

**STATE OF NEW HAMPSHIRE
LOTTERY COMMISSION**

**MANAGEMENT LETTER
FOR THE FISCAL YEAR ENDED JUNE 30, 2010**

To The Fiscal Committee Of The General Court:

We have audited the financial statements of the New Hampshire Lottery Commission (Lottery), a department of the State of New Hampshire, as of and for the fiscal year ended June 30, 2010 and have issued our report thereon dated December 21, 2010.

This management letter, a byproduct of the audit of the New Hampshire Lottery Commission for the fiscal year ended June 30, 2010, contains our auditor's report on internal control over financial reporting and on compliance and other matters and related audit findings. The appendix, included as an attachment to the management letter, provides a summary of the status of observations presented in the fiscal year 2009 management letter of the Lottery Commission.

The Lottery is again submitting its comprehensive annual financial report (CAFR) to the Government Finance Officers Association (GFOA) for consideration for the GFOA's Certificate of Achievement for Excellence in Financial Reporting. A certificate of achievement is a prestigious national award for CAFRs that are prepared in accordance with program standards. The program standards are intended to promote easily readable and understandable financial reports that demonstrate financial accountability and comparability. The Lottery received GFOA certification for its 2009 CAFR, and it is believed that the 2010 CAFR also conforms to the certificate of achievement program requirements. A copy of the Lottery's 2010 CAFR can be obtained from the New Hampshire Lottery Commission, 14 Integra Drive, Concord, NH 03301. The Lottery CAFR can also be accessed online at <http://www.gencourt.state.nh.us/lba/audit.html>.

Office Of Legislative Budget Assistant

December 21, 2010

**STATE OF NEW HAMPSHIRE
LOTTERY COMMISSION
2010 MANAGEMENT LETTER**

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* Audit comment may require legislative action.

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

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 New Hampshire Lottery Commission as of and for the fiscal year ended June 30, 2010 and have issued our report thereon dated December 21, 2010. 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 Lottery Commission's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Lottery Commission's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Lottery Commission's internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying audit comments, we identified a certain deficiency in internal control over financial reporting that we consider to be a material weakness and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of 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. We consider the deficiency described in Observation No. 1 to be a material weakness.

A *significant deficiency* is a deficiency or a combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in Observations No. 2 through No. 8 to be significant deficiencies.

Compliance And Other Matters

As part of obtaining reasonable assurance about whether the 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*. However, we noted immaterial instances of noncompliance which are described in Observations No. 9 through No. 11.

The Lottery Commission's written response to the observations in this report have not been subject to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This report is intended solely for the information and use of the management of the New Hampshire Lottery Commission, others within the Lottery Commission, and the Fiscal Committee of the General Court, and is not intended to be used by anyone other than these specified parties.

Office Of Legislative Budget Assistant

December 21, 2010

Internal Control Comments
Material Weakness

Observation No. 1: Risk Assessment Should Be Performed

Observation:

The Lottery did not perform risk assessment procedures during fiscal year 2010 even though there were significant changes in the Lottery's operations that increased the risk to those operations.

Risks affecting an entity must be periodically assessed so that the entity can be proactive in its response to those risks. Otherwise the entity is forced to operate in a reactive mode, often after a loss has been incurred. The Lottery has developed risk assessment policies and procedures, which indicate risk assessments are to be performed semi-annually, in June and December, or more frequently. However, the Lottery reported it did not adhere to its risk assessment policies and procedures during fiscal year 2010.

During fiscal year 2010, the Lottery experienced turnover in its long-held Executive Director position and prepared for the July 1, 2010 implementation of a new gaming system serviced by a new gaming system vendor. The gaming system is critical to the controlled processing of essentially all Lottery sales.

The change in the Lottery's gaming system came at a time when the Lottery no longer had embedded information technology (IT) employees and relied upon Department of Information Technology (DoIT) support personnel who reportedly had relatively little experience with the Lottery's systems. No formal reassessment of IT risks was performed during fiscal year 2010, in spite of the pending implementation of the new gaming system.

An example of where the performance of a well-designed risk assessment would have been beneficial includes the Lottery's use of its Replay Program system to draw prizes for certain instant ticket games. The Lottery's Replay Program system was designed as a marketing program, which included a system for drawing winners from submitted entries. During fiscal year 2010, the Lottery began to use the Replay Program system to select second-chance winners from certain of its instant ticket games. As noted in Observation No. 4, the Lottery has not fully reviewed and documented the controls in the Replay Program system to ensure the system controls are sufficiently robust for that purpose. The Lottery's advertising vendor maintains the Replay Program, including the related IT system. The Lottery does not perform any procedures to ensure the entries are secure, the population from which the winner is selected is complete, and the method of selection is appropriate. The Replay Program is not covered by the Lottery's disaster recovery plan, and is not independently reviewed and tested to establish that controls are in place and operating as intended. During fiscal year 2010, the Lottery awarded \$200,000 in top prizes using the Replay Program.

Recommendation:

The Lottery should perform periodic risk assessments as provided for in its policies and procedures. Action should be taken to mitigate identified risks.

The Lottery should perform, or have performed, a risk and controls review of the Replay Program system to ensure the design and operation of the controls in the Replay Program system are appropriate for the Lottery's use, including for awarding instant ticket game prizes.

Auditee Response:

We concur. During fiscal year 2010 we did have changes in the Executive Director position with an interim for a period of time. We also had a new on-line games system that was activated on July 1, 2010 and the Lottery accounting system was changed to the Lawson system statewide program. The risk assessment group will continue to review the Lottery operation in accomplishing its mission. This will include the Replay program.

Significant Deficiencies

Observation No. 2: Controls Over Lottery's Assets Should Be Strengthened

Observation:

The Lottery reported a total of nearly \$7.7 million of assets at June 30, 2010. Those assets included cash, accounts receivable, instant ticket inventory, prepaid expenses and prizes, restricted deposits, and capital assets. We noted instances of weak controls over these assets.

