Audit Report

State Lottery Agency

December 2008

OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Department of Legislative Services
Office of Legislative Audits
Maryland General Assembly

Karl S. Aro
Executive Director

Bruce A. Myers, CPA
Legislative Auditor

December 8, 2008

Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

We have audited the State Lottery Agency (SLA) for the period beginning February 3, 2005 and ending March 16, 2008.

Our audit disclosed that SLA did not adequately monitor certain provisions of its gaming system contract, and did not document its reasons for not assessing contractor liquidated damages totaling approximately $1.3 million applicable to untimely installations of lottery gaming equipment at ticket sales agent locations.

Our tests identified two instances in which SLA lacked documentation to adequately support lottery prize payments totaling $10,000, and five instances in which the social security numbers of winning recipients were not accurately recorded in its automated records. In addition, SLA lacked procedures to ensure that certain promotional broadcasts, which were valued at $2.1 million annually, were aired on television and radio as required by the related advertising contract. Finally, SLA's wide area network, which including the gaming contractor, was not adequately secured.

SLA's response to this audit is included as an appendix to this report. We wish to acknowledge the cooperation extended to us during the course of this audit by SLA.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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* **Denotes item repeated in full or part from preceding audit report**

Background Information

Agency Responsibilities

The State Lottery Commission, which consists of five members appointed by the Governor with the advice and consent of the State Senate, has oversight responsibilities for SLA's operation.

Financial Information

According to SLA's audited financial statements for the fiscal year ended June 30, 2007, the Agency's gross revenues totaled approximately $1.6 billion of which

- $927 million was used for prize claims,
- $112 million was distributed for agent commissions and claims fees,
- $55 million was used to pay SLA's operating expenses,
- $21 million was transferred to the Maryland Stadium Authority in accordance with the State Government Article, Section 9-120 of the Annotated Code of Maryland, and
- $473 million was credited to the General Fund of the State.

SLA engages an independent accounting firm to perform annual audits of its financial statements and monthly audits of special-purpose financial statements, and to provide assistance in technical accounting matters. In the related audit reports for the fiscal years ended June 30, 2005, 2006, and 2007, the firm stated that SLA's financial statements presented fairly, in all material respects, its financial position, results of its operations and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Status of Findings From Preceding Audit Report

We reviewed the status of the six findings from our preceding audit report dated October 12, 2005. We determined that SLA satisfactorily addressed five of those findings. The remaining finding is repeated in this report.

Findings and Recommendations

Online Gaming Contract

Background

In October 2005, the State Lottery Agency (SLA) contracted with a private company to operate and maintain an automated online gaming system and to develop, design, and implement related lottery games. In addition, the contractor was to install and maintain online gaming equipment (such as monitors and terminals) necessary to support the lottery games. The current contract extends through June 2011 at a cost of .95 percent of net lottery sales, not to exceed $81 million. The contract also provides that, at its discretion, SLA may assess the contractor specific liquidated damages for non-performance related to matters including untimely installations and repairs of online gaming equipment and malfunctions of the contractor's central computer system. According to its records, during fiscal year 2007, SLA made payments to the contractor totaling approximately $14 million. In addition, during the period from October 2005 through March 2008, SLA assessed the contractor liquidated damages totaling approximately $575,000 related primarily to computer system and online gaming equipment malfunctions.

Finding 1

SLA did not adequately monitor the provisions of its gaming system contract related to equipment installations and certain liquidated damages, and did not document its rationale for not assessing potential liquidated damages totaling approximately $1.3 million.

Analysis

SLA lacked adequate procedures to ensure that the contractor complied with provisions of the gaming contract related to the installation of gaming equipment and the calculation and documentation of liquidated damages for untimely installations and equipment malfunctions.

