

**STATE OF NEW HAMPSHIRE
LOTTERY COMMISSION**

**MANAGEMENT LETTER
FOR THE FISCAL YEAR ENDED JUNE 30, 2004**

To The Fiscal Committee Of The General Court:

We have audited the financial statements of the business-type activities of the New Hampshire Lottery Commission, a department of the State of New Hampshire, as of and for the fiscal year ended June 30, 2004 and have issued our report thereon dated December 2, 2004.

The primary objective of our audit was to express an opinion on the fairness of the presentation of the financial statements of the New Hampshire Lottery for the fiscal year ended June 30, 2004. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we considered the effectiveness of the internal controls in place at the Lottery and tested the Lottery's compliance with certain provisions of applicable laws, rules, regulations, and contracts.

This management letter, a byproduct of the audit of the New Hampshire Lottery Commission for the fiscal year ended June 30, 2004, contains an auditor's report on internal control over financial reporting and on compliance and other matters and related audit findings. These conditions were considered in determining the nature, timing, and extent of the audit tests applied in our audit of the June 30, 2004 financial statements, and this report does not affect our report on those financial statements dated December 2, 2004. The appendix, included as an attachment to the management letter, provides a summary of the status of observations presented in the fiscal year 2003 management letter of the Lottery Commission, previously known as the Sweepstakes Commission.

The Lottery received a Government Finance Officers Association (GFOA) Certificate of Achievement for Excellence in Financial Reporting for its 2003 comprehensive annual financial report (CAFR). The Lottery has submitted its 2004 CAFR to the GFOA for consideration in its certificate program. A copy of the Commission's 2004 CAFR can be obtained from the New Hampshire Lottery Commission, 14 Integra Drive, Concord, NH 03301.

Office Of Legislative Budget Assistant
Office Of Legislative Budget Assistant

December 2, 2004

**STATE OF NEW HAMPSHIRE
LOTTERY COMMISSION
2004 MANAGEMENT LETTER**

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This report can be accessed in its entirety on-line at www.gencourt.state.nh.us/lba.

Auditor's Report On Internal Control Over Financial Reporting And On Compliance And Other Matters

To The Fiscal Committee Of The General Court:

We have audited the financial statements of the business-type activities of the New Hampshire Lottery Commission (Lottery) as of and for the fiscal year ended June 30, 2004 and have issued our report thereon dated December 2, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the New Hampshire Lottery Commission's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Lottery's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in Observations No. 1 through No. 10 of this report.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.

Compliance And Other Matters

As part of obtaining reasonable assurance about whether the New Hampshire Lottery Commission's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, rules, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This auditor's report on compliance and on internal control over financial reporting is intended solely for the information and use of the management of the New Hampshire Lottery Commission and the Fiscal Committee of the General Court and is not intended to be and should not be used by anyone other than these specified parties.

Office Of Legislative Budget Assistant
Office Of Legislative Budget Assistant

December 2, 2004

Internal Control Comments
Reportable Conditions

Observation No. 1: The Lottery Should Establish Formal Risk Assessment Policies And Procedures

Observation:

The Lottery does not have formal risk assessment policies and procedures in place for recognizing and responding to risks potentially affecting its operations.

Management's monitoring and assessment of risks facing the organization is an integral component of internal control. The purpose of an entity's risk assessment efforts is to identify, analyze, and where appropriate respond to risks and thereby manage risks that could affect the entity's ability to reach its objectives. Effective risk monitoring and assessment practices should be a core element of management's planning activities and should be an ongoing activity.

The Lottery does not have formal policies and procedures in place for regularly reviewing its operations for risks that could jeopardize its ability to continue to function as management intends. Currently, when risks are identified, the Lottery may respond with a change in procedure or other action; however, there are no formal policies and procedures promoting a regular ongoing review of operations for risks. A lack of understanding of risks generally pushes an entity toward a reactive mode when significant risks are realized or a problem occurs. A reactive mode may compromise the efficiency and effectiveness of a response due to the lack of prior identification and understanding of the risks and ramifications.