1. The Lottery has not established policies and procedures for its annual physical inventory count of instant tickets. The lack of policies and procedures may have contributed to an ineffective inventory cut-off control between the time of the count and the end of the fiscal year.
 - Lottery received a shipment of instant tickets on June 30, 2010, subsequent to the physical inventory count on June 24. The accounting department was not made aware of the receipt of the tickets and, as a result, the Lottery failed to recognize the \$70,000 cost of the tickets in its preliminary June 30, 2010 financial information. This amount was adjusted in the financial statements when the auditors notified the Lottery of the oversight.
2. The Lottery did not ensure physical safeguards were operating as intended over the instant ticket inventory stock. During fiscal year 2010, an electronic door lock intended to separate individuals with incompatible gaming system access from unnecessary access to the ticket stock was not consistently kept locked. On July 15, 2010, Lottery reported the door remained unlocked due to continuing problems with the electronic door lock.

The Lottery's decision to void the control provided by the locked door without instituting mitigating controls is a significant control deficiency, as it increased the potential for uncontrolled access to the ticket stock inventory, which increases the risk of errors or frauds involving Lottery tickets. Such apparent inattention to controls can diminish an organization's control environment, including employees' understanding of the importance of control compliance.

3. The Lottery does not maintain inventory records for merchandise prizes acquired for certain instant ticket games. During fiscal year 2010, the Lottery's game vendor purchased and held motorcycles, prepaid gas and music download cards, and other merchandise prizes on behalf of the Lottery. The merchandise prizes are generally held and distributed by a third-party vendor, at the direction of the Lottery. The Lottery does not maintain a centralized listing of the prizes on hand with the vendor, and relies upon the vendor's prize-fulfillment reports to track the distribution of the prizes paid. The vendor does not report to the Lottery the number or value of prizes on hand at any given point in time. The Lottery does calculate the value of prizes on hand for year-end financial reporting purposes as the number of prizes purchased less the number awarded multiplied by the unit cost. Due to the Lottery using an inaccurate

unit cost in its June 30, 2010 calculation, the Lottery overvalued its calculated merchandise prizes on hand by approximately \$18,000.

4. Responsible personnel did not make the Lottery's financial management aware when they did not complete several significant financial control processes near year-end. Lottery's accounting personnel did not perform monthly reconciliations of the cash account for the final three months of fiscal year 2010 and did not reconcile and adjust certain accounts receivable for Lottery games, including determining and posting an accounts receivable write-off for approximately \$40,000 deemed uncollectible at June 30, 2010. The responsible employee reported an overwhelming workload prevented the completion of the reconciliations. The Lottery's financial management reported it was unaware the reconciliations had not been performed.
5. The Lottery does not have adequate policies and procedures in place to ensure that its share of the reported Multi-State Lottery Association (MUSL) prize reserves is accurate. Lottery reported its MUSL reserves were approximately \$2.3 million at June 30, 2010. In response to a fiscal year 2009 audit observation, Lottery reported it implemented a spreadsheet-based process for weekly review of its MUSL Mega Millions prize reserve; however, the procedures were largely ineffective as they were not supported by policies and procedures and were not fully performed. The Lottery did not implement procedures to monitor and review its MUSL Powerball and Hot Lotto reserves.

These weaknesses could result in misstatement to the financial statements and errors or frauds not being detected and corrected in a timely manner.

Recommendation:

The Lottery's controls over its assets should be strengthened.

1. The Lottery should improve year-end inventory policies and procedures to include procedures to ensure an appropriate cut-off at the time of the observation counts of inventory on-hand and to properly capture and report receipts of inventory that may occur between the time of the count and the end of the financial reporting period. Those policies and procedures should also include increased channels of communication between those responsible for completing the inventory and the Lottery's business office.
2. The Lottery should ensure physical safeguards are operating as intended. Physical safeguards that prove either temporarily or permanently ineffective should be immediately replaced. Increased risk due to known failures of physical safeguards should be mitigated by other appropriate control activities pending repair, replacement, or other correction. Management should demonstrate to employees its concern for control effectiveness and compliance through its timely response to known control failures.
3. A complete inventory should be maintained to track the balance of merchandise prizes on hand. The prize inventory and valuation should also be subject to periodic verification.

4. The Lottery should reestablish monthly reconciliation controls to ensure errors are detected and corrected in a timely manner. Policies and procedures should be expanded to include a reasonable review and approval control intended to ensure the monthly reconciliation controls are performed completely and timely.
5. The Lottery should establish policies and procedures to ensure the Lottery's share of the MUSL prize reserve accounts are accurately reported. The policies and procedures should include well-designed processes that will provide assurance of the accuracy and completeness of the balances reported by MUSL.

Auditee Response:

We concur in part and disagree in part with this observation.

1. This was a gaming conversion occurrence. The previous vendor of 10 years did not load the games received on their last day of their contract, as the games would not be used on their system, the old system. The new vendor, who took over on July 1, could not load the games until July 9, due to a system issue.

The auditors were able to assist us during this extremely critical time with our limited resources in identifying this issue.

2. The Lottery concurs that the door was not working properly.

The failure of the door to work properly caused it to remain locked; this means that employees could not open the door to enter and exit their work area without manually unlocking it with a key.

Leaving the door unlocked was necessary to facilitate employees working in their area and also in support of health and safety reasons. The action taken was authorized for business hours only; the door remained locked at all other times. Further, this particular door is located in the operations area which is not accessible to unauthorized persons.

On or about June 15, 2010, it was reported to management that the door was not functioning properly; the vendor was subsequently notified. On June 17, 2010 the vendor completed an inspection of the door and the electronic lock; all aspects of the door and lock were found to be functioning properly according to the manufacturer's specifications. Since the safeguard was determined to be functioning properly, there was not sufficient justification to incur the cost of a replacement.

The Lottery purposely implements a security program that encompasses a broad range of mitigating controls in all facets of its physical security because it is presumed that on occasion equipment may malfunction. Our personnel are trained, vigilant, and appropriately in charge of their area and over the years, have fostered a great appreciation and strong understanding of the importance of control compliance.

