

As part of a sample, we tested 32 operating expense transactions and found that 10 of the transactions did not have evidence of a division director's approval or evidence of review by accounting personnel for accuracy. In addition, we found that 14 of the 32 transactions did not have adequate support that demonstrated the expense was valid; were coded to the incorrect account or fiscal year; and/or were not in compliance with applicable state accounting policies.

Lottery personnel stated that because of the excessive turnover in the Lottery personnel, for much of the audit period there was only one accounting employee who was responsible for all aspects of the accounting function. Because of this, the Lottery fell behind in recording transactions and when fiscal year-end approached, employees focused more on ensuring all transactions were recorded rather than following established controls to ensure only valid transactions were properly recorded. Internal controls are vital to preventing or detecting and correcting errors or fraud. Because the Lottery was not following the controls it had designed, there is an increased risk that errors or fraudulent activity could have occurred and have not yet been detected.

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**RECOMMENDATION #6**

*We recommend the Lottery follow its established control procedures for review and approval of operating expenses.*

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# Independent Auditor's Report and Montana State Lottery Financial Statements



## LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor  
Monica Huyg, Legal Counsel



Deputy Legislative Auditors  
Cindy Jorgenson  
Angie Grove

INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited the accompanying enterprise fund Statement of Net Assets of the Montana Lottery as of June 30, 2010, and the related Statement of Revenues, Expenses and Changes in Fund Net Assets, and Statement of Cash Flows for the year then ended. The information contained in these financial statements is the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Lottery as of June 30, 2009, were audited by other auditors whose report dated December 8, 2009, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the enterprise fund of the Montana Lottery and do not purport to, and do not, present fairly the financial position of the State of Montana, as of June 30, 2010, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the enterprise fund of the Montana Lottery as of June 30, 2010, and its changes in net assets and cash flows for the fiscal year then ended, in conformity with accounting principles generally accepted in the United States of America.

Respectfully submitted,

*/s/ Cindy Jorgenson*

Cindy Jorgenson, CPA  
Deputy Legislative Auditor

March 2, 2011



**MONTANA LOTTERY**  
**STATEMENT OF NET ASSETS**  
**JUNE 30, 2010 AND 2009**

	2010	2009
<b>ASSETS:</b>		
<b>CURRENT ASSETS</b>		
Cash and Cash Equivalents	\$ 2,995,655	\$ 1,845,899
Receivables (Net)	1,786,398	1,344,939
Due from Primary Government	0	1,015
Inventories	528,373	795,040
Cash Collateral - Security Lending	45,616	109,844
Other Current Assets	90,497	427,934
	<hr/>	<hr/>
TOTAL CURRENT ASSETS	5,446,539	4,524,671
<b>NONCURRENT ASSETS</b>		
Computer, Furniture & Equipment	1,460,176	545,289
Leasehold Improvements	45,448	0
Receivable - Equipment	1,625,000	0
Accumulated Depreciation	(456,052)	(310,853)
Investments	71,375	139,273
Multi-State Reserve fund	1,430,386	1,763,784
	<hr/>	<hr/>
TOTAL NONCURRENT ASSETS	4,176,333	2,137,493
<b>TOTAL ASSETS</b>	<b>\$ 9,622,872</b>	<b>\$ 6,662,164</b>
<b>LIABILITIES:</b>		
<b>CURRENT LIABILITIES</b>		
Accounts Payable	\$ 1,027,549	\$ 655,690
Estimated Prize Liability	2,570,063	1,524,464
Transfer Obligations	2,467,133	2,536,330
Liability under Security Lending	45,616	109,844
Deferred Revenue	137,757	252,863
Compensated Absences	108,283	114,845
	<hr/>	<hr/>
TOTAL CURRENT LIABILITIES	6,356,401	5,194,036
<b>NONCURRENT LIABILITIES</b>		
MUSL Prize Liability	1,223,060	1,155,717
Compensated Absences	118,550	96,223
OPEB Liability	299,861	216,188
	<hr/>	<hr/>
TOTAL NONCURRENT LIABILITIES	1,641,471	1,468,128
<b>TOTAL LIABILITIES</b>	<b>7,997,872</b>	<b>6,662,164</b>
<b>NET ASSETS:</b>		
Invested in Capital Assets, net of related debt	1,120,947	234,436
Unrestricted Net Assets	504,053	(234,436)
	<hr/>	<hr/>
TOTAL NET ASSETS	1,625,000	0
<b>TOTAL LIABILITIES AND NET ASSETS</b>	<b>\$ 9,622,872</b>	<b>\$ 6,662,164</b>

The accompanying notes are an integral part of these financial statements.