An entity faces many risks. Risk can be defined as the threat that an event or action will adversely affect an entity's ability to achieve its objectives. Risk can be classified in many ways. For example:

External risks - threats from broad factors external to the entity including changes in the public's perception and acceptance of the entity's operations, changes in statutes and rules, competition from other sources, and illegal activity external to but affecting the organization.

Operational risks - threats from ineffective or inefficient processes, as well as loss of physical, financial, or information assets.

Information risks - threats from the use of poor quality information for operational, financial, or strategic decision-making within the entity and providing misleading information to others.

A formal and continuous process for monitoring and assessing risks would assist the Lottery in its effective management of and response to risks. Identifying risks significant to Lottery operations and strategies requires the involvement of managers at all levels of the organization. Efforts to mitigate those risks should enhance the effectiveness of the Lottery's planning, resource allocation, and control processes.

Recommendation:

The Lottery should formalize its risk assessment process with policies and procedures. A continuous monitoring of Lottery processes and activities using a risk-based mindset will promote effective planning and assist in resource allocation decision-making. Risks identified should be analyzed to determine whether current internal controls mitigate risk to a level desired by management or whether other actions are required in response to the risk.

Auditee Response:

We concur in part.

In light of the numerous reviews currently conducted on the Lottery's operations and the constant reviews of industry issues and risks performed by Lottery management throughout their day to day operations, the Lottery believes that it already meets the intent of this audit observation. The Lottery is always open to ideas for improving its operations and welcomes the opportunity to review a copy of a risk assessment report from another State agency and then determine whether to expand its current risk assessment practices.

The Office of Legislative Budget Assistant (LBA) conducts extensive audits of the Lottery every year, including issuing a report on internal controls, which is incorporated into the review of the operation.

In addition to the annual LBA audit, the Lottery has other independent periodic security audits to identify risks. In fiscal year 2002, a security audit was performed by an outside audit firm contracted by the LBA, KPMG Risk and Advisory Services, which identified risks and security issues for the Lottery. The Lottery addressed the auditor's recommendations to the satisfaction of LBA.

As part of the participation in the Multi-State Lottery (MUSL), every two years a security employee of the MUSL performs a security review of the Lottery gaming system and related operations. In addition to that, twice a year, the Lottery reviews rigorous policies and procedures set by MUSL requiring the review and compliance of established security standards. The Lottery has incorporated the MUSL security standards into all aspects of the operation.

The Lottery has a computerized internal control system (ICS) in place where by the Lottery uses independently developed software to balance all on-line ticket transactions against our vendor's system totals on a daily basis. This ICS provides significant control over many informational risk factors.

And finally, an independent audit firm annually performs a service audit of the Lottery's gaming systems' vendor.

LBA Rejoinder:

We grant that there are a number of regular reviews of Lottery operations performed by outside organizations; however, an organization's proper consideration and response to risk is not something solely evidenced in a report or in work performed by someone else. Management's risk monitoring, assessment, and response are integral components of an organization's internal controls and methods of operation and should be evident in essentially all aspects of an organization's daily operations. Management's demonstrated response to risks, whether risks are immediately and appropriately addressed or discounted without due consideration, provides evidence of whether appropriate risk assessment consciousness has been adopted by management and communicated to lower-level managers and employees. By establishing policies and procedures, management could become more systemically proactive in identifying and mitigating risks and not as reliant upon periodic external reviews.

Observation No. 2: Comprehensive Manual Of Policies And Procedures Should Be Established Covering Lottery Operations

Observation:

The Lottery does not have a comprehensive manual of policies and procedures that addresses its day-to-day operations. A significant portion of the Lottery's daily processes are performed based on employee experience, practice, and policies communicated verbally or through emails or memos. The Lottery has not compiled the policies and procedures into a manual that could be referred to for guidance on an as-needed basis or for employee training purposes.