In the event of a similar occurrence, it will be the procedure of the management to meet with personnel assigned to the affected area(s) to discuss and reinforce the importance of control compliance and to oversee the implementation of any other reasonable measures that the circumstances existing at that time may dictate.

3. The Lottery does keep an inventory for merchandise prizes it holds in house. Merchandise prizes held elsewhere are inventoried on the instant ticket liability reports. Accounting has to rely on vendor system reports and other in-house employees to give them the correct amounts.

The Lottery has forwarded spreadsheets detailing merchandise inventory held in the Lottery warehouse. As stated in response to an observation made last year, the vendor will assign special validation codes to merchandise and other non-cash prizes; these codes will be included in the validation files. As prizes are awarded, they will be validated using the codes; as a result, reports can be generated showing the prizes claimed for a game and the balance of remaining prizes. We have not had any new merchandise prizes since the last audit observation.

4. The accounting staff was under pressure during fiscal year 2010 due to the implementation of a new state accounting system. The new system was unable to fully service Lottery as required by GAAP; therefore personnel were required to perform their duties twice, once in the state system and once in an in-house financial system. At the same time frame staff were testing and learning a new gaming system for the Lottery system conversion. Controls were completed, but in later months. During fiscal year 2011 controls already in place should be completed in a more timely fashion.
5. Lottery prize reserves held with MUSL were established in 1995 and do not change by material amounts. The change in funds fiscal year 2011 was \$27,357. The funds have always been looked at on an annual basis by management. Lottery is currently developing spreadsheets to track the small changes and will document them as procedures are established.

Observation No. 3: Compliance With Financial Control Activities Should Be Improved

Observation:

Certain instances were noted where the Lottery's financial controls did not operate as intended during fiscal year 2010. This lack of control effectiveness raises concerns as to whether Lottery employees are fully trained in those control activities. The fact that Lottery management was unaware of the inconsistent control compliance with these financial control activities also raises question as to whether there are effective communication and monitoring efforts in place at the Lottery.

1. A Lottery claims-payment control requires all prize claims exceeding \$599 receive management approval prior to payment. Approval for payment is evidenced by a responsible

party initialing the claim form. During testing of claims payments, we noted two paid jackpot claims, one for \$956,568 and another for \$600,000, that lacked evidence of management review and approval.

In a related matter, approximately five Lottery employees have the access authority in the Lottery gaming system to create a prize and also generate a Lottery prize-payment check without other employee involvement. This lack of segregation of duties over creating a prize and preparing a check to pay the same prize is a significant deficiency.

2. The Lottery requires supervisory approval prior to posting journal entries to the Lottery's financial system. During testing of posted journal entries, we noted four of 20 reviewed journal entries lacked evidence of management's review and approval. This issue was also noted in the fiscal year 2009 audit of the Lottery.

Also, entries to record certain accounts payable as of June 30 were not prepared, reportedly due to miscommunication within the accounting department. The auditors brought these missing entries to the attention of the Lottery and those accounts payable were subsequently recorded.

3. The Lottery prepares a monthly reconciliation of certain Lottery assets. As discussed in Observation No. 2, the employee responsible for preparing the monthly reconciliation discontinued the preparation of those reconciliations during fiscal year 2010 and the Lottery's financial management only became aware of it when the auditors inquired about the status of the reconciliation in October 2010.

Failure to perform and adequately monitor intended financial controls increases the risk that errors or frauds could occur without being detected and corrected in a timely manner.

Recommendation:

The Lottery should improve compliance with its control activities. Employees should be adequately trained in the control activities to ensure they are aware of the control purpose and proper control procedures, including directing employees not to process transactions unless required reviews and approvals are evidenced.

The Lottery should improve its communication and monitoring of its financial control activities. Financial management should proactively monitor controls and respond to changes in the performance and effectiveness of financial controls in a timely manner.

The Lottery should establish appropriate segregation of duties controls over establishing a prize and the preparation of an associated prize-payment check. No one employee should be able to prepare and sign a check without appropriate controls applied to the process.

Auditee Response:

We concur.

1. Lottery management always approves claims paid for more than \$5,000. Lottery management personally presents to winners, all prizes over \$5,000. It is the policy of the Lottery to initial the claims document for processing prizes over \$5,000.
2. It is policy for Lottery accounting managers to approve all accounting entries. All financial statements are examined every month by accounting managers.

The Lottery accounting staff was running two accounting systems, both of which were done very differently. The new state Lawson system could not completely service the requirements for financial reporting of Lottery activities and therefore staff was required to manage two systems. The state's reporting group is working on solving the issues Lottery has with the new state accounting system and will hopefully resolve them in fiscal year 2011.

3. As reported earlier Lottery accounting staff and management had to perform all their duties twice and learn and implement a new gaming system. Lottery anticipates during fiscal year 2011 all of the controls Lottery has had in place will be performed in a timely manner.

Observation No. 4: Replay Program Should Be Fully Documented

Observation:

The Lottery has not fully documented its Replay Program (Replay). While the risks to Lottery operations related to the lack of Replay documentation was also noted in our 2009 audit report, the Lottery did not substantially improve its Replay documentation during fiscal year 2010, even while it expanded its use of the Replay system.

Replay is primarily an Internet-based second-chance game where players can enter non-winning New Hampshire Lottery tickets to win instant prizes or earn Replay points. These points can be used to purchase entries into drawings to win various merchandise prizes, which have been provided by businesses (advertising partners) in exchange for promotional consideration on the Replay website and on on-line tickets. The Lottery and its advertising vendor use demographic information entered by players into Replay in their advertising program. The Replay system is comprised of a website, database, and random number generator (RNG). Drawings are held monthly using the RNG to select winners from the population of entries.

1. The Replay system is operated and maintained by the Lottery's advertising vendor. The Lottery has arranged for the Multi-State Lottery Association (MUSL) to host the Replay website, including the related Lottery player information database. The memorandum of agreement for the Replay Program entered into by the Lottery and the advertising agency at the inception of the program, in conjunction with the advertising contract in effect at the time, outlined certain rights and responsibilities of both the Lottery and the advertising

vendor. However, neither the agreement nor the subsequent contracts addressed the responsibilities for error detection, security breaches, and processing disruptions, nor did it envision MUSL hosting the Replay website.