MONTANA LOTTERY STATEMENT OF REVENUES, EXPENSES AND CHANGES IN FUND NET ASSETS FOR THE YEARS ENDED JUNE 30, 2010 AND 2009
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	2010	2009
OPERATING REVENUES:		
Scratch ticket revenue	\$ 14,274,286	\$ 13,231,442
On Line ticket revenue	32,578,512	30,595,437
License, permits, and misc	<u>20,661</u>	<u>25,162</u>
Total Operating Revenues	46,873,459	43,852,041
Less Direct Game Costs:		
Scratch ticket prize expense	9,361,059	7,953,974
On-line ticket prize expense	16,580,066	15,126,369
Retailer commission	2,338,036	2,517,344
Cost of tickets sold	1,193,018	1,186,582
Vendor fees	<u>2,811,246</u>	<u>2,701,988</u>
Total Direct Game Costs	32,283,425	29,486,257
Income before Operating Expenses	14,590,034	14,365,784
OPERATING EXPENSES:		
Advertising	617,438	852,736
Advertising Production	429,878	217,682
Audit Fees	71,160	47,029
Bad Debts Expense	3,546	764
Communications	83,752	106,603
Contractual Services	203,802	217,827
Depreciation and Amortization	161,934	44,969
Administrative Service Fee	64,460	50,987
Multi-State Dues	47,973	30,143
Public Relations	51,448	49,128
Other	63,268	44,180
Personal Services	1,818,562	1,830,625
Repairs and Maintenance	20,429	104,421
Supplies and Materials	161,597	351,151
Travel	56,002	76,379
Utilities and Rent	<u>139,054</u>	<u>157,887</u>
Total Operating Expense	3,994,303	4,182,511
Operating Income	10,595,731	10,183,273
NONOPERATING REVENUES (EXPENSES)		
Interest earnings	16,333	55,714
Security Lending Income	1,203	5,274
Security Lending Expense	(406)	(1,773)
Gov FA Disp Proceeds	686	0
Gain/(Loss) on sale of asset	(2,953)	(4,361)
Capital Contribution - Non State	1,625,000	0
OPEB Expenses	<u>(83,673)</u>	<u>(111,819)</u>
Total Nonoperating Revenues(Expenses)	<u>1,556,190</u>	<u>(56,965)</u>
Income Before Operating Transfers	12,151,921	10,126,308
Operating Transfers In (Out) - General Fund	<u>(10,526,921)</u>	<u>(10,126,308)</u>
Total Operating Transfers Out	<u>(10,526,921)</u>	<u>(10,126,308)</u>
CHANGE IN NET ASSETS	1,625,000	0
Total Net Assets, Beginning of Period	0	0
TOTAL NET ASSETS, END OF PERIOD	<u>\$ 1,625,000</u>	<u>\$ 0</u>

The accompanying notes are an integral part of these financial statements.

MONTANA LOTTERY  
STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED JUNE 30, 2010 AND 2009

	2010	2009
Cash Flows from Operating Activities		
Receipts for Sales & Services	46,314,363	43,980,936
Payments for Goods & Services	(7,860,670)	(8,460,193)
Payments to Employees	(1,802,797)	(1,831,086)
Payments for Prizes	<u>(24,828,183)</u>	<u>(23,525,745)</u>
Net Cash Provided by Operating Activities	11,822,713	10,163,912
Cash Flow from Noncapital Financing Activities		
Transfer to Other Funds	<u>(10,526,921)</u>	<u>(9,872,976)</u>
Net Cash Used For Noncapital Financing	(10,526,921)	(9,872,976)
Cash Flows from Capital and Related Financing Activities		
Acquisition of Fixed Assets	(565,149)	(60,675)
Proceeds from Sale of Fixed Assets	687	4,000
Principal & Interest Payment on Notes	<u>0</u>	<u>0</u>
Net Cash Used For Capital Financing	(564,462)	(56,675)
Cash Flows from Investing Activities		
Interest and Dividends on Investments	17,130	59,215
Received from (Paid to) MUSL Prize Reserve Fund	333,398	(137,749)
(Purchase) sale of long term investments (reclassification of STIP)	<u>67,898</u>	<u>607</u>
Net Cash Provided (Used) by Investing Activities	418,426	(77,927)
Net Increase(Decrease) in Cash and Cash Equivalents	1,149,756	156,334
Cash and Cash Equivalents, July 1	<u>1,845,899</u>	<u>1,689,565</u>
Cash and Cash Equivalents, June 30	<u><u>2,995,655</u></u>	<u><u>1,845,899</u></u>
Reconciliation of Operating Income to Net Cash Provided by Operating Activities		
Operating Income	10,595,731	10,183,273
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities		
Depreciation	161,934	44,969
Change in Assets and Liabilities:		
Decr (Incr) in Account Receivable	(441,459)	67,308
Decr (Incr) in Due from Other Funds	1,015	(425)
Decr (Incr) in Inventories	266,667	604,585
Decr (Incr) in Collateral securities on loan	64,228	(44,082)
Decr (Incr) in Prepaid expenses	337,437	(371,037)
Incr (Decr) in Accounts Payable	(43,016)	43,602
Incr (Decr) in Lottery Prizes Payable	1,112,942	(445,402)
Incr (Decr) in Liability for securities on loan	(64,228)	44,082
Incr (Decr) in Deferred Revenue	(115,106)	62,012
Incr (Decr) in Due to other funds	(69,197)	(24,512)
Incr (Decr) in Compensated Absences Payable	<u>15,765</u>	<u>(461)</u>
Total Adjustments	<u>1,226,982</u>	<u>(19,361)</u>
Net Cash Provided by Operating Activities	<u><u>11,822,713</u></u>	<u><u>10,163,912</u></u>
Schedule of noncash transactions:		
Capital Contributions - Non State	<u>1,625,000</u>	<u>0</u>
Total noncash transactions	<u><u>1,625,000</u></u>	<u><u>0</u></u>

**MONTANA LOTTERY**  
Notes to the Financial Statements  
June 30, 2010

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Reporting Entity.

The Montana Lottery, established under the provisions of Section 23-7-101, Montana Code Annotated (MCA), was approved by the Montana electorate through Legislative Referendum No. 100 on November 4, 1986.

Montana's first lottery tickets went on sale June 24, 1987.

The Montana Lottery is operated by a five-member commission consisting of Montana residents appointed by the Governor. The Commission, by law, has the power to operate a state lottery, determine the types and forms of lottery games, set the ticket price, number and size of prizes, conduct lottery drawings, enter into agreements to offer lottery games in conjunction with other lottery states and countries, and prepare financial reports. The Montana Lottery is attached to the Montana Department of Administration for administrative purposes.

The Montana Lottery is included as an enterprise fund in the State of Montana's Comprehensive Annual Financial Report. In accordance with governmental accounting and financial reporting standards, there are no component units to be included within the Montana Lottery's financial statements as a reporting entity.