The Lottery currently has relatively few formal policies and procedures. Many of the policies and procedures that the Lottery has adopted were established in response to prior audit comments. Examples of areas that could benefit from formal policies and procedures, in addition to other comments in this report, include the following:

- Receipt, inspection, and storage of tickets;
- Distribution and delivery of tickets;
- Acceptable advertising and promotional venues, practices, and guidelines, including discussions with the media;
- Accounting functions, including reconciliations performed, compilation of journal entries, etc.;
- Claims for and payment of prizes; and
- Collections and deposits of Lottery sales, including sales at retailers, sales offices, and instant ticket vending machines.

The lack of policies and procedures increases the risk that procedures will not be performed as the Lottery intended. Also, the Lottery may become reliant upon the experience and knowledge of employees for the continued performance of significant operations and suffer disruption if those employees leave Lottery service on short notice.

Recommendation:

The Lottery should develop a comprehensive manual of policies and procedures to safeguard it from the risk that significant Lottery operations and functions may not be performed as intended, that controls the Lottery may assume in operations may not be present, and that the Lottery may become reliant upon key employees for continued performance of significant aspects of its operations.

Auditee Response:

We concur.

A comprehensive manual of policies and procedures had already been prepared for the accounting and claims departments, this will be expanded to the rest of the agency in an electronic format. Estimated completion date is October 2005.

Observation No. 3: Incident Handling And Reporting Policies And Procedures Should Be Established For Significant Control Processes

Observation:

The Lottery does not have incident handling and reporting policies and procedures to inform and direct its employees of protocols for handling unexpected occurrences and to inform management of the sufficiency and effectiveness of its significant control processes.

The Lottery performs a number of public functions requiring direct and indirect interaction with its gaming customers including performing game draws, handling cash, paying prizes, selling tickets, and participating in promotional activities, etc. Because of the nature of the Lottery and the necessity for customer confidence, the risk to the Lottery of a mishandled incident negatively affecting customer confidence is great.

Once during fiscal year 2004 and again shortly after the start of the new fiscal year, the Lottery experienced incidents in its drawing of Pick 3/Pick 4 Tri-State Daily Numbers, which had the potential to negatively affect the confidence of the games' players.

- In the first incident, the draw team failed to make certain that all numbered game balls had been released into the draw machines prior to the game draw. After successfully picking the Pick 3 number, a problem was noticed in the Pick 4 machines. Apparently without contacting anyone outside the draw room, the draw team decided to redraw a new Pick 3 number and a Pick 4 number. This resulted in the Lottery paying off on two Daily Numbers for that draw. The Lottery could not explain why it was appropriate to draw a second Pick 3 number to resolve this problem draw.
- In the second incident, the draw team again failed to make certain that all numbered game balls had been released into the draw machine prior to the game draw. The error was only noticed when the game balls were being placed back into storage at the conclusion of the

draw. This time, the draw team phoned other Lottery management staff and a draw team member left the room for a short time, apparently to discuss the problem, prior to proceeding with any further draw actions. A video recording of the draw mishap shows that the Lottery's Executive Director appears to take over control of the draw and after leaving the room several times, apparently to confer with others, a second draw was made and two Daily Numbers were paid for that draw.

As part of a review of controls over the Lottery's draw process, we reviewed the videotapes and the security tapes for these two draw incidents. In the videotape of the first incident the audio was lost part way through the taping. Because the audio is not complete, it is impossible to establish exactly what was discussed and how the team determined how to proceed when the problems were recognized. In the videotape of the second incident it is clear that the video recorder was turned off periodically, including during periods when the individuals in the draw room were apparently discussing how to proceed.

In reviewing available documentation of the incidents with the Lottery, it appears that neither the Lottery employees in the draw room nor the contracted Certified Public Accountant (CPA) hired to observe the draws were asked to prepare written statements describing the incidents and their perspective on the causes of the incidents. While subsequent to the first incident the Lottery revised its draw procedures, including changing the location of the CPA observing the draw to improve his view of the draw machine, the Lottery did not establish or clarify protocols for handling future draw incidents.

The direct causes of the problems with the two draws were not exactly the same; however, the effect of not having all of the game balls in the machine prior to the draws was the same and the failure to recognize that not all of the balls were loaded is concerning in a control consciousness sense. All of the Lottery's controls in the draw process including observation by a contracted CPA and filming the draws by Lottery employees, failed to notice the game balls were not placed successfully in the machines.