2. The Lottery relies upon its advertising vendor for the security of personal information, including names, e-mail and residential addresses, and dates of birth collected from players. There are no documented agreements and procedures between the Lottery and its advertising vendor describing the rights and responsibilities for the use and security of that confidential information, including procedures intended to ensure the appropriate maintenance and security for that information.
3. During fiscal year 2010, a Replay advertising partner notified the Lottery, six weeks prior to a prize drawing, that it would not be able to satisfy a contracted prize award due to the close of the business. The drawing proceeded and the winner was awarded a \$5,000 cash prize in lieu of the unavailable prize. The Lottery paid the \$5,000 Replay prize award from its advertising budget. There are no documented procedures to address risks related to vendor or advertising partner performance, including whether bonds or guarantees should be required for significant Replay prizes.
4. During fiscal year 2010, the Lottery began to use the Replay system to conduct second-chance drawings for certain of its instant ticket games. The second-chance games were previously controlled and conducted by the Lottery itself. The top-tier prizes selected by the Replay system for Lottery instant ticket games totaled approximately \$200,000. The Lottery reported it chose to use the Replay system as the method of entering and drawing these second-chance prize winners due to the high volume of potential second-chance ticket entries. Prior to the use of the Replay system for this purpose, the Lottery collected and secured second-chance tickets submitted by players and manually picked winning tickets from a prize drum.

The Lottery used the normal monthly Replay drawings procedures and RNG algorithm to select winners for the second-chance instant ticket drawings. While the RNG algorithm was independently “certified” during the development of the Replay system in 2006, the Lottery has not performed tests and established controls to ensure the validity of the entries included in the population of entries subject to selection by the algorithm. The Lottery relies on the advertising vendor’s implied assurances that all player data and Replay drawing entries are obtained, recorded, and secured. As a result, the Lottery may not be aware if entries were inappropriately included or excluded from drawing populations.

For example, during fiscal year 2008, Lottery detected a Replay system vulnerability that allowed a player to inappropriately add Replay points to their account. The Lottery became aware of this system flaw when, in conducting a Replay drawing, it noted an individual won multiple prizes. Review of the unexpected results by the Lottery and its advertising vendor identified the vulnerability. The Lottery reported a change was subsequently made to the Replay website to eliminate the vulnerability.

While the Lottery has Replay policies or “rules”, distinctive from rules adopted under RSA 541-A, posted on the Replay website that address certain interactions between the Lottery’s Replay and a Replay player, the Lottery does not have documented agreements and procedures addressing critical roles and responsibilities of the Lottery, the advertising vendor, the marketing partners, and MUSL for Replay. The lack of these agreements and procedures increases the risk that critical responsibilities will not be understood and met.

Recommendation:

The Lottery should ensure that all critical aspects of, and responsibilities for, the Replay Program and system are fully understood and documented by current contracts, agreements, and system documentation, including appropriate policies and procedures.

The Lottery should establish and document the controls provided in the Replay system and determine whether those controls are sufficient to support the Lottery’s use of the Replay system to draw Lottery game prizes. Those documented controls should include information technology general and application controls, program change controls, regular plans of system testing, and reviews of the security over the Replay system and the information the system contains.

As noted in our recommendation to Observation No. 1, the Lottery should perform or have performed a risk and controls review of the Replay Program system to ensure the design and operation of the controls are appropriate for the Lottery’s reliance on the system for awarding prizes and maintaining confidential information.

Auditee Response:

We concur in part with this observation. However, we assert that the Replay program is documented.

1. The Replay website is hosted by MUSL. Since it is hosted by MUSL, error detection, security breaches, and processing disruption are the cumulative responsibility of the NH Lottery, its advertising vendor, and MUSL. MUSL performs vulnerability scans twice a year on all websites hosted by their organization. Further, upon request of a lottery, MUSL will also perform additional scans on an as needed basis.
2. The policies and procedures which govern the Replay program document the following in regard to security of personal information and maintenance of said information include the following.

15.0 Privacy Policy:

Your e-mail address will not be sold or shared with any outside parties. The NHLC does not sell, rent, share, or otherwise disclose mailing lists or other personally identifiable information. Participants may choose to opt-in for NHLC Replay® e-mail communications, consisting of program news, NHLC game information, and marketing messages about marketing prize partner companies. E-mail messages will only be sent from the NHLC or its agent, and profiles will not be released to marketing prize partners without expressed electronic consent from the player.

New Hampshire Right to Know state law requires that a winner's name, town, and prize won be available for public information. Street address and phone number is not considered public information unless ordered by a court of appropriate jurisdiction. By agreeing to these terms, the NHLC and promotional partners reserves the right to use your name, town, and image in any promotional materials, including Web site, e-mail, print, TV and/or radio.

16.0 Security Policy:

The New Hampshire Lottery Commission (NHLC) and its web site vendor have taken numerous steps to protect the safety and security of the NH Lottery Replay web site. These measures are designed and intended to prevent corruption of data, block unknown or unauthorized access to our systems and information, ensure the security of any information that is transmitted, and maintain the integrity of the Replay promotion.

The NH Lottery Replay web site is a promotional platform and it is separate and distinct from all other NHLC gaming operations and associated data. The NH Lottery Replay web site is hosted in a secure server environment entirely separate from NHLC gaming operations and networks. Data related to the web site is also maintained in a secure environment separate from NHLC gaming operations and networks.

WARNING -- The NH Lottery Replay system is monitored regularly by NHLC personnel and its web site vendor. If security monitoring reveals possible criminal activity or any attempts to circumvent the security and rules of the game, information pertaining to such activity may be provided to the New Hampshire Attorney General's Office, possibly resulting in prosecution. Additionally, the NHLC will also immediately and without warning revoke a player's Replay membership permanently and all points or prizes that have been awarded.

