

700 North Tenth Street
Sacramento, CA 95811
calottery.com



DATE: December 18, 2013
TO: Michael Cohen, Director of Finance
FROM: Paula D. LaBrie, Acting Director, California State Lottery
SUBJECT: Review of the Systems of Internal Control

In accordance with the Financial Integrity and State Manager's Accountability Act of 1983, Government Code sections 13400 through 13407, I am submitting the enclosed report describing the review of our systems of internal control for the biennial period ended December 31, 2013.

As statutorily required, the California State Lottery is in compliance with Government Code section 12439. At the inception of the Lottery, the Department of Finance exempted the Lottery from its budgetary review. Accordingly, the budget and related positions are established, approved, and monitored by the Lottery Commission.

Enclosure(s)

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

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December 18, 2013

Mr. Michael Cohen, Director
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 system of internal control for the biennial period ended December 31, 2013.

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, 96 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 order to achieve significant growth in sales and profits over the next three years, the Lottery identified four essential goals in their Strategic Plan. All major initiatives will link to one of these goals, which include:

1. Increase sales not only in the Scratchers® category but also in the Jackpot Games and other Lottery products;
2. Build the playership of Lottery products so more California adults participate in Lottery games;
3. Grow the network of Lottery retailers and concentrate the best service to the most productive retailers and those with potential; and
4. Improve the Lottery's infrastructure to handle sales growth, increase efficient and effective operation; and to cultivate an internal culture that is more collaborative and performance driven with an eye towards the common, overall Lottery goal.

The Lottery is organized into 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.

In August 2011, the World Lottery Association (WLA) awarded the Lottery a Level Three Certification. This prestigious designation is granted to lottery organizations that can demonstrate Responsible Gaming is an integral part of their organization and shows their on-going commitment by allocating sufficient resources in key areas. In the United States, only California and Kentucky hold this designation.

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 Officers Association of the United States and Canada has awarded a Certificate of Achievement for Excellence in Financial Reporting to the Lottery for the past ten consecutive fiscal years (the most recent award was fiscal year 2011/2012).

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 is responsible to assist and facilitate the review process to conduct a risk assessment on behalf of the Lottery. Internal Audits met with Senior Management Staff during the summer of 2013 to facilitate the process, determine a timeline and establish an understanding of expectations regarding the control self-assessment. During the interviews with Lottery management, we discussed prior audit findings and associated action plans related to their division.

The control self-assessment did not focus on one specific area but considered input of management's observations of risk areas that could severely impact our mission. 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 2012 and 2013:

SCO Otto Construction Audit.....	January 2012
Scratchers Ticket Activation.....	February 2012
SCO Budget Process.....	March 2012
Travel Program.....	March 2012
SCO Casanova Pendrill Publicidad Contract.....	April 2012
SCO Personnel and Payroll Process.....	May 2012
SCO Accounts Receivables.....	October 2012
GTECH Financial Assessment Process Audit.....	October 2012
KPMG Financial Statement Audit.....	October 2012
SCO Time Advertising Contract.....	November 2012
SCO Draw Management Process.....	November 2012
Investigative Claims Process.....	January 2013
SCO Retailer Network.....	January 2013
SCO Scratchers Ticket Distribution Audit.....	January 2013
Gaming Laboratories International (GLI) Security Audit.....	February 2013
SCO Otto Construction Audit Follow-up.....	March 2013
SLED 2009 Audit Follow-up.....	April 2013
SCO David & Goliath Contract.....	April 2013
Press Check Process Audit.....	May 2013
Infomatix ITSD Risk Assessment.....	June 2013
Camelot Global Contract Audit Follow-up.....	August 2013
Travel Program Audit Follow-up.....	October 2013
SCO Cash Receipts.....	October 2013

In addition to the audit work completed in the last two years, the Lottery formally established Enterprise Risk Management (ERM) as a process and appointed a Chief Risk Officer in April 2013. This formalizes and coordinates risk management with a comprehensive enterprise-wide, strategic and transparent view of risks. This includes not only the traditional operational and compliance-related risks, but extends to emerging and intangible risks.

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.

We found that findings cited in the audits performed during 2012 and 2013 have either been corrected or are in the process of correction. Therefore, along with the addition of the ERM process as a pro-active approach to risk, the Lottery reports there are no significant vulnerabilities critical to the Lottery's success.

Corrective Action Plan (CAP)

Accordingly, there will be no corrective action updates for FISMA 2013. Further, actions completed and on-going monitoring supports that two of the three FISMA 2011 reported risks; Policies and Procedures, and Asset Management; are considered closed. The corrective actions are still underway for the final FISMA 2011 risk, Data Classification; therefore, continued corrective actions will be reported. The December 2013 CAP to detail actions completed and/or planned will be submitted.

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.


Paula D. LaBrie
Acting Director

cc: Governor's Office
Legislature
State Controller's Office
State Treasurer's Office
Attorney General
State Auditor
State Library
Internal Audits File