While the extra payouts required to pay winners on two winning numbers for these two days were relatively insignificant to the operations of the Lottery, if similar problems were to occur with the Megabucks draw performed by the Lottery, the cost could be much more significant.

Recommendation:

The Lottery should establish incident handling and reporting policies and procedures over its critical activities to assist in monitoring the sufficiency and effectiveness of its significant control processes.

Auditee Response:

We concur in part.

The Lottery has a security policy on fraud that was adopted in November 2003, this was distributed to all employees at that time and is redistributed yearly. It is also in electronic format

where all employees can access it. The Lottery also has an employee code of ethics policy that employees are required to read and sign every year as part of the employee review process.

Lottery documentation, relevant to the two drawing incidents mentioned above by LBA, included auditor draw reports, detailed draw incident memos prepared by the draw supervisor, VHS live draw tape reports, Tri-State meeting minutes, and a memo to all Draw Team employees on procedures. There were also discussions conducted by Lottery management with the draw supervisor and auditor on duty shortly after the incident occurred and subsequently thereafter Lottery management reviewed the drawing security tapes, as well as well as notifying the proper authorities including the Tri-State Commission. Incident handling and reporting policies will be documented with a direct line of authority so that all employees will have a clear process for their reaction to possible occurrences. Completion date would be September 30, 2005.

LBA Rejoinder:

The applicability of the documentation listed by the Lottery to the subject of the comment should be clarified. The documents listed by the Lottery do not report how the situations that led to the error draws were not detected and corrected prior to the draws. Additionally, none of the documents provided evidenced that the causes of the problem draws were established and appropriately handled. While the incipient cause may have been balls sticking in the machines, ultimately it was the responsibility of the employees and others in the room to ensure that all machines were properly prepared prior to the draw. Whether it was a lack of employee training or attention that allowed the misdraws to occur, there was no documented evidence that management made an analysis of the risk of a reoccurrence and undertook the appropriate response to that risk, including establishing policies and procedures for the controlled handling of problems that may occur in future draws.

Observation No. 4: Statutes And Administrative Rules Should Be Reviewed For Continued Applicability

Observation:

The Lottery does not periodically review the State statutes and administrative rules regulating its activities to ensure statutes and rules continue to be relevant.

Certain State statutes regulating the activities of the Lottery appear to be in conflict with other statutes or no longer relevant to Lottery operations. Certain administrative rules, which remain in effect, relate to games that have been discontinued by the Lottery and are no longer offered.

For example:

- RSA 284:21-d sets the compensation for a member of the Lottery Commission at \$2,400 per year while RSA 94:1-a, II provides the salary for a commissioner to be \$7,375 and the chairman's salary to be \$13,829.

- RSA 284:21-h, II (d) provides a five percent commission as the sole compensation for selling tickets; however, RSA 284:21-s provides for the payment of cash incentives above the five percent provided for in RSA 284:21-h, II (d).
- RSA 284:21-h, IV and V appear vestigial as they address advertising and ticket sales authorization and limits that do not reflect current Lottery practices.
- N.H. Admin. Rules, Chapters Sw 1100, 7000, and 8100 relate to games no longer offered by the Lottery.

Allowing outdated and conflicting statutes and rules to remain unaddressed can obfuscate the statutory and administrative rule authority for the operation of the Lottery and negatively impact the ability of the Lottery to remain in compliance with these statutes and rules.

Recommendation:

The Lottery should regularly review all statutes and rules pertaining to Lottery operations to ensure the statutes and rules remain current and relevant to Lottery operations.

The Lottery should request amendments to statutes where appropriate to clarify or resolve apparent conflicting or vestigial statutes. The Lottery should seek to have outdated administrative rules repealed.

Auditee Response:

We concur.

Rules for chapter 1100, 7000 and 8100 relating to lottery games will be repealed. This process should be completed by December 31, 2005. Statutes will be reviewed and any changes deemed needed by the Commission will be submitted for correction or deletion. This process should be completed by June 30, 2006.