3. The possibility of a Replay Prize not being available is covered. The substitution of a prize was done pursuant to the policies which govern the Replay program:

Pursuant to 4.2.7 of the NH Lottery Rules: if a prize won is not readily available to be awarded the NHLC reserves the right, in its sole discretion, to substitute another prize of similar value.

4.2 Prize characteristics:

1. Prizes can not be redeemed for cash unless otherwise authorized by the NHLC prior to the drawing.
 2. A prize shall be awarded to the player and address that corresponds with the account that won a prize.
 3. Prizes are non-transferable and non-refundable unless otherwise authorized by the NHLC prior to the drawing.
 4. Any applicable local, state or federal taxes are the sole responsibility of the prize winner unless otherwise stated.
 5. Replay® rules are subject to modification and change and will be posted at www.nhlotteryreplay.com.
 6. The awarding of all prizes is subject to eligibility verification.
 7. If a prize won is not readily available to be awarded the NHLC reserves the right, in its sole discretion, to substitute another prize of similar value.
4. The concept of second-chance drawings for monetary prizes, within the prize structure of a commercially sold game, is being canceled. We currently have four games on sale that contain the second-chance feature and it is anticipated that these drawings will be held within the next 6 months. There are no plans to order games in the future with this feature.

Observation No. 5: Appropriateness Of Instant Ticket Revenue Collection Policies And Procedures Should Be Reviewed

Observation:

The Lottery has not established policies and procedures for controls over the collection of instant ticket revenue from retailers. The lack of documented policies and procedures increases the risk that retailers may not forward revenue from those ticket sales to the Lottery in the most efficient, controlled, and timely manner.

Any delay in settling a book of instant tickets delays the retailer's forwarding the related sales revenue to the Lottery, negatively impacting the Lottery's cash flow and revenue recognition and also increasing the risk for more significant vendor defaults.

Lottery retailers forward instant ticket sales revenue to the Lottery when instant ticket books are "settled". Ticket books are settled when a predetermined percentage of the assumed lower-tier prizes in a book of tickets have been claimed, as tracked by the Lottery's gaming system. The percentage is referred to as the retailer's settlement rate which can be set in the Lottery's gaming system at a rate between 1-100%. Lottery typically sets the settlement rate for new retailers well above 75%. If a retailer is deemed to be a credit risk, Lottery may set the settlement rate for that retailer at a very low percentage. Some larger retailers, for their own inventory-control purposes, settle ticket books immediately upon receipt from the Lottery. At the time of audit inquiry in August 2010, approximately five million instant tickets with sales value of approximately \$10 million were in an activated-for-sale status with retailers. The Lottery has not historically documented its consideration of the amount of Lottery revenue held by the retailers prior to settlement to determine the most efficient settlement rate for the Lottery and its retailers.

In addition, Lottery's timely collection of revenue can be hampered by retailers who sell tickets from multiple books to delay reaching the settlement rate in any book. During fiscal year 2010, Lottery personnel reported they became aware of one retailer who intentionally delayed settling instant ticket books stopping sales from the book prior to reaching the settlement rate. During fiscal year 2010, the Lottery did not have policies and procedures relative to the number of books of tickets retailers may have active at any time and did not regularly track and review that information.

According to the Lottery, the new game management system will allow Lottery to set settlement rates by game as well as by retailer. The new system also features a books active management feature that allows the Lottery to better control the number of books a retailer is allowed to have active in a game at any given time. The Lottery reports these features will lessen the delay in forwarding revenue to the Lottery.

Recommendation:

The Lottery should establish policies and procedures for the collection of instant ticket revenue from retailers. The policies and procedures should include criteria for establishing and maintaining an instant ticket settlement process that promotes both retailer and Lottery

operations. Individuals authorized to set and change settlement rates in the games management system should be provided clear guidelines including measurable criteria to establish and change settlement practices to ensure management's expectations in that process are followed. Procedures for monitoring retailer sales activity, and evidence of that monitoring activity, should be documented.

The Lottery should perform an analysis of Lottery revenues held by retailers pending settlement of books of instant tickets with the intention of determining the most efficient settlement rates that expedite the collection of revenue by the Lottery without placing unnecessary burden upon retailers. The Lottery should actively monitor and control retailer settlement rates to lessen the risk that Lottery revenues are not collected and deposited by the Lottery as soon as practical.

The Lottery should take advantage of the enhancements in the new games management system, which reportedly provides increased ability to control and monitor retailer sales of instant tickets and their timely forwarding of those sales revenues to the Lottery.

Auditee Response:

We concur.

The Chief Accountant did review this topic and made recommendations.

The Lottery has been performing an analysis of this issue and will be making changes to accomplish a better processing of the instant ticket settlements from the retailers and a more timely collection of funds.

Observation No. 6: Only Advertising Costs Should Be Charged To Advertising Accounts

Observation:

The Lottery charged a total of approximately \$1,400 for meeting expenses to its New Hampshire and Tri-State advertising accounts, even though the meetings did not appear to be advertising related. The Lottery requested its advertising contractor to initially cover the costs of the meetings and to charge the meeting costs back to the Lottery through the advertising contracts.

The State's operating budget for fiscal year 2010 appropriated \$2.1 million for advertising and marketing of the Lottery's New Hampshire games. In addition, the Lottery budgeted \$1.3 million in its Tri-State budget plan for fiscal year 2010 for marketing Tri-State games in New Hampshire. The Tri-State Policy No. 10 provides that, "The participant states may expend their advertising dollars at their own discretion provided that these monies are expended only for the promotion of Tri-State products." Amounts budgeted by the Lottery in the Tri-State budget plan are not subject to the State budget or expenditure controls.

The Lottery's advertising contractor invoiced the Lottery for the following meeting costs at the direction of the Lottery.