SLA did not verify that the contractor timely completed installations of online gaming equipment, such as ticket dispensing terminals and video monitors, at ticket sales agent locations for periods prior to July 2007. Although SLA subsequently began monitoring such performance, it did not assess, nor document its reasons for not assessing, the contractor for liquidated damages, which we estimate totaled approximately $1.3 million, related to 36 untimely installations of such equipment during the period from July 2007 through March 2008. For late terminal installations, the gaming contract allows SLA to assess liquidated damages of $700 per day after the due date, which is increased to $1,500 per day after 15 calendar days. Late installations of terminals result in the loss of lottery sales due to the equipment not being operational.

In addition, SLA did not independently verify the amount of potential liquidated damages calculated by the contractor applicable to instances when online gaming equipment became inoperable (for example, when a terminal could not print and dispense tickets). In these instances, SLA relied on the contractor to determine whether liquidated damages were warranted or if such damages should be waived by SLA due to mitigating circumstances (such as when the ticket agent has a second working terminal).

We were advised by SLA management that, in January 2008, it began reviewing these determinations made by the contractor and the accuracy of the associated calculations of assessable liquidated damages related to inoperable gaming equipment. In this regard, we noted that, in June 2008, SLA assessed the contractor liquidated damages totaling approximately $417,000 related to instances of inoperable gaming equipment that occurred during calendar year 2007.

Recommendation 1
We recommend that SLA continue to verify that all equipment installations are completed by the contractor in accordance with established installation schedules. We also recommend that SLA assess liquidated damages or formally document its reasons when damages are not assessed. Regarding inoperable equipment, we further recommend that SLA either calculate the amount of assessable liquidated damages or independently verify any related calculations performed by the contractor.

Lottery Prize Payments

Finding 2
Two lottery prize payments made by SLA were not adequately supported. In five other instances, the social security numbers of winning recipients were not accurately recorded in its automated payment system.

Analysis
SLA lacked adequate documentation to support certain lottery prize payments made during our audit period. In addition, supporting prize payment information was not always accurately recorded in its automated payment system. Specifically, our test of 44 prize payments (such as for the Keno and Daily Pick-4

games) totaling $291,000 disclosed that, for 7 payments totaling $23,700, either required supporting documentation (such as a properly completed and signed prize claim form for winnings over $600) was inadequate, or claimant information was not accurately recorded in its automated payment system. We noted the following conditions:

- For one prize payment of $5,000, the documentation provided by the prizewinner to substantiate this individual's identity was fraudulent. Specifically, this winning player presented to SLA an identification card, which included a name and a social security number, purportedly issued by the Maryland Department of Human Resources to identify recipients of services. However, we were subsequently advised by the Department that it contained inconsistencies (for example, it contained the signatures of two service recipients) and that it had not issued the card. After we brought this matter to SLA's attention, it referred this situation to the Office of the Attorney General – Criminal Division for further review. In addition, for another prize payment of $5,000, SLA was unable to locate any related supporting documentation.

- For five prize payments totaling $13,700, the social security numbers of the winning recipients, as reflected on the prize claim forms and accompanying supporting documentation, differed from those recorded in SLA's automated payment system. Moreover, although SLA had a procedure in place to verify the accuracy of information posted to the automated payment system, we noted that this was not performed in these five instances.

In accordance with State regulations and the SLA website, individuals claiming prize payments for $600 or more are requested to provide proof of identity, including social security numbers. SLA reports the names, social security numbers, amounts of income taxes withheld, and amounts disbursed to certain winning players to the Internal Revenue Service, which is responsible for providing such information to the State Comptroller of the Treasury. The extent to which withholding amounts are sufficient to satisfy tax liabilities is unknown without the corresponding tax returns. Nevertheless errors affecting the accuracy of reported information could enable persons to avoid the full extent of related federal and state income tax liabilities, and to circumvent the State's debt intercept procedures.

Recommendation 2
We recommend that SLA ensure that prize payments are adequately supported. We also recommend that SLA maintain complete and accurate documentation to support all disbursed prize payments. Furthermore, we recommend that SLA ensure that all claim form information is accurately recorded in its automated system.

Broadcast Advertising Contract

Finding 3
SLA lacked procedures to ensure that an advertising contractor aired all required promotional broadcasts.