Observation No. 5: Accountability For Cash Collected In The Sales Office Should Be Improved

Observation:

Accountability over sales receipts in the Lottery sales office could be improved.

Ticket sellers in the sales office are responsible for cashing out their terminals, including counting the cash drawer, separating out the starting cash and change balance, and placing the remaining cash and a balancing report into a locked cash bag for further processing the next day. The following day, an account tech reconciles the cash bag to the day's activity and notes any overages or shortages for management's review. Because the initial count of the day's proceeds is not confirmed prior to the proceeds being transferred to a second employee, the responsibility for any overages or shortages cannot be definitively established. The accountability for any

shortage reported by the account tech could be the responsibility of either the ticket seller or the account tech.

Recommendation:

The Lottery should review the current collection and balancing procedures performed for the sales office to minimize the risk that employees may become vulnerable to improper assignment of responsibility for shortages or overages. The Lottery should consider whether revised procedures could be implemented to increase accountability over these proceeds. Procedures could include dual counts of proceeds prior to or upon their transfer to the account tech or requiring the ticket seller to prepare and make the bank deposit.

Auditee Response:

We concur.

There will be a dual count of the ticket seller funds prior to the accounting tech receiving these funds. This process will be done immediately.

Observation No. 6: Policies And Procedures Should Be Established For Calculating Unclaimed Prize Liabilities

Observation:

The Lottery has not established policies and procedures to guide its employees in developing accounting estimates for unclaimed prize liabilities.

Annually as of June 30, the Lottery estimates the amount of claims that will be paid in the subsequent fiscal year for winning tickets that were sold prior to the end of the current fiscal year. The Lottery estimated a total unclaimed prize liability of \$1.9 million at June 30, 2004 for its Instant, Powerball, and Hot Lotto games. The accounting estimates are prepared by accounting personnel based on prior year's experience and review of prior year calculation documents.

In developing its estimate for the Powerball game liability at June 30, 2004, the Lottery used historical data to obtain a three-year average of the percentage of prizes that do not get claimed. Instead of applying this percentage against the same activity base to compute the June 30, 2004 estimate, the Lottery adjusted the base prior to applying the percentage. While this calculation methodology was consistent with the calculation used in the prior year, the prior year estimate resulted in a \$288,000 overstatement of the liability at June 30, 2003. Because of the adjustment made in the fiscal year 2004 calculation, the June 30, 2004 liability is likely to also be overstated.

The liability amount, like all other accounting estimates, should be based on knowledge and experience about past and current events and assumptions about future conditions. Because estimates are based on subjective as well as objective factors, it may be difficult for management

to establish controls over them, yet an entity's internal control may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of internal control include:

- Management's communication of the need for accounting estimates;
- Accumulation of relevant, sufficient, and reliable data on which to base the estimate; and
- Adequate review and approval of the accounting estimate by appropriate levels of authority, including relevant factors, assumptions, consistency with prior periods, and review of prior period estimates with subsequent results to assess the reliability of the process to develop estimates.

While the Lottery understands the need for making the liability estimate, it has not consistently performed the review and approval of the amounts accrued, including a comparison of the prior period estimates with the subsequent payments, to assess the reliability of their process to increase the accuracy of the estimated liability amounts.

Recommendation:

The Lottery should establish policies and procedures covering the calculation of unclaimed prize liability. The policies and procedures should provide controls to improve the reliability and accuracy of the accounting estimate.

Auditee Response:

We concur.

The Lottery has always had procedures for the calculation of unclaimed prize liabilities. For instant tickets a calculated estimate has to be performed based on past history. The online games have system reports that tell us exactly what the legal prize liability is, but due to a past LBA audit observation the Lottery adjusts this amount by an estimated amount of prizes that may never get claimed. In response to the auditor's suggestion during this year's audit process we documented a method for adjusting the online games' system reported liability. These processes have been amended and documented in an electronic format. The Lottery believes that if fiscal year 2004 [prize liability] is overstated it will only be \$68,000.