1. A review of the supporting documentation for \$847 charged to the Lottery's State advertising budget indicated the amount was to reimburse the Lottery's advertising agency for a breakfast buffet for 30 people. According to the Lottery, the food was for a Governor and Executive Council breakfast meeting at the Lottery Commission headquarters. According to the Lottery, due to a lack of payment options on short notice, the Lottery contacted its advertising vendor who agreed to pay the caterer on behalf of the Lottery and invoice the Lottery for the full amount through the advertising contract. The Lottery then paid the invoice and recorded the expense as an advertising contract expense.
2. The Lottery split a \$545 invoice equally between the New Hampshire's Tri-State advertising budget and the Lottery's State advertising budget to reimburse the advertising agency for food purchased for a Tri-State meeting. A review of the Tri-State meeting minutes did not reveal any information that would indicate the meeting was to discuss the marketing and promotion of the New Hampshire Tri-State or State Lottery games.

The Lottery acknowledged neither expense was advertising related.

A similar comment was included in our prior management letter for the fiscal year ended June 30, 2009.

Recommendation:

The Lottery should only charge advertising expenses to its advertising accounts.

The Lottery should not direct its advertising contractor to improperly invoice non advertising expenses through the advertising contract. Advertising expenses should be limited to promotion of the games.

The Lottery should develop policies and procedures that define what constitutes an advertising expense and when such expense can be charged to its advertising accounts.

Auditee Response:

We concur, but note as follows.

1. During the Governor and Council Breakfast – ways to increase sales through marketing our products and advertising them were discussed by the Governor, the Executive Council members, the Lottery Commission and Executive Director. Moreover, the breakfast itself was covered in media reports, garnering for the Lottery earned media coverage.
2. Following the Tri-State Meeting held, a lunch was served to members of the Maine, New Hampshire and Vermont Lotteries to further discuss our products. This included the meeting

before the meal was served which documents the extensive discussion of our products, financial updates, marketing/advertising/product development updates.

However, the Lottery will continue to monitor the advertising expenses for proper classification.

Observation No. 7: Policies And Procedures For Accessing The Draw Room Should Be Expanded

Observation:

The Lottery's policies and procedures for controlling access to the room in which it performs prize drawings (draw room) do not address non-draw related access to the room and the equipment in the room. The draw room contains the equipment used to draw winning ticket numbers for Lottery and Tri-State games.

The Lottery's Winning Number Draw Policies and Procedures Manual provides specific policies and procedures for controlling access to the draw room at the time of a drawing. The policies and procedures include requiring all members of the draw team enter and exit the draw room at the same time and to log the entries and exits to the room. There are no policies and procedures controlling access to the draw room for purposes other than conducting a draw. While the Lottery's security system limits access to the draw room through the use of a computerized keypad lock and log, employees with keypad authority are allowed unaccompanied access to the room without being required to log a valid purpose for their access

A review of a draw room access report for the month of May 2010 indicated authorized employees accessed the draw room 15 times outside of normal draw times. While, as noted above, the Lottery does not require documenting the purpose for unscheduled entry into the room and there is no available documentation to support the non-draw access to the room, the Lottery reports unscheduled access to the room is not considered unusual and is generally related to an employee retrieving tapes, paperwork, and other items that may have been unintentionally left behind when exiting the draw room after a draw. The individuals entering the room outside of the normal draw time are not accompanied by another authorized employee, which is inconsistent with the policy requirement that all draw personnel enter and exit the room at the same time.

It appears the Lottery has not fully considered the risk associated with accessing the draw room outside of normal draw times and its impact on its ability to maintain the integrity of the draw room and the equipment in the room.

Recommendation:

The Lottery should establish policies and procedures for controlling access to the draw room and equipment in the room, including access for other than draw purposes. Access should be limited to documented need and monitored by appropriate security protocols.

Auditee Response:

We concur.

The policy and procedures for controlling access to the draw room will be updated.

For non-draw times, employees with access to the draw room may enter to:

- 1) Retrieve records of drawings
- 2) Retrieve related camera equipment
- 3) To respond to an alarm/emergency
- 4) For vendor to maintain equipment
- 5) For any further disaster recovery

The draw room is monitored by security at all times. In the event that entry to the draw room is necessary at non-draw times, and for reasons other than for emergency purposes (no. 3), written notification will first be made to the Lottery Security Director or the Security Director's designee.

Observation No. 8: Access Controls Should Be Improved

Observation:

Access controls to the Lottery's games management system (GMS) during fiscal year 2010 were not sufficiently designed to ensure management's ability to limit access to authorized employees whose job responsibilities require that access.

Information technology (IT) access controls are the policies and procedures designed to restrict access to data processing assets and systems only to the usage authorized by management. The fiscal year 2009 audit of the Lottery noted controls over access to the GMS had an unintended weakness as one employee had the access authority to make changes to employee access permissions, including her own, without the knowledge of any other Lottery employee and without the changes being logged and reviewed. The Lottery reported this weakness continued during fiscal year 2010, due to the Lottery's then GMS vendor being unwilling to make the necessary improvement to the GMS during the last months of the contract. While the Lottery reported it intended to incorporate an automated log to permit review of access permission changes as part of its July 1, 2010 conversion to the new GMS system, referred to as the back office system (BOS), that log had not been implemented as of September 29, 2010.

The Lottery self-identified an access control weakness inherent in the BOS. The BOS access controls are assigned to groups and all employees in a particular group are provided access to BOS functions required by that group. The BOS does not provide for the modification of the access authority of an individual member within a group that may be necessary to ensure an appropriate segregation of incompatible functions. For example, employees of a group who need access to merchandise inventory are granted access to all inventory which includes instant ticket

inventory. The segregation of responsibilities for employees with the ability to activate or otherwise change the status of instant tickets within BOS from also having physical access to the instant ticket inventory is of critical concern and was violated by the BOS group access granted to the employee group with merchandise inventory duties. As of December 2010, The Lottery reported it was continuing to work with the BOS vendor to find a solution to the BOS granting incompatible functional access authorities.

Lottery personnel also expressed concern regarding the BOS vendor acting on Lottery employee requests for increased user access permissions without requiring the vendor to first verify Lottery management's authorization for the change. The inability of management to control BOS access changes leads to an increased risk of fraud and errors.