Analysis
SLA lacked procedures to ensure that promotional broadcast clips (for example, "ribbons" appearing at the bottom of a television screen showing daily winning lottery game numbers) were aired on television and radio as required by the related advertising contract. Specifically, we noted that the contractor did not provide periodic reports of certain types of promotional clips that it aired and, for those reports that SLA did receive, there was no documentation to indicate that SLA had verified that any of the promotions had aired. Under the terms of its annual $2.5 million advertising contract, SLA was to receive airtime for the televised drawings of its online games. In addition, SLA was to receive approximately 450 weekly gratis promotional broadcast clips on radio and television. Although not specifically charged for these promotional clips, a technical consultant, hired by SLA to review portions of the advertising proposals received, valued such broadcasts at $2.1 million annually. SLA formally considered these broadcasts when it evaluated the technical proposals received from interested bidders for advertising services.

Recommendation 3
We recommend that SLA ensure that it receives all required reports from the contractor. We also recommend that SLA verify, at least on a test basis, that promotional television and radio commercial broadcasts provided for in the aforementioned advertising contract are aired, as required.

Information Systems Security and Control

Background
SLA's Division of Information Technology manages the development, maintenance, and support of SLA's information technology infrastructure, including all related networking, telecommunications, and business information systems. The Division's staff operates a mainframe computer and an internal network which includes email, application, and database servers. Furthermore, the internal network connects to networkMaryland, the Internet, and a separate SLA wide area network that includes connections to SLA's Lanham, Maryland location and to the gaming contractor.

Finding 4
SLA's wide area network was not adequately secured.

Analysis
SLA's wide area network, which includes segments operated by SLA's lottery gaming contractor, was not adequately secured. Specifically, we noted the following conditions:

- SLA used default passwords to administratively access the three critical network devices, which controlled access to the wide area network. Accordingly, this allowed anyone capable of accessing these devices (that is, SLA and gaming contractor employees) to obtain full administrative privileges on these devices and to perform unauthorized modifications to these critical devices.

- Administrative connections to these three critical devices were not restricted to the computers of SLA's network administrators, thereby allowing all users on SLA's wide area network (that is, the aforementioned employees) to access these devices.

- Remote administration of these three devices used an insecure communications protocol, which did not encrypt network traffic. As a result, passwords used to connect to these devices could be captured and inappropriately used to access these devices.

- SLA did not filter traffic between its gaming contractor's locations on the wide area network and SLA's claim center local network in Lanham, Maryland. Accordingly, the claim center network was not adequately protected from the contractor, and the contractor's wide area network locations were exposed to security risks and possible malicious traffic from the claim center. A similar condition was commented upon in our preceding audit report.

Recommendation 4
We recommend that SLA improve security over the critical wide area network devices by changing default passwords, restricting administrative access to only network administrators, and using only secure (encrypted) protocols to connect to these devices. Also, we again recommend that SLA adequately secure all network traffic on its wide area network.

Audit Scope, Objectives, and Methodology

We have audited the State Lottery Agency (SLA) for the period beginning February 3, 2005 and ending March 16, 2008. The audit was conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

As prescribed by State Government Article, Section 2-1221 of the Annotated Code of Maryland, the objectives of this audit were to examine the SLA's financial transactions, records and internal controls, and to evaluate its compliance with applicable State laws, rules, and regulations. We also determined the status of the findings included in our preceding audit report.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of the SLA's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

Our audit scope was limited with respect to SLA's cash transactions because the Office of the State Treasurer was unable to reconcile the State's main bank accounts during a portion of the audit period. Due to this condition, we were unable to determine, with reasonable assurance, that all SLA cash transactions prior to July 1, 2005 were accounted for and properly recorded on the related State accounting records as well as the banks' records.

SLA's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings relating to conditions that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect the SLA's ability to maintain reliable financial records, operate effectively and efficiently, and/or comply with applicable laws, rules, and regulations. Our report also includes findings regarding significant instances of noncompliance with applicable laws, rules, or regulations. Other less significant findings were communicated to SLA that did not warrant inclusion in this report.