Basis of Presentation. The Montana Lottery reports its financial activity in accordance with generally accepted accounting principles (GAAP) as prescribed in pronouncements of the Governmental Accounting Standards Board (GASB).

Enterprise Fund. The Montana Lottery is classified as an Enterprise Fund of the Proprietary Fund Type. Enterprise Funds account for operations: a) financed and operated similar to private business enterprises, where the intent of the Legislature is that costs are to be financed or recovered primarily through user charges, or b) where the Legislature has decided that periodic determination of revenue earned, expenses incurred, or net income is appropriate.

Basis of Accounting. The Montana Lottery's financial statements are prepared using the accrual basis of accounting. Revenues are recognized in the accounting period in which they are earned and become measurable; expenses are recognized in the period incurred, if measurable.

Property and equipment. Property and equipment are recorded at cost. Donated property and equipment are recorded at their estimated fair market value at the date of donation. Ordinary maintenance and repairs are charged to operations as incurred; major renewals and betterments are capitalized. Upon disposition or retirement of property and equipment, the cost and related accumulated depreciation or amortization are removed from the accounts. Gain or loss on disposal is reflected in non-operating revenues and expenses. Depreciation and amortization are calculated on a straight-line basis over estimated useful lives of three to ten years. The Lottery conforms to the State of Montana capitalization threshold for capitalizing property and equipment as well as buildings and building/land improvements. The threshold for capitalizing property and equipment is \$5,000 and the threshold for capitalizing buildings/land improvements is \$25,000.

Revenue Recognition. Lottery scratch ticket sales are recorded as revenue based on the time the retailer activates the pack of tickets for sale. In accordance with an established policy, retailers may return unsold tickets to the Lottery for credit. Sales are decreased by an allowance for estimated ticket returns.

Ticket sales for lotto games Powerball, Wild Card, Montana Cash, Hot Lotto, Montana Millionaire, Mega Millions, and 10 Spot are recorded as revenue based on drawings. Tickets sold in advance for future drawings are recorded as deferred revenue until such time as the tickets become valid for the most current drawing.

Ticket sales for Fantasy Sports games are based upon MCA 23-4-302 and an interagency agreement between the Lottery and the Board of Horse Racing.

Classification of Revenues. The Lottery has classified its revenues as either operating or non-operating according to the following criteria:

Operating revenues – include activities that have characteristics of exchange transactions, including (1) ticket sales, net of returns, and (2) retailer license fees and administrative fees in relation to selling lottery tickets.

Non-Operating revenues – include activities that have the characteristics of non-exchange transactions, such as gifts and other revenue sources that are defined as non-operating revenues by GASB No. 9, “Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting,” and GASB No. 34, “Basic Financial Statements and Management Discussion and Analysis for State and Local Governments.” Types of revenue sources that fall into this classification are state appropriations, investment income, and gain or loss on disposition of assets.

Free Tickets. Some Montana Lottery scratch games award free tickets as prizes. Net lottery ticket revenue does not include the value of free tickets given away and free plays won. The face value of these free ticket prizes distributed for the quarter and twelve months ended June 30, 2010 was \$116,508 and \$217,822, respectively.

Promotional Credits. The Lottery issues promotional credits to retailers to be used to distribute free tickets to players. The tickets are distributed as part of a promotion run by the retailer, e.g., "Ask for the Sale" or second chance drawings. The Lottery also directly distributes scratch tickets for promotional purposes at trade shows, for media give-aways, and during new game introductions. The tickets distributed as a result of promotional credits are reflected as a reduction in revenue. The related prize expense and ticket cost for all promotions are reclassified as an advertising expense. For the quarter ended June 30, 2010, promotional credits resulted in a revenue reduction of approximately \$7,865 and an expense reclassification of approximately \$5,886. For the twelve months ended June 30, 2010, promotional credits resulted in a revenue reduction of approximately \$110,713 and an expense reclassification of approximately \$91,709.

Prizes. Expenses for scratch prizes are recorded based on the predetermined prize structure for each game. Expenses for lotto prizes are recorded based on the predetermined prize structure for each individual game. No prize expense is recorded for free tickets distributed.

Unclaimed Prizes. Prizes for the lotto games must be claimed within six months after the appropriate draw date. Prizes for scratch games must be claimed within six months of the announced end of each game. The unclaimed prize amounts for the Montana Lottery lotto games are taken as a reduction in the Lottery Prizes Payable liability and the Prize Expense and are transferred to the State of Montana General Fund as a portion of the quarterly transfer. The amount of unclaimed prizes for all Montana Lottery games is represented in the table below.

	Quarter Ended 6/30/10	Quarter Ended 6/30/09	Year To Date 6/30/10	Year To Date 6/30/09
Lotto	\$130,731	\$132,235	\$543,364	\$732,122
Scratch	\$134,468	\$322,914	\$402,006	\$635,838
<b>TOTALS</b>	\$265,199	\$455,149	\$945,370	\$1,367,960

## 2. SUMMARY OF ACCOUNTS

Cash and Cash Equivalents. Cash and cash equivalents consist of interest-bearing deposits with the Montana Board of Investments short-term investment pool, cash on deposit in revolving account with a non-state financial institution and cash on deposit with the Montana State Treasurer that is part of the State's pooled cash and is not separately identifiable as to specific types of securities. These funds are highly liquid and may be drawn on daily.