Recommendation:

The Lottery should work with the new gaming system vendor to improve BOS access controls. The Lottery should review the vendor's current group determinations and related access permissions to identify instances that allow access to incompatible functions. The Lottery should continue to work with the vendor to develop access controls that will allow the efficient granting of access authorities, yet provide for restrictions of authorities where appropriate.

The Lottery should establish appropriate policies and procedures for the controlled changing of BOS access authorities to ensure that the vendor only acts upon requests that have originated with appropriate Lottery management authorized to direct those requests.

The Lottery should establish appropriate policies and procedures for the periodic review of employee access and changes made to that access to ensure that access remains appropriate for the employees' current job responsibilities.

Auditee Response:

We concur.

As observed, the Lottery and the new gaming vendor have had a series of meetings to discuss access controls and to identify a solution that is agreeable to both parties.

In late January 2011, both parties met again and agreed to implement a pilot modification to the BOS that is intended to restrict access authorities to an individual level rather than at group designation. The pilot will consist of several employees whose user authorities are currently characteristic of the "access control weakness". In discussion, we are optimistic that the modification will not reduce efficiency to a level that would be disruptive to operations. If the pilot is successful, it will be the Lottery's intention to implement the modification to all BOS users.

In conjunction with the implementation of a permanent solution to the access controls issue, the Lottery will continue to work with the vendor to develop an electronic reporting method that

encompasses all aspects of user roles and that maintains data at sufficient levels in order to conduct in depth periodic reviews of user status.

The Lottery will formulate a new policy and procedure reflective of the new gaming system parameters which will eliminate the possibility of unqualified requests for access authorities.

State Compliance Comments

Observation No. 9: Tax Status Of Tri-State Lotto Prizes Should Be Determined

Observation:

Application of the State's tax on lottery winnings to Tri-State Lotto game prizes is contrary to RSA 287-F:17, which provides "prizes received pursuant to this [Tri-State Lotto] compact shall be exempt from all state, county, municipal and local taxes within the party state." This issue was also reported in the fiscal year 2009 audit of the Lottery Commission.

Chapter 144:249, Laws of 2009, effective July 1, 2009, amended RSA 77 to provide for a 10% tax on gambling winnings. The chapter law also repealed RSA 284:21-r relative to the tax exempt status of lottery and sweepstakes winnings. The chapter law did not address RSA 287-F:17.

RSA 287-F:7, II, provides "the provisions of this [Tri-State Lotto] compact shall apply and take precedence in the event of any conflict between the provisions contained in this compact and the provisions of other laws of any of the party states."

The Lottery has withheld the State's gambling tax from Tri-State Lotto prizes since shortly after the effective date of Chapter 144:249. The Lottery continues to withhold the taxes, even though it is aware of the conflicting statute.

The fiscal year 2009 audit of the Lottery recommended Lottery review with legal counsel, the Department of Revenue Administration, the Tri-State Lotto Commission, and other interested parties the applicability of the tax provisions of Chapter 144:249, Laws of 2009 to Tri-State Lotto prizes and whether revisions of the Tri-State Lotto Compact, RSA 287-F, should be sought. No revisions have been made.

Recommendation:

The Lottery Commission should initiate appropriate steps to resolve conflicting statutes governing the taxation of gambling winnings. In the interim, Lottery should seek legal advice regarding the withholding of the State gambling tax for Tri-State Lotto prizes.

Auditee Response:

We concur.

During fiscal year 2010 there was an attempt to introduce legislation in clarifying the gaming tax provision of Chapter 144:249, Laws of 2009. The Commission was not successful in requesting legislation in 2010 to address this issue. The current legislative session has multiple proposals in repealing this tax completely.

Department Of Revenue Administration Response:

The Department of Revenue Administration (DRA) concurs that RSA Chp. 287-F should be revised to repeal RSA 287-F:17 (exempting Tri-State Lotto winnings from state tax) as a “housekeeping” measure. In 1985, the State of New Hampshire entered into a tri-state compact with Maine and Vermont to implement operation of the Tri-State Lotto to raise additional revenue. At that time, each state enacted Tri-State Compact language in statute. Originally, within the statutory compact language, each state had enacted a provision exempting Tri-State Lotto winnings from all state, county, municipal and local taxes (Maine – ME. REV. STAT. ANN. Title 8, Sec. 423), (New Hampshire – RSA 287-F:17) and (Vermont – VT. STAT. ANN. Title 31, Sec. 674, S.). It is important to note that, in 1987, Maine repealed its tax exemption provision. Likewise, during the 2003-2004 legislative session, Vermont also repealed its tax exemption provision (effective January 1, 2005). Apparently, both repeals of the tax exemption by two of the three party states has rendered the tax exemption provision of the original compact ineffectual. Nonetheless, New Hampshire should revise RSA Chp. 287-F to repeal the tax-exemption. This revision should be completed through the introduction of legislation during the current legislative session as a housekeeping measure. To that end, DRA engaged Lottery in two separate meetings to discuss this course of action, one in December, 2009, and again in October, 2010.

Observation No. 10: Prize Payment Rules Should Be Followed

Observation:

During fiscal year 2010, the Lottery validated and paid a \$250,000 instant ticket claim that was not in compliance with administrative rules for prize assignment. In the payment of this claim, outside of the administrative rules, the Lottery effectively provided legal and tax advice that it would not appear to be in a position to give.

N.H. Admin. Rules, Sw 602.01(b) states, “Each lottery ticket, whether instant or on-line, shall be a bearer instrument until such time as a signature is placed in the designated area on the back of the ticket.”

N.H. Admin. Rules, Sw 500 provides rules concerning assignment of prizes, and refers to payment of *any* prize to a person other than the winner (emphasis added). N.H. Admin. Rules, Sw 503.01(c) requires a court of competent jurisdiction certify the voluntary assignment of the right to a prize. The rule further specifies the court must find that the assignment agreement be in writing and contain the assignor’s name, social security or tax identification number, citizenship or resident alien number (if applicable), address, the specific prize payment or payment assigned, and a notice of the right to cancel the assignment in immediate proximity to the space reserved for the signature of the assignor. Additionally, N.H. Admin. Rules, Sw 503.01(d) further states, “Failure to provide the notice of right to cancel as provided in (c)(3)d, above, shall render the assignment agreement unenforceable.”