SLA's response to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise SLA regarding the results of our review of its response.

APPENDIX

MARYLAND LOTTERY
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Baltimore, Maryland 21230
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www.mdlottery.com
Martin O'Malley, *Governor* • Buddy Roogow, *Director*

December 5, 2008

Mr. Bruce A. Myers, CPA
Legislative Auditor
Office of Legislative Audits
301 West Preston Street
Baltimore, Maryland 21202

Dear Mr. Myers:

Enclosed please find the Maryland State Lottery Agency's response to the November 2008 audit report covering the period beginning February 3, 2005 and ending March 16, 2008.

If you have any questions, please contact me at 410-230-8790.

Sincerely,

Buddy Roogow

Buddy Roogow
Director

Online Gaming Contract

Finding 1
SLA did not adequately monitor the provisions of its gaming system contract related to equipment installations and certain liquidated damages, and did not document its rationale for not assessing potential liquidated damages totaling approximately $1.3 million.

Recommendation 1
We recommend that SLA continue to verify that all equipment installations are completed by the contractor in accordance with established installation schedules. We also recommend that SLA assess liquidated damages or formally document its reasons when damages are not assessed. Regarding inoperable equipment, we further recommend that SLA either calculate the amount of assessable liquidated damages or independently verify any related calculations performed by the contractor.

SLA Response:

SLA agrees to continue to verify that all equipment installations are completed by the contractor in accordance with established installation schedules. We also agree to assess liquidated damages or formally document the reasons when damages are not assessed. For inoperable equipment, we agree to independently verify the calculations performed by the contractor. The Lottery did not assess its contractor the $1.3 million noted by the auditors, as approximately $987,000 of this amount related to the failure of Verizon to install telecommunication lines at 10 agent locations in a timely manner. Despite repeated attempts made by both the contractor and the Lottery, Verizon did not respond in a timely manner. The actual revenue loss to the State as a result of these delayed installations was negligible. The remaining $313,000 in liquidated damages referred to by the auditors was not the fault of the contractor as the installations were delayed by the agents for reasons such as not attending agent training as required by the Lottery.

Lottery Prize Payments

Finding 2
Two lottery prize payments made by SLA were not adequately supported. In five other instances, the social security numbers of winning recipients were not accurately recorded in its automated payment system.

Recommendation 2
We recommend that SLA ensure that prize payments are adequately supported. We also recommend that SLA maintain complete and accurate documentation to support all disbursed prize payments. Furthermore, we recommend that SLA ensure that all claim form information is accurately recorded in its automated system.

SLA Response:
SLA agrees to ensure that prize payments are adequately supported and maintain complete and accurate documentation to support all disbursed prize payments. In addition, we agree to ensure that all claim form information is accurately recorded in our automated system. Procedures are in place to comply with these recommendations.

Broadcast Advertising Contract

Finding 3
SLA lacked procedures to ensure that an advertising contractor aired all required promotional broadcasts.

Recommendation 3
We recommend that SLA ensure that it receives all required reports from the contractor. We also recommend that SLA verify, at least on a test basis, that promotional television and radio commercial broadcasts provided for in the aforementioned advertising contract are aired, as required.

SLA Response
SLA agrees with the recommendations. SLA has established procedures to ensure that it receives all required reports from the contractor. Procedures are also in place to verify, on a test basis, that promotional television and radio commercial broadcasts provided for in the aforementioned advertising contract are aired, as required.

Information Systems Security and Control

Finding 4
SLA's wide area network was not adequately secured.

Recommendation 4
We recommend that SLA improve security over the critical wide area network devices by changing default passwords, restricting administrative access to only network administrators, and using only secure (encrypted) protocols to connect to these devices. Also, we again recommend that SLA adequately secure all network traffic on its wide area network.

SLA Response:
SLA agrees to improve security over the critical wide area network devices by changing default passwords, restricting administrative access to only network administrators, and using only secure (encrypted) protocols to connect to these devices. All recommendations will be fully complied with by the end of February 2009.

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