State of Arizona
Office
of the
Auditor General

PERFORMANCE AUDIT

ARIZONA
STATE LOTTERY
COMMISSION

Report to the Arizona Legislature
By Douglas R. Norton
Auditor General
October 1997
Report # 97-15

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AUDITOR GENERAL

STATE OF ARIZONA
OFFICE OF THE
AUDITOR GENERAL

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October 10, 1997

Members of the Arizona Legislature

The Honorable Jane Dee Hull, Governor

Mr. Jody Spicola, Executive Director
Arizona State Lottery Commission

Transmitted herewith is a report of the Auditor General, A Performance Audit of the Arizona State Lottery Commission. This report is in response to a May 29, 1995, resolution of the Joint Legislative Audit Committee. The performance audit was conducted as part of the Sunset review set forth in A.R.S. §§41-2951 through 41-2957.

The report addresses the need for the Lottery to increase ticket sales and to improve management of its retail network. Arizona's Lottery sales rank among the lowest in the nation on a per capita basis. Turnover of Lottery directors, failure to update on-line games, and poor use of the sales staff have contributed to the low sales. In addition, the Lottery could do a better job of managing its retail network, thus reducing its costs and increasing revenues. For instance, the Lottery should do more to collect amounts owed by retailers for tickets sold. It should also enforce its minimum sales requirements, and stop paying the costs of maintaining outlets that do not generate enough revenue to justify the expense. The report also addresses the need to improve the Lottery's protection of cash on hand and other state assets, and to correct weaknesses in the security of its computer system.

As outlined in its response, the Arizona State Lottery Commission agrees with all but 1 of the 18 findings and recommendations, and has stated that the recommendations will be implemented. The Lottery does not agree with, and will not implement, 1 recommendation relating to computer security procedures.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on October 14, 1997.

Sincerely,

Douglas R. Norton
Auditor General

Enclosure

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SUMMARY

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Lottery Commission (Lottery). The audit was conducted in response to a May 29, 1995, resolution of the Joint Legislative Audit Committee and under the authority vested in the Auditor General by Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957.

The purpose of the Arizona Lottery, which Arizona voters established by an initiative petition in 1980, is "to produce the maximum amount of net revenue" for the State of Arizona. The Lottery, overseen by a five-member commission appointed by the Governor, generates revenues by selling state-sanctioned games of chance in the form of both on-line computerized games and instant ticket games. Since its inception, the Lottery has returned approximately $1 billion to the State, which has been used for a variety of programs.

Poor Lottery Sales Limit Returns to State
(See pages 7 through 16)

The Lottery should take action to increase sales that currently rank among the lowest in the nation on a per capita basis. As a result of low sales, less money is generated for state programs, and Lottery sales have been flat for a number of years. In fiscal year 1996, the Arizona Lottery ranked 35th out of 38 state lotteries in per capita sales. When compared with 8 other states having populations similar to Arizona's, the Lottery ranked lowest in both per capita sales and total sales.

A number of factors contribute to the Lottery's poor overall sales. First, Lottery management's constant turnover has resulted in a lack of continuity and effective long-term strategic planning. The Lottery has operated under five different Executive Directors in the last four years, and has also had high turnover in other key management positions. In addition, the Lottery has not efficiently planned, promoted, and updated its games. For example, the Lottery has not updated important on-line games, such as Lotto, despite decreasing sales. Further, the Lottery has done a poor job of planning for the production and scheduling of instant ticket games, and, as a result, has not only lost sales but has wasted money by printing and then paying to destroy excess tickets. Finally, the Lottery makes poor use of its sales staff, who spend only 10 percent of their time in direct sales activities, while 45 percent of their time is spent simply delivering tickets.

To increase sales, the Lottery should improve its management practices. The Lottery could generate higher sales by addressing problems with its current games and by using technology and advertising techniques known to increase sales in a short period of time. Further, the Lottery should incorporate sound planning and other innovative techniques that will allow it to operate more effectively. Finally, the Lottery should implement retailer incentive programs that are directly tied to increased sales.