According to the Lottery, during fiscal year 2010, two individuals jointly presented a \$250,000 winning ticket at Lottery headquarters for payment. The back of the winning ticket was signed by the two parties, with the name of the first party crossed out. The first signer reportedly claimed to have won the prize and expressed the intention to give the prize to the second signer, the assignee. While the individuals waited, the Lottery drafted a letter on Lottery letterhead stating the first winner voluntarily gave up any and all rights to the ticket. The letter did not include information required by the rules for prize assignment including the assignor's social security number, address, the assignee's social security number, and notice of the right to cancel the assignment. The letter was not notarized and the assignment was not submitted to a court for certification. While the Lottery checked the second signer's name against the New England Child Support Enforcement System (NECSES), prepared federal tax withholding documentation in the second signer's name, and made payment to the second signer, net of the withholding amount, the Lottery did not check whether the first signer had an obligation under NECSES or any other court-ordered obligation, and did not consider whether the federal tax withholding should have been in the name of the first winner.

Recommendation:

The Lottery should review the circumstances related to the above prize payment with legal counsel to determine whether any actions are required.

The Lottery should review with its employees the necessity for following procedures outlined in administrative rules. If, in that review, the Lottery determines the rules should be changed or otherwise clarified, the Lottery should take timely action to do so.

The Lottery should establish appropriate policies and procedures and employee training to assist with compliance to its administrative rules.

Auditee Response:

We concur.

It should be noted that the instant ticket in question was presented at the sales office, signed by the first party. After the ticket was validated for prize payment the original claimant stated he wanted the prize to go to his companion and drew a line through his signature on the ticket. As both parties asserted that they each acted willingly and without any coercion, Lottery staff decided the best way to deal with the matter was to award the prize to the second party.

Observation No. 11: Prize Claims Should Be In Compliance With Rules

Observation:

The Lottery has not revised its administrative rules to reflect the Lottery's changing game structures. The Lottery pays claims for second-chance prizes without requiring the claimant to have physical possession of the winning ticket, in apparent conflict with N.H. Admin. Rules, Sw 602.01(a), which states, "No prize shall be paid without the physical possession of a winning ticket or a valid subscription recorded in the Lottery's central computer system."

The Lottery does not require players whose winning ticket is selected in a second-chance drawing using the Replay system to present a physical ticket at the time the claim is filed. The Lottery reports it does not consider the presentation of a physical ticket as necessary because a player is required to enter ticket validation information at the time the player enters the ticket into the Replay system.

The Lottery incorporates second-chance drawings in the prize structure of several instant-ticket games. Depending on the game, either all non-winning tickets or tickets reflecting a designated symbol enable the ticket holder to enter into a second-chance prize drawing at the conclusion of the game. Instructions on the back of the ticket direct the ticket holder to either mail or personally deliver the instant ticket to Lottery headquarters for entry into a manual drawing or to enter the ticket into the Lottery's Replay website for a second-chance prize to be drawn through the Replay system.

According to the Lottery, it awarded over \$900,000 in second-chance drawing prizes during fiscal year 2010. Of those second-chance drawing prizes, the Lottery awarded \$200,000 through the Replay system.

Recommendation:

The Lottery should review with legal counsel whether its current practice of paying certain second-chance prizes without requiring the winner to present a winning ticket is in compliance with N.H. Admin. Rules, Sw 600, Rules for Prize Claims.

The Lottery should consider whether N.H. Admin. Rules, Sw 602.01(a) should be clarified to describe the prize structure of the Lottery's games.

Auditee Response:

We neither concur nor disagree with the observation, but understand that there exists uncertainty with the issue of when a ticket is presented. Given the evolving nature of what physically constitutes a "ticket" or "entry" and when each ticket is presented, both within and without the Lottery context, the Lottery will confer with counsel and make changes to rules and policies for clarity purposes as may be necessary.

APPENDIX

Current Status Of Prior Audit Findings

The following is a summary of the status, as of December 21, 2010, of the observations contained in the New Hampshire Lottery Commission Management Letter for the fiscal year ended June 30, 2009. That report can be accessed at, and printed from, the Office of Legislative Budget Assistant website: www.gencourt.state.nh.us/lba/audit.html.

	<u>Status</u>		
<i>Internal Control Comments</i>			
<i>Significant Deficiencies</i>			
1. Sale Of Replay Program Assets Should Be Reviewed	●	●	○
2. Replay Program Should Be Fully Documented (<i>See Current Observation No. 4</i>)	○	○	○
3. Segregation Of Duties Should Be Improved Over Merchandise Prizes - Replay Program	●	●	○
4. Controls Should Be Improved Over Merchandise Prizes - Lottery Games (<i>See Current Observation No. 2</i>)	●	○	○
5. User Access Change Log Should Be Prepared And Reviewed (<i>See Current Observation No. 8</i>)	○	○	○
6. Advertising Costs Should Be Properly Charged To Lottery Advertising Accounts (<i>See Current Observation No.6</i>)	●	○	○
7. Reported Prize Reserves Should Be Reviewed For Accuracy (<i>See Current Observation No. 2</i>)	●	○	○
8. Accountability For Tickets Removed From The Lottery's Instant Ticket Vending Machines Should Be Improved	●	●	○
9. Approval Of All Journal Entries Should Be Evidenced (<i>See Current Observation No. 3</i>)	●	●	○
10. The Lottery Should Prepare All State Required Accounting Reports	●	●	●
 <i>State Compliance Comment</i>			
11. Tax Status Of Tri-State Lotto Prizes Should Be Determined (<i>See Current Observation No. 9</i>)	●	○	○

<u>Status Key</u>	<u>Count</u>
Fully Resolved	● ● ● 1
Substantially Resolved	● ● ○ 4
Partially Resolved	● ○ ○ 4
Unresolved	○ ○ ○ 2

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