Cash and cash equivalents consist of the following:

	June 30,	
	<u>2010</u>	<u>2009</u>
Short-term investment pool	\$1,112,340	\$1,534,754
Cash on deposit with State Treasurer	1,876,708	300,925
Cash in revolving deposit account	5,284	10,000
Petty Cash & Cash on Hand	1,323	220
<b>TOTALS</b>	<b>\$2,995,655</b>	<b>\$1,845,899</b>

The bank balance of the revolving deposit account, not including outstanding deposits or checks, was \$11,081 at June 30, 2010 and was covered by federal depository insurance. The carrying amount reported in the balance sheet for cash and cash equivalents approximates the fair market value.

Receivables. Receivables include \$2,045,414, representing amounts due the Lottery for tickets purchased by retailers. Receivables also include \$930 for interest income due from the Montana Board of Investments short-term investment pool. An allowance for ticket returns is included in the receivables amount. This allowance represents a reduction in receivables at June 30, 2010, for estimated ticket returns. This is an estimate based on returns received to date, as well as an estimate of tickets unsold by retailers for games that have a public sale end date prior to July 1, 2010. The allowance for ticket returns is \$275,951 at June 30, 2010. The return of vendor fees related to the allowance for returns is \$16,005.

Inventories. Inventories consist of merchandise and supplies inventories. Merchandise inventory includes scratch tickets valued at \$466,511 stored in the warehouse, at retailers prior to being activated by the retailer, and with the marketing representatives. These ticket inventories are recorded at cost using the specific identification method and maintained on a perpetual inventory system. Tickets are charged to cost of tickets sold upon activation or after game end.

Supplies inventories include ticket dispensers, premiums and point-of-sale materials. At year end, supplies inventories totaled \$61,862. These inventories are also recorded at cost using the specific identification method.

Property and Equipment. A summary of property and equipment for the Lottery is as follows:

	June 30,			June 30,
	2009	Additions	Deletions	2010
Leasehold Improvements	\$ -	\$ 45,448	\$ -	\$ 45,448
Furniture & Equipment	\$ 545,289	\$ 934,575	\$ (19,688)	\$ 1,460,176
Accumulated Depreciation	\$ (310,853)	\$(161,934)	\$ 16,735	\$ (456,052)

Receivable – Equipment. The equipment receivable by the Lottery of \$1,625,000 was for 250 on-line vending machines due from the Lottery's primary vendor. The vendor consolidated their Montana operations with the operations of another state. Since this consolidation took place outside of Montana, the vendor installed these machines throughout the state for the Lottery's use for the inconvenience caused by the restructure.

Other Current Assets. Other current assets include the following:

	June 30,	
	2010	2009
Prepaid Expenses	\$90,497	\$427,934
Employee Advances	-	-
TOTALS	<u>\$90,497</u>	<u>\$427,934</u>

The prepaid expense amount consists of \$67,491 for the remaining truck prizes, \$8,000 for booth fees for upcoming summer fairs, and \$15,006 for prepaid commissions and vendor fees related to deferred revenue.

Transfer Obligations. The account "Transfer Obligations" is \$2,467,133 payable to the General Fund at June 30, 2010.

Compensated Absences. State employees earn vacation leave ranging from 15 to 24 days per year depending on the individual's years of service. Vacation leave may be accumulated not to exceed two times the maximum number of days earned annually. With no limit on accumulation, sick leave is earned at 12 days per year. Upon retirement or termination, an employee is paid 100% for unused vacation and 25% for unused sick leave. The Lottery's liability for compensated absences is detailed below.

Balance	Net Leave	Balance
<u>June 30, 2009</u>	<u>Earned/(Used)</u>	<u>June 30, 2010</u>
\$211,068	\$15,765	\$226,833

Commissions. Section 23-7-301(10), MCA, provides retailers a commission on scratch and lotto tickets or chances sold. The Lottery Commission established this commission at 5% of the face value of scratch tickets activated by the retailers and the face value of lotto tickets sold. Section 23-4-302 (5)(b)(i), MCA establishes a 3.99% commission of the face value of Fantasy Sports tickets sold. In addition retailers can earn bonus commissions on tickets sold based on incremental sales of scratch tickets. For the quarter and twelve months ended June 30, 2010 retailers earned bonus commissions of \$117,180 and \$443,363, respectively. For the quarter and twelve months ended June 30, 2010 total commissions were \$222,090 and \$2,338,036, respectively.

OPEB (Other Post Employment Benefits) Implicit Rate Subsidy LT. Effective for Fiscal Year End 08, GASB Statement 45 and the reporting requirements for the “implied rate subsidy” required the State of Montana to book substantial liabilities. The liability is a result of the state’s requirement to allow retired employees to remain in the retirement plan after retirement. This results in an implicit rate subsidy since retirees pay the same amount as active employees. “Actuaries Northwest” prepared the report for the State of Montana to calculate the Annual Required Contribution under the Governmental Accounting Standards Board (GASB). The allocation is made based on the fiscal year’s benefits expense and the number of full time employees for an agency.

The Lottery’s OPEB obligations for 2010 and 2009 are as follows:

<u>Year ended June 30,</u>	<u>2010</u>	<u>2009</u>
Annual Required Contribution	\$ 83,673	\$ 111,819
Adjustment to annual required contributions	-	-
Annual OPEB cost	\$ 83,673	\$ 111,819
Contributions made	-	-
Increase to net OPEB obligation	\$ 83,673	\$ 111,819
Net OPEB obligation – beginning of year	\$ 216,188	\$ 104,369
Net OPEB obligation – end of year	\$ 299,861	\$ 216,188

### 3. **MARKETING PRODUCTION EXPENSES**

The Lottery has contracted with several vendors to provide marketing related services and materials. These services include media placement, creative design and layout, and media production. Those services and materials not included in the Advertising and Advertising Production expense categories are printing and ticket dispensers. The cost of these services and materials, included in Operating Expenses as Contracted Services and Supplies and Materials, are detailed below for the twelve months ended June 30, 2010:

Printing	\$65,980
Ticket Dispensers	<u>14,785</u>
	\$80,765

#### 4. PAYMENTS TO OTHER STATE AGENCIES

The Lottery receives a variety of services, supplies, and materials from other state agencies. These services and materials are detailed below for the fiscal year ended June 30, 2010:

Insurance	\$ 7,819
Warrant Writing Services	817
Payroll Services	7,493
Audit Fees	36,108
Computer Fees	33,416
Printing	996
State Accounting System Support	5,117
Supplies & Materials	11,284
Mail Processing Fees	10,088
Telecommunications	58,828
Vehicle Rental Fees	128
Administrative Service Fees	64,460
Other	<u>2,869</u>
<b>TOTAL</b>	<b>\$ 239,423</b>

#### 5. PRIZES

Paid Prizes. Section 23-7-402, MCA states, "A minimum of 45% of the money paid for tickets or chances must be paid as prize money". Prize expense is recorded based on the predetermined prize structure percentage for each game less unclaimed prizes. For the quarter ended June 30, 2010, the prize expense of \$6,349,379 is 57.59% of net Lottery ticket revenue of \$11,024,506. For the year ended June 30, 2010, the prize expense of \$25,941,125 is 55.37% of net Lottery ticket revenue of \$46,852,798.

#### 6. TRANSFER TO STATE GENERAL FUND

Section 23-7-402(3), MCA, states "That part of all gross revenue not used for payment of prizes, commissions, and operating expenses, together with the interest earned on the gross revenue while the gross revenue is in the enterprise fund, is net revenue. Net revenue must be transferred quarterly from the enterprise fund established by 23-7-401 to the State General Fund." For the quarter ended June 30, 2010, the net revenue payable to the State General Fund totaled \$2,467,133.

## 7. MULTI-STATE LOTTERY

In November 1989 the Montana State Lottery joined the Multi-State Lottery Association (MUSL). MUSL was created in September 1987 to operate a multi-state lottery game for the benefit of party lotteries. Powerball, Wild Card, Hot Lotto, and Mega Millions are the games jointly operated by the members, in which Montana presently participates. Each lottery participating in MUSL is represented on the Board of Directors.

The Multi-State Lottery Reserve Fund with a balance of \$1,430,386 as of June 30, 2010 is comprised of several reserve accounts, which are maintained by the Multi-State Lottery Association (MUSL). The balance of these reserve accounts is as follows:

	June 30, <u>2010</u>	June 30, <u>2009</u>
Powerball Prize Reserve Account	\$ 518,311	\$ 518,311
Powerball Set Prize Reserve Account	172,770	170,892
Powerball Unreserved Account	207,326	608,067
Wild Card Prize Reserved Account	233,604	205,717
Hot Lotto Set Prize Reserve Account	300,638	260,797
Mega Millions Prize Reserve Account	<u>( 2,263)</u>	<u>-</u>
<b>Total</b>	<b><u>\$1,430,386</u></b>	<b><u>\$1,763,784</u></b>

The Powerball Prize Reserve Account is to be used only in the event of an unanticipated prize claim. It is an insurance fund intended to protect the member lotteries against the liability that could result from a system failure at one of the member lotteries. All money paid to this fund would be returned to the Lottery one year after the Lottery leaves the Powerball game, assuming that no unanticipated prize claims have been paid. Interest earned on the Lottery's share of the fund, represented by the Unreserved Account, would be returned to the Lottery upon leaving MUSL. The amounts in the Unreserved Account may be used at the MUSL Board's discretion.

The Powerball Set Prize Reserve Account is used to fund prize payments for current drawings. Since the Powerball game has fixed prizes, it is often necessary to draw from this reserve to fund payment of prizes at the fixed amount. This account would be returned to the Lottery upon withdrawal from the Powerball Game.

The Lottery contributes to these reserve funds through the 50% set aside for prizes. In addition the Lottery was required to contribute for its portion of the reserve funds accumulated since the start of the Powerball game. Payments made to this fund are considered a portion of prize expense associated with the game.

The Wild Card Reserve Account is to be used in the event of an unanticipated prize claim on the Wild Card game. This account is also administered by MUSL and would be returned to the Lottery one year after the Wild Card Product Group of Idaho, Montana, South Dakota, and North Dakota is disbanded. The Lottery contributes to this account through the 55% set aside for prizes. Payments made to this fund are considered a portion of prize expense related to the Wild Card game.

The Hot Lotto Set Prize Reserve Account is administered by MUSL and is to be used only in the event of unanticipated prize claims. Like other MUSL games the reserve amount would be returned to the Lottery one year after withdrawal from the Hot Lotto game. The Lottery contributes to the reserve through the 50% set aside for prizes. Payments made to the reserve are considered a portion of the prize expense related to the game.

The Mega Millions Prize Reserve Account is to be used only in the event of an unanticipated prize claim. It is an insurance fund intended to protect the member lotteries against the liability that could result from a system failure at one of the member lotteries. All money paid to this fund would be returned to the Lottery one year after the Lottery leaves the Mega Millions game, assuming that no unanticipated prize claims have been paid. The Lottery contributes to the reserve through the 51% set aside for prizes. Payments made to the reserve are considered a portion of the prize expense related to the game. The Lottery had just started cross-selling Mega Millions during the fiscal year end 2010. As a start-up game, the reserve was negative at the year end as the Lottery had not built up enough history and accumulated enough sales to create an excess reserve.

## **8. GAMES**

Currently, the Montana Lottery games are scratch ticket games, seven lotto games referred to as Powerball, Montana Ca\$h, Wild Card, Hot Lotto, Mega Millions, 10 Spot, and Montana Millionaire, a limited edition lottery game. The lottery is facilitating Fantasy Sports Games on behalf of the Board of Horse Racing. Currently the Lottery is selling the Montana Sports Action Fantasy Football and the Racing games.