Lottery Poorly Manages Its Retail Network

(See pages 17 through 21)

The Lottery poorly manages its retail network. Currently, the Lottery depends on a network of approximately 2,500 retailers to sell Lottery tickets. While many of these retailers generate acceptable levels of sales for the Lottery, some do not. In fact, over 25 percent of Lottery retailers fail to meet the Lottery's minimum ticket sales standards. The Lottery incurs phone line, sales staff, and other operational costs for all its retailers, including those who fail to meet minimum sales requirements. Further, these retailers use some of the Lottery's limited supply of on-line ticket machines, which in the future may be needed for other retailers with higher sales potential as those retail chains expand.

Additionally, the Lottery has failed to collect monies some retailers owe for tickets sold. As of March 1997, 266 retailers owed the Lottery a combined total of more than $800,000. In fact, 14 retailers owed more than $10,000 each, including 1 owing $32,000 and another owing $64,000. As of March 1997, over 100 retailers had 3 or more instances in which they failed to pay the Lottery for tickets sold. However, none of these retailers had their licenses revoked until April 1997 when, during the course of this audit, the Lottery, for the first time, began collection efforts.

The Lottery should incorporate better management practices for its retail network. First, the Lottery should enforce its administrative rules requiring retailers to meet minimum sales levels for on-line and instant ticket sales. The Lottery should also better enforce a policy of canceling the licenses of retailers who have insufficient monies to pay for Lottery tickets. Further, the Lottery should continue to collect amounts owed for tickets by first notifying nonpaying retailers that their licenses will be revoked if they fail to pay; second, referring retailers who continue not to pay their bills to collection agencies; and, finally, requesting the Department of Revenue to intercept tax refunds owed to retailers who owe the Lottery money for tickets. Additionally, the Lottery should conduct routine credit checks of retailers as part of its licensing process. The Lottery should develop guidelines for credit checks, including actions to take when retailers are poor credit risks, such as requiring a bond.

Lottery Does Not Adequately Protect Cash on Hand and Other State Assets

(See pages 23 through 28)

The Lottery lacks adequate managerial and procedural controls to protect state assets against potential fraud, waste, or abuse. Specifically, the Lottery fails to protect cash, prizes, and inventory. For example, some employees have unlimited access to cash drawers and vaults, making theft possible and difficult to detect. Further, its prize and promotional item inventory records are inaccurate, and Lottery staff have distributed game prizes to retailers and others in violation of statutory provisions governing promotional items.

Furthermore, the Lottery does not ensure that advertising money is effectively spent. The Lottery pays approximately $8 million annually to an advertising firm that acts as the principal advertising and marketing planner for Lottery games; however, the Lottery does not provide sufficient oversight of the contract.

The Lottery should correct several factors that contribute to its poor internal control environment. The Lottery should review its management of cash, vaults, and inventories to properly safeguard against theft. Further, the Lottery should review the management of its revolving fund and conduct more frequent reconciliations. Additionally, the Lottery needs to increase employee training to ensure that employees are properly trained. The Lottery also needs written policies and procedures to guide its employees in the performance of their duties relating to cash-handling and inventory management. Finally, the Lottery should better use its internal audit unit to conduct more audits. Such audits should examine adherence to policies and procedures, internal control compliance, and reviewing Lottery contracts and payments to vendors.

Significant Weaknesses Exist in Lottery Computer System

(See pages 29 through 32)

The Lottery computer system contains significant weaknesses that may compromise the system and adversely affect the Lottery's ability to operate. Despite the system's importance to Lottery operations, it lacks adequate security and does not have sufficient backup capabilities and disaster recovery planning. Some Lottery staff have inappropriate access to the system, which allows them to access and potentially alter or divulge important confidential data. Further, the Lottery's computer system does not have a backup processor.

Should a disruption occur, the Lottery would be unable to continue operations, such as instant ticket validations or on-line game sales, for days or even weeks. Additionally, a disruption would disable the entire Powerball game, adversely impacting 20 participating states and thousands of players and leaving the Lottery vulnerable to lawsuits. Finally, the Lottery relies on an untested and outdated disaster recovery plan, which makes its ability to continue operations in case of a disaster (such as a fire or acts of negligence) questionable.

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INTRODUCTION AND BACKGROUND

The Office of the Auditor General has conducted a performance audit and Sunset review of the Arizona State Lottery Commission. The audit was conducted in response to a May 29, 1995, resolution of the Joint Legislative Audit Committee and under the authority vested in the Auditor General by Arizona Revised Statutes (A.R.S.) §§41-2951 through 41-2957.