Observation No. 7: Disaster Recovery Plan Should Be Completed And Periodically Tested

Observation:

The Lottery's updated disaster recovery plan remains incomplete and has not been subject to a comprehensive test to ensure the plan would protect the Lottery from unreasonable interruption in the event of an unforeseen future event or occurrence that makes continued operations using the Lottery's headquarters or systems problematic.

This comment was first noted during the fiscal year 2001 audit and subject to a continuing comment in the fiscal year 2002 audit. While the Lottery has apparently continued to work on its plan, the following weaknesses were noted.

- The plan identifies the Connecticut Lottery as a backup drawing site, however no formal agreement with Connecticut has been finalized. The Lottery has not identified a contact person or provided directions for personnel to get to the draw site. Additionally, there is no indication that the Lottery has determined whether the machines and accoutrements are compatible for the Tri-State draws and no procedures have been established to address how to proceed if a draw could not be held on time, etc.
- The plan does not address how the public would be notified of important details such as where to claim prizes in the event the Lottery headquarters is unavailable, whether draws will take place on time, who to call to gain more information, etc.
- The plan does not establish a program of periodic testing of the plan and documentation of testing results, including assumptions made, outcomes, where improvements or changes need to be made, etc. The Lottery has tested certain components of the plan such as determining that the State's accounting systems (NHIFS and GHRS) could be accessed from its backup site (another State agency) for State accounting purposes, including viewing payment vouchers in NHIFS and payroll in GHRS, and performing inquiries in the Games Management System, to ensure that the Lottery could view the information. However, testing of data entry has not been performed.

Recommendation:

The Lottery should continue in its efforts to complete the update to its disaster recovery plan. The plan should address all significant areas of risk to the Lottery's operations.

The plan should be periodically tested with the results of the tests subject to analysis to ensure that the plan performs as intended and minimizes the risks to continued operations from an unforeseen event or occurrence that makes continued operations using the Lottery's headquarters or systems problematic.

Auditee Response:

We concur.

The Disaster Recovery Plan has been an evolving document and we will continue adding and deleting from this document. A few months ago the Tri-State Commission entered into an agreement with the Multi-State Lottery to conduct back-up drawings in the event of an emergency. In October 2004 the Lottery's Office of Information Technology (OIT) staff person was asked to update the plan with the new backup draw information. For a reason not yet determined this was not done. The plan is now updated with the new backup draw procedures. Most parts of the plan were tested but not fully documented. Periodic testing will continue and the test results documented. This will be done in conjunction with the OIT. The Lottery will work with OIT to coordinate dates for testing, therefore a completion date cannot be established at this time.

Observation No. 8: Audits Of The Gaming System Vendor Should Include Tests Of The Effectiveness Of Controls

Observation:

Recent service auditor's reports of the Lottery's gaming system vendor have not included tests of the effectiveness of controls. The most recent service auditor's report that included testing the effectiveness of the vendor's system controls impacting the Lottery's operations (type 2 report) was performed during fiscal year 2000. Since 2000, the service auditor's reports covering the Lottery's gaming system's operations have not included testing controls (type 1 reports).

The Lottery contracts with a gaming system vendor to obtain a number of critical services including:

- A central processing site for the New Hampshire Lottery,
- Duplexed central and hot-back-up site computer systems,
- Online games and instant ticket validation software,
- System operators,
- Telecommunications interface,
- Historical and real-time management reporting,
- Retailer terminals and supplies,
- A call center,
- Customer service representatives to provide repairs and training, and
- Development and testing support.

The Lottery is highly dependent upon the controls in its contracted gaming system in operating a controlled and secure lottery. In an effort to ensure that the controls at the gaming system vendor are relevant to the requirements of the Lottery and sufficient to the needs of the Lottery, the Lottery's Request For Proposal (RFP) for gaming system services specified that the successful vendor would be required to have a Statement on Auditing Standards No. 70 (SAS 70) type audit performed annually. However, the RFP and resulting contract was silent as to whether the audit should be a type 1 or type 2 audit.