Scratch ticket games provide players the opportunity to win instantly by scratching latex covering to reveal a prize.

The Powerball game allows players the chance to win a minimum pari-mutuel jackpot of approximately \$20 million. A player must match all 6 numbers to win the jackpot; players win prizes ranging from \$3 to \$200,000 for matching less than all 6 numbers. Drawings are held twice weekly on Wednesday and Saturday nights. For any drawing, if no ticket matches 6 out of 6 numbers, the jackpot rolls over to the next drawing to create a progressive jackpot. In March

2001, the Lottery added Power Play to the Powerball game. For an additional bet, the Power Play option provides non-jackpot winners the chance to multiply their prize amount by a factor of two through five.

The Montana Ca\$h game allows players the chance to win a minimum pari-mutuel jackpot of \$20,000. Players select 5 numbers from a field of 37 and must match at least 3 out of 5 to win a prize. Matching 3 of 5 wins \$5 and 4 of 5 wins \$200. The drawing is conducted twice weekly on Wednesday and Saturday nights. If no ticket matches all 5 numbers, the jackpot rolls over to the next drawing to create a progressive jackpot.

The Wild Card game allows players the chance to win a pari-mutuel jackpot, with a guaranteed minimum of \$100,000. Players select 5 numbers from a field of 31 plus one of 16 face cards and must match all 5 numbers and the wild card to win the jackpot; players win prizes from \$1 to \$5,000 for matching less than all 5 numbers and/or the wild card. Drawings are held twice weekly on Wednesday and Saturday nights. If no ticket matches all 5 numbers and the wild card, the jackpot rolls over to the next drawing to create a progressive jackpot.

Hot Lotto allows players the chance to win a pari-mutuel jackpot with a guaranteed minimum of \$1 million. Players choose 5 numbers from a field of 39 plus 1 Hot Ball number from a field of 19; the first 5 numbers and the Hot Ball must be matched to win the jackpot. Players can win prizes ranging from \$2 to \$10,000 by matching less than all 5 numbers and/or the Hot Ball. If no ticket wins the jackpot, it rolls over to the next drawing to create a progressive jackpot. Drawings are held twice weekly on Wednesday and Saturday nights. In January 2008, the Lottery added the Sizzler option to the Hot Lotto game. For an additional bet, the Sizzler option provides non-jackpot winners the chance to multiply their prize amount by three.

Mega Millions is a multi-state game that allows players to win a minimum pari-mutuel jackpot starting at \$12 million. Mega Millions went on sale March 1, 2010 in Montana. To win the jackpot, players must match all six numbers drawn; other prizes range from \$2 to \$250,000. Drawings are held each Tuesday and Friday. Mega Millions has a Megaplier option which multiplies non-jackpot prizes by two, three, or four. The Megaplier options costs \$1 extra per play.

10 Spot, which went on sale February 1, 2010, is a Montana-only, twice daily game. Players select ten numbers from one through eighty. The Lottery draws twenty numbers, and players win by matching ten, nine, eight, seven, six, five, or none of the numbers drawn. Prizes range from \$2 to \$25,000.

Montana Sports Action is a product line introduced by the Lottery in August 2008 on behalf of the Board of Horse Racing. Montana Sports Action Fantasy Football was the first game within the Fantasy Sports Games to begin. Players choose five eligible offensive players and a defensive unit from the official roster of

professional football players and teams, to create their own team. The players then choose a play amount (\$5, \$10, \$20, \$50, or \$100) which determines the shares the player is eligible to win should their team have one of the three highest point totals for the week.

After completion of each week's professional football games, points are assigned to football players and defensive units based on their performance to determine the Lottery players' team's performance. Prizes paid must be 74% of sales for the week. How much the player wins is determined by their team's points and their share (\$5 per share). Ticket sales are allowed each week of the professional football season beginning Tuesday morning for that week's games with no advanced purchasing allowed.

Fantasy Racing was introduced in February 2009, and follows the NASCAR® Sprint Cup Series. Fantasy Racing teams are created by selecting a driver from the top nine-ranked drivers for the week; three drivers ranked from ten through 34; and one driver ranked 35 or above. The sixth element in a player's Fantasy Racing team is the number of yellow-flag cautions the player believes might occur in that week's race. Players also choose the number of shares they wish to buy (\$5, \$10, \$20, \$50 or \$100). Like Fantasy Football, the number of shares determines the amount of the prize each winning ticket will win. After each Sprint Cup race, points are assigned to each driver's performance, and teams with the top three point totals win. Ticket sales begin each week on Monday.

Montana Millionaire began on November 1, 2009 with the final drawing on January 1, 2010. The tickets were sold sequentially across the state with 1 to 150,000 available. There were 400 - \$50 instant win prizes for every 375<sup>th</sup> ticket purchased. The final drawings were held on January 1, 2010 and consisted of one \$1 million dollar top prize, five \$100,000 prizes, and five \$10,000 prizes. This game will begin again on November 1, 2010 with the final drawing on approximately January 1, 2011. The number of tickets available will be reduced to 125,000, and the prize structure will be modified accordingly. An early bird prize of \$10,000 will also be awarded in late November.

## **9. COMMITMENTS - GAMING SUPPLIER CONTRACTS**

Scratch Tickets. On June 27, 2008 the Montana Lottery Commission approved the award of a five-year contract with Scientific Games International (SGI) for the provision of scratch tickets. The contract is for five years with the option for two additional one-year renewals. The contract contains specifications regarding ticket design, printing, game ownership, inspection, and prize structure.

SGL, as the vendor, provided a performance bond covering the contract term and an errors and omissions policy covering an ultimate net loss of \$3,000,000. The Lottery may terminate this contract by providing proper notification to Scientific Games.

On-line Services. On October 11, 2005, the Lottery signed a seven-year contract with Intralot, Inc. of Duluth, GA to provide an on-line gaming system and the associated services beginning March 31, 2006. The contract requires Intralot to provide new terminals to all retailers with the associated software and communications. Payment under the contract is based on 5.8% of net weekly Lottery sales of lotto and scratch games. On August 18, 2008 an addendum was signed to provide services for the Fantasy Sports games at 3% of net weekly Lottery sales up to \$2,999,999 of Montana Sports Action games. The contract currently has a termination date of March 30, 2016.

#### **10. LOTTO\*AMERICA/POWERBALL/TRI-WEST JACKPOT PRIZES**

Jackpot prizes awarded in the Lotto\*America/POWERBALL and TRI-WEST LOTTO games are funded through the purchase of U.S. Treasury Zero-Coupon Bonds purchased in the name of the Montana Lottery by MUSL. MUSL will cash the bonds each year as they mature and will wire the funds to the Lottery for payment to winners on the Anniversary date of the win.

On January 13, 1990 the Montana Lottery awarded its first Lotto\*America jackpot prize totaling \$1,740,000. The first annual payment of \$87,000 was made on February 1, 1990. On May 9, 1990 the Lottery awarded a second Lotto\*America jackpot prize of \$3,000,000. The first annual payment of \$150,000 was made on May 23, 1990. A third jackpot prize was awarded on February 2, 1991 for \$7,360,000. The first annual payment of \$368,000 was made February 15, 1991. On November 23, 1991 a fourth jackpot prize was awarded totaling \$46,967,738.57. The first annual payment of \$2,355,738.57 was made December 12, 1991. On April 11, 1992 a fifth jackpot prize was won totaling \$2,000,000. The first annual payment of \$100,000 was made on April 27, 1992.

On July 6, 1994 the Montana Lottery awarded its first Tri-West Lotto jackpot prize totaling \$700,565. The first annual payment of \$35,000 was made on July 26, 1994.

On July 22, 1995 the Montana Lottery awarded its first Powerball jackpot prize totaling \$31,401,655.99. The first payment of \$1,571,655.99 was made on August 8, 1995. On April 5, 1997 the Lottery awarded a second Powerball jackpot prize totaling \$11,000,000. The first annual payment of \$550,000 was awarded on April 18, 1997.

On March 27, 1999 the Montana Lottery had a Powerball jackpot winner. The prize was \$35.1 million (\$19.35 million cash option). The winner chose the cash option and was paid a lump sum in June 1999.

On June 23, 2010 the Montana Lottery awarded its fourth Powerball jackpot prize. The total jackpot was \$96,856,406 and was split between another ticket in Ohio. Half of the jackpot, which was again split between two winners in Montana, totaled \$48.5 million (25.08 million cash option). The winners chose the cash option and were paid a lump sum in July 2010.

As of June 30, 2010, the combined total of future prize payments funded through the purchase of U.S. Treasury Zero-Coupon Bonds for Lotto\*America winners was \$2,448,000. The combined total of future prize payments funded through the purchase of U.S. Treasury Zero-Coupon Bonds for Powerball and Tri-West Lotto winners was \$11,290,000. Total annual payments due as of June 30, 2010 are as follows:

<u>FYE</u>	
2011	\$ 4,603,000
2012	2,155,000
2013	2,155,000
2014	2,155,000
2015	2,120,000
Thereafter	<u>550,000</u>
	<u>\$ 13,738,000</u>

#### 11. LEASES/INSTALLMENT PURCHASES PAYABLE

Rent. The Montana Lottery leases its office, administrative and warehouse facilities under a lease agreement that is effective September 2007 through August 2017. The monthly lease payment is \$10,776 through August 2010. The base rate will increase 3% annually.

Capital Lease. The Lottery has contracted with its vendor to lease equipment for the remaining life of its contract with them. Obligations under this capital lease/installment purchase at June 30, 2010 are as follows:

<u>FYE</u>	
2011	\$ 94,155
2012	89,977
2013	85,827
2014	81,677
2015	77,528
Thereafter	<u>55,423</u>
Total Minimum Payments	484,587
Less: Interest	<u>( 69,622)</u>

Present value of Minimum Payments	<u>\$ 414,965</u>
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## 12. INVESTMENT RISK DISCLOSURES

Effective June 30, 2005, the State of Montana implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures*. The Lottery participates in two investment pools: the Multi-State Lottery Association (MUSL) reserve accounts and the State of Montana's Short Term Investment Pool (STIP). There are four types of risk that must be disclosed. These risks are defined below, followed by their applicability to each of the investment pools.

Multi-State Lottery Association The MUSL investment policy for prize reserve and unreserved funds states that permitted investments "include direct obligations of the United States government, perfected repurchase agreements, and obligations issued or guaranteed as to payment of principal and interest by agencies or instrumentalities of the United States government, and mutual funds of approved investments".

Short-term Investment Pool All short-term funds are held in the State's Short Term Investment Pool (STIP) administered by the Board of Investments (BOI). STIP is an external 2a-7 like pool.

**Credit risk** is defined as the risk that an issuer of an investment will not fulfill its obligation, i.e., not make timely principal and interest payments. The STIP securities have credit risk as measured by major credit rating services, however, the pool is not rated. The Lottery does not have a policy regarding credit risk

Per MUSL, the prize reserves held on behalf of the Montana Lottery are invested in the Montana Winners Trust and include 51% in securities held as obligations of the U.S. Government and are not considered to have credit risk. The other 49% of the prize reserves are invested in Federal Agencies and have an AAA credit quality rating. The Lottery does not have any authority or a policy regarding the investment portfolios.