Lottery History and General Information

Arizona citizens established the Arizona Lottery in 1980 through an initiative petition in the general election. The purpose of the Lottery is "to produce the maximum amount of net revenue" for the State of Arizona. Since its inception, nearly $1 billion in prizes has been awarded to Lottery players and approximately $1 billion has been returned to the State, which has been used for a number of programs. Arizona uses a complicated funding distribution formula to allocate monies to 12 programs. Table 1 (see page 2) shows how the State has distributed Lottery monies from fiscal years 1982 through 1996.

The Lottery offers state-sanctioned games of chance, which are delivered in both an on-line and instant ticket format.

- **On-Line Games**—Lotto, Powerball, and Fantasy 5 are called on-line games because retailers use computer terminals to record the numbers players select. Players attempt to select numbers that will match numbers drawn biweekly or weekly to win cash or prizes. For example, players attempt to match 6 of 42 numbers to win the *Lotto* jackpot. The *Powerball* game is operated jointly by Arizona and 20 other states. On-line games historically account for a minimum of 65 to 75 percent of total Lottery sales. However, as shown in Table 2 (page 4), they are currently experiencing declining sales.

- **Instant Ticket Games**—Instant ticket games do not require computer terminals and offer immediate results to players. Players simply scratch off a protective latex covering to determine if they have won cash or prizes. *Win for Life,* where players attempt to match numbers to win $1,000 per month for life, is an example of a current Lottery instant ticket game. The Lottery usually introduces at least 20 new instant ticket games per year. Instant ticket games generate lower revenues than on-line games but their share of total revenues has grown. Statute also requires the Lottery to introduce two special annual instant ticket games to generate revenues to be used by the Arizona Department of Commerce for economic development.

Table 1

Arizona State Lottery Commission
State Programs Receiving Lottery Revenues
Years Ended June 30, 1982 through 1996
(Unaudited)

Programs	Total Statutory Distributions in Millions of Dollars
State General Fund—Appropriated for a variety of purposes including education, public health, public safety, general government, inspection, regulation, and natural resources.	$ 466
Local Transportation Assistance Fund—Used by Arizona cities and towns for a variety of transportation-related purposes, including mass transit. Up to 10 percent of these monies can be used for sociocultural programs if matched by private monies.	328
State Heritage Fund—Used by Arizona State Parks and the Arizona Game and Fish Commission to pay for trail and park maintenance, land acquisition, and educational programs.	111
County Assistance Fund—Used by the counties for a variety of programs such as law enforcement, education, and health.	76
Economic Development Fund—The Arizona Department of Commerce uses these monies to attract new businesses into the State.	23
Clean Air Fund [1]—Created in 1996, this fund will be used by the Arizona Department of Commerce for a variety of purposes, including grants promoting the use of alternative fuels and High Occupancy Vehicle (HOV) signs on federal and state roads.	None
Healthy Arizona Programs [1]—Proposition 203, passed in the 1996 general election, created Lottery funding for the following programs: ■ Healthy Families Pilot Program ■ Arizona Area Health Education System ■ Teenage pregnancy prevention programs ■ Health Start Pilot Program ■ Disease Control Research Fund ■ Women, Infants, and Children Food Program	None
Total	$1,004

[1] JLBC forecasts that the Clean Air Fund will receive about $7.5 million in fiscal year 1998, but projects Lottery sales will be too low to provide any funding to the Healthy Arizona programs that year.

Source: Arizona State Lottery Commission.

Retailers, such as grocery and convenience stores, must obtain a license from the Lottery in order to sell Lottery tickets. Currently, there are approximately 2,500 Lottery vendors, who receive a commission for selling tickets. For fiscal year 1996, retailers received $15.5 million in commissions. Legislation passed in 1997 increased the amount of retailer commissions from 6 percent of ticket sales to a minimum of 6.5 percent and a maximum of 7 percent. The Lottery has not yet determined the requirements retailers must meet to receive a 7 percent commission.

Staffing and Organization

A.R.S. §5-502 establishes the Arizona State Lottery Commission, which oversees the Lottery. The Commission consists of five members, appointed by the Governor, who meet monthly to set policy and transact business to guide efforts toward maximizing Lottery revenues. An Executive Director appointed by the Governor administers Lottery operations. The Director also serves as the Commission's secretary and executive officer.