SAS 70 describes two types of service auditor reports that may be issued. These reports are generally referred to as type 1 and type 2 reports. While both type 1 and type 2 SAS 70 audit reports provide a description of the service organization's controls that may be relevant to a user organization's internal control, whether such controls were suitably designed to achieve specific control objectives, and whether they had been placed in operation as of a specific date, only the type 2 audit includes auditor testing of the controls to determine that controls were operating with sufficient effectiveness to provide reasonable assurance that related control objectives were achieved during the period specified. The SAS 70 reports received by the Lottery since the fiscal year 2000 report have provided no assurance that controls intended by the vendor and described in the SAS 70 reports were operating effectively.

Recommendation:

In order for the Lottery to have greater confidence that its operations, including those significant portions performed by its gaming systems vendor, are operating in a secure and controlled manner, the Lottery should require its vendor to have a type 2 SAS 70 audit performed regularly on its Lottery related operations.

Auditee Response:

We concur.

A type 2 SAS 70 audit was performed four years ago with the start up of a new system. Since then there have been no major system changes. A type 1 SAS 70 audit has been performed annually since the type 2, and in addition to that there have been periodic reviews through other independent system security audits, as noted in the response to observation No. 1. As mentioned in an earlier response, the Lottery also has a computerized internal control system, supported by an independent vendor that performs a daily audit of the main gaming system wagers and prizes. The Lottery will request the on-line vendor to have a type 2 SAS 70 audit performed for FY06.

Observation No. 9: General And Information Technology Security Measures Should Be Reviewed

Observation:

The changes that have occurred with the Lottery's information technology (IT) personnel being transferred to the State's Office of Information Technology (OIT) provide an opportune time to perform a general security review of Lottery operations.

As of late October 2004, the Lottery's IT personnel were transferred to OIT. General office security duties that had been the responsibility of the Lottery's IT staff were transferred to the Lottery's Games Manager, reportedly pending the creation and filling of a Lottery Security Officer position.

A number of areas were noted during the audit where the Lottery could tighten its security over its operations. For example:

1. The equipment in the Lottery's computer room is not secured in locked racks or closets to prevent unauthorized access to the equipment and to minimize the risk of other intentional or unintentional damage to the equipment.
2. Access to the Lottery's computer room is controlled by keypad and card key locks. Certain Lottery employees have unrestricted access to the computer room. There is no policy requiring a periodic review of employee computer room access rights and comparison to job responsibilities to ensure that the employee access privileges remain consistent with current responsibilities.

3. The Lottery's *Information Technology Procedures and Policy Manual* has not been updated to reflect changes that have occurred in the Lottery's operations with the transfer of Lottery IT personnel to the OIT.
4. The Lottery's security policies do not address the placement and review of security cameras and the videotape from those cameras. While electronic locks record the card codes and personal identification numbers used to unlock the doors, the security videotapes provide the best evidence of how many individuals enter the Lottery building after normal business hours.
5. The Lottery's security policies do not prohibit employees from bringing non-Lottery individuals into the building after hours. While the policy does state that "any building employee allowing access to outside individuals will be held responsible for their behavior and is to remain with them at all times" it appears the Lottery is accepting an unnecessary risk by allowing outside people into its building after hours.
6. The Lottery does not periodically review building security videotape other than the videotape of the daily draws. The building security videotapes are not periodically reviewed for suspicious or illegal activity or unauthorized access into or within the building.

Recommendation:

The Lottery is responsible for instituting and monitoring a security policy sufficient to protect the Lottery's resources and integrity. The Lottery should review its general and IT security measures to ensure that the controls in place are suitable for the Lottery's operations. The Lottery should emphasize to its employees the importance of public confidence in the security of the Lottery's operations and the potential impact of even a seemingly minor security breach to the public's sense of confidence in the fairness of the Lottery operations. The Lottery should increase its monitoring efforts to ensure that the controls in place are operating and providing the intended effects.

Auditee Response:

We concur in part.

The Lottery takes the issue of lottery security very seriously. As stated in our response to observation No. 3, the Lottery has a security policy on fraud that was adopted in November 2003; this was distributed to all employees at that time and is redistributed yearly. It is also in electronic format where all employees can access it. The Lottery also has an employee code of ethics policy that employees are required to read and sign every year as part of the employee review process. Management has always strived to make employees and retailers aware of the importance of public perception. It is a topic that is discussed and considered often.

A new position has been established for a lottery security officer. These security issues will be addressed by this employee and management. The Information Technology (IT) issues are being addressed working with the Office of Information Technology (OIT). A mutually agreed to completion date has not been established.

A security audit was performed in Fiscal Year 2002 by KPMG. As stated in response to that audit, the Lottery does not feel that the first bullet is cost effective, since the equipment is located in a room that is locked and has restricted access. In fiscal year 2002 the cost of obtaining lockable security racks was approximately \$12,000 for two, not inclusive of any additional costs for the proper cooling and ventilation.

In response to bullet #2 the Lottery initiated periodic reviews of employee access throughout the building in accordance with a suggestion from an earlier KPMG security review. The Lottery will document the procedures for this review process.

Observation No. 10: Policies And Procedures Should Be Established For Handling Delinquent Agent Accounts

Observation:

The Lottery does not have written policies and procedures covering its employee's handling of delinquent agent accounts and bad checks.

The Lottery apparently relies upon its training processes and experience of its employee responsible for performing the duties related to delinquent accounts. There are no policies and procedures to guide the employee in making decisions as to:

- The number of bad payments an agent is allowed before a bond is required,
- How long an agent has to make good a prior bad payment,
- Which agents with uncleared bad payments are allowed to continue to sell tickets,
- When an agent's status is to be categorized as delinquent, and
- How many and what types of attempts are made to collect delinquent amounts prior to requesting the amount to be written off.

The Lottery employee responsible for delinquent accounts relies upon experience and circumstances to make these decisions.

Decisions made based on an employee's experience without regard to established policies and procedures are subject to increased risk of inconsistent application and application not in conformance with management's intention. Lack of established policies and procedures contribute to inefficiencies when functions have to be performed in the absence of the employee regularly assigned these responsibilities and places the organization at great risk of a disruption of operations if the responsible employee terminates employment on short notice.

Recommendation:

All significant Lottery operations should be covered by appropriate policies and procedures including its handling of delinquent agent accounts. All such policies and procedures must be documented and distributed to be effective.

The policies and procedures should be established with an appropriate level of management involvement and be subject to regular monitoring to ensure that the controls provided by the policies and procedures remain relevant and effective.

Auditee Response:

We concur.

The Lottery currently has policies and procedures established for employees to follow when processing delinquent agents, they will now be formally documented and placed in an electronic format for access by all employees. The expected date of completion would be August 30, 2005.

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APPENDIX

CURRENT STATUS OF PRIOR AUDIT FINDINGS

The following is a summary of the status, as of December 2, 2004, of the observations contained in the New Hampshire Sweepstakes Commission Management Letter for the fiscal year ended June 30, 2003. A copy of the prior management letter can be obtained from the Office of Legislative Budget Assistant, Audit Division, 107 North Main Street, State House, Room 102, Concord, NH 03301-4906.

<i>Internal Control</i>	<u>Status</u>
<i>Reportable Conditions</i>	
1. Investment Account Should Be Reconciled	● ● ●
2. Consistently Account For Accruals Due To/Due From Tri-State Lotto Commission	● ● ●
3. Management Should Monitor Adherence To Contract Provisions	● ● ●
4. Policies And Procedures Should Be Established For Information Technology Change Management And Key Distribution	● ● ●
5. Information Security Issues Identified By Fiscal Year 2001 Security Review Should Be Resolved (See Current Observation No. 9)	● ● ○
<i>Management Issue</i>	
6. Performance Measures Should Be Implemented For Advertising Campaigns	● ● ●

Status Key

Fully Resolved	●	●	●
Substantially Resolved	●	●	○
Partially Resolved	●	○	○
Unresolved	○	○	○

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