**Custodial credit risk** is the risk that the Lottery would not be able to recover the value of the investment or collateral securities that are in the possession of an outside party in the event of the failure of that party. Custodial credit risk does not apply to STIP because it is a 2a-7 like pool.

The MUSL prize reserves are held in the Montana Winners Trust using policies set forth by the MUSL board regarding policies for the type of securities, as well

as the custody, trading and the use of proceeds of the securities. The Lottery does not have any authority or a policy regarding the investment portfolios.

**Concentration of credit** is the risk of loss attributed to the magnitude of a government's investment in a single issuer. Because STIP is a pooled investment, this risk does not apply. Because the MUSL reserves are also a pooled investment, this risk does not apply to them either.

**Interest rate risk** is the risk that changes in interest rates will adversely affect the fair value of an investment. Interest rate risk does not apply to STIP because it is a 2a-7 like pool.

The MUSL prize reserves are invested through the Montana Winners Trust in the Morgan Stanley Government Portfolio Funds with daily liquidity and therefore have no interest rate risk. The MUSL board's investment policy limits the individual security and the portfolio's maturity. As of June 30, 2010, the duration for the U.S. Government Treasury securities was 1.036 years and for the Agency securities was 0.739 years.

MONTANA STATE  
LOTTERY

LOTTERY RESPONSE





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March 2, 2011

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MAR 04 2011

**LEGISLATIVE AUDIT DIV.**

Ms. Tori Hunthausen  
Legislative Auditor  
Office of the Legislative Auditor  
State Capitol Building  
Helena, MT 59620-1705

**Subject: Response to 2010 Montana Lottery Finance Services Audit**

Dear Ms. Hunthausen:

Thank you for the opportunity to respond to the report on the Montana Lottery Financial Services Section dated March 1, 2011. We have or will take the necessary action to comply with all recommendations. As the new Director, I intend to use these findings and recommendations presented as a base line for the development of short and long-term internal controls. The following is our response to specific recommendations of your audit team:

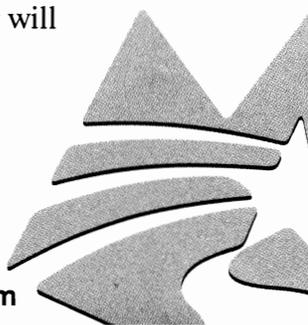
**RECOMMENDATION NO. 1**

**A. Comply with state law and record transactions in accordance with generally accepted accounting principles.**

We concur. Going forward a new procedure will be developed along with updated reviewing processes, training and accountability measures.

**B. Provide accounting personnel training in proper application of state accounting policy and generally accepted accounting principles.**

We concur. During this audit year, the Lottery had a high turnover in the Accounting department and did not have the experience and resources required for a short period of time. Currently, the Accounting department is fully staffed with trained employees including the Finance Director who is a CPA and is required to attend 40 hours a year in continuing professional education. The Lottery Director has determined that the Lottery Finance Director will monitor compliance of these recommendations and that the Lottery Security Director will provide a second level of verification that recommendations are being implemented and training conducted.



Tori Hunthausen, Legislative Auditor  
March 2, 2011  
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**RECOMMENDATION NO. 2**

**A. Comply with applicable appropriate laws for all payments.**

We concur. Accounting staff turnovers have ceased so the administrative processing review gaps that occurred during this audited year are now restored.

**B. Follow established control procedures for all payments.**

We concur. The Montana Lottery will follow established procedures.

**RECOMMENDATION NO. 3**

**We recommend the Lottery follow its established procedures for major contracts and obtain Commission concurrence in accordance with state law to mitigate its financial risks.**

We concur. A management review by the five top Directors will be conducted when contract modifications are required and this action will be documented and presented to our commissioners. The accounting Director will then prepare the footnotes for any changes documented involving monetary impacts.

**RECOMMENDATION NO. 4**

**We recommend the Lottery implement effective control to prevent or detect and correct errors or irregularities in the financial information it obtains from the contractor's system.**

We concur. The accounting section will establish an internal control policy that will require training of employees in other Lottery sections to verify financial information obtained from the Lottery vendors system. This will be in addition to these other action:

- Files from another vendor (Scientific Games) will be used to test each individual scratch game to ensure that the correct number of winning tickets are in each pack and that they claim and validate properly on Intralot's system. Part of this testing includes ensuring that the game properly tracks to several other individual reports used by various departments including accounting within the Lottery.

Tori Hunthausen, Legislative Auditor  
March 2, 2011  
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- Security will periodically sample multiple reports used by various sections of the Lottery to track in real time where scratch tickets are and where they have been. Tickets can be reviewed by game, pack, or by the ticket status (warehouse, received at a retailer, activated at a retailer, or settled at a retailer).
- The Marketing and Sales staff will review several reporting tools daily and weekly that would quickly alert to problems with the system, games or retailers.
- The Security section will also review various accounting reports, sales reports and retailer incentive reports to identify trends and abnormal patterns.

#### **RECOMMENDATION NO. 5**

**We recommend the Lottery implement effective reconciliation controls over its prize payment process to ensure all prize payments are valid and accurate.**

We concur. Every claim processed will go through several steps in accounting before a check or EFT is authorized. Updated internal control procedures will be ready for review by the next audit in July 2011.

#### **RECOMMENDATION NO. 6**

**We recommend the Lottery follow its established control procedures for review and approval of operating expenses.**

We concur. Internal control and policy procedures will be followed now that we are fully staffed.

Thank you again for the opportunity to respond. Your team established a good rapport with our office and showed strong professional knowledge and personal professionalism while working in our area. Please express my appreciation of these facts to them for their efforts.

Sincerely,

  
Angela Wong, Director  
Montana Lottery