In fiscal year 1996, the Lottery employed 121 full-time employees in Phoenix and Tucson offices working in 4 divisions: Administrative, Management Information Systems, Sales and Marketing, and Security. Each division has a Director.

Budget Information

The Lottery receives monies annually from the State Lottery Fund. The Lottery is restricted by statute to spending no more than 18.5 percent of its revenues on administrative expenses, and no more than 4 percent of its revenues on advertising. Table 2 (see page 4) summarizes the Commission's actual revenues and expenditures for fiscal years 1994, 1995, and 1996.

Audit History

The Office of the Auditor General has conducted several audits of the Lottery in the past. A performance audit was last conducted in February 1987 as part of a Sunset review of the Lottery (Auditor General Report 87-3). The audit found that the Lottery's administrative budget needed to be reduced and recommended stronger budgetary oversight. The Legislature has since reduced the Lottery's administrative budget from 25 percent to 18.5 percent of total revenues. The audit also recommended that the Lottery improve its contract selection process.

Table 2

Arizona Lottery Commission
Income Statement
Years Ended June 30, 1994 through June 30, 1996
(Based on Independent Auditor's Report)

	1994	1995	1996
Revenues:			
Lottery ticket sales:			
Instant	$ 57,514,820	$ 69,724,511	$ 82,860,334
Economic Development	5,706,804	7,488,838	4,925,255
Powerball (introduced April 1997)	19,180,539	92,889,772	77,772,697
Lotto	142,286,940	97,075,149	75,853,040
Fantasy 5	24,036,667	18,810,756	17,424,824
Total lottery ticket sales	248,725,770	285,989,026	258,836,150
Lottery prize payouts:			
Instant	30,327,779	40,953,795	46,684,497
Economic Development	2,797,408	4,883,228	2,712,285
Powerball	9,590,270	46,096,959	38,251,164
Lotto	68,243,281	48,226,394	37,622,309
Fantasy 5	11,472,452	9,288,743	8,173,460
Total lottery prize payouts	122,431,190	149,449,119	133,443,715
Net lottery ticket sales	126,294,580	136,539,907	125,392,435
Retail license fees	8,900	6,875	6,800
Other revenues	388,143	464,925	1,130,570
Total revenues	126,691,623	137,011,707	126,529,805
Expenses:			
Retailers' commissions	15,372,198	17,217,701	15,551,375
Advertising and promotion	10,485,453	10,955,481	9,888,283
On-line system expenses	7,399,794	8,175,629	4,793,347
Tickets purchased	1,769,122	1,771,747	2,460,514
Personnel	4,071,522	4,134,350	3,993,479
Contract services	135,730	206,851	435,247
Other expenses	1,848,564	2,205,016	2,628,771
Total expenses	41,082,383	44,666,775	39,751,016
Net income before transfers to other State of Arizona funds	85,609,240	92,344,932	86,778,789
Transfers to other State of Arizona funds	(82,420,376)	(92,544,165)	(87,283,086)
Increase (Decrease) in retained earnings	3,188,864	(199,233)	(504,297)
Retained earnings, beginning of year	5,078,449	8,267,313	8,068,080
Retained earnings, end of year	$ 8,267,313	$ 8,068,080	$ 7,563,783

Source: Arizona Lottery Commission financial statements audited by Deloitte & Touche LLP.

Further audit work determined that contracting continues to be a problem at the Lottery. Two special audits by the Auditor General have examined Lottery contracts and contracting practices. First, in 1993, a special audit examined three contract awards. The audit determined that the Lottery failed to competitively bid a contract for over $10,000 in violation of A.R.S. §§41-2533 and 41-2534, questioned the appropriateness of another contract award, and found that a consultant's travel costs were being reimbursed without following state guidelines regarding allowable daily expenses. In 1995, another special audit was conducted to determine whether payments made by the Lottery to its contracted advertising firm were being made in accordance with statute and the specific terms of the contract. The audit determined that payments to the vendor did not comply with statute, travel cost reimbursements paid to the vendor exceeded state allowances, the contract was not properly amended, and the Lottery's internal audit staff did not play an active role in administering the contract. The current audit determined that the Lottery has not rectified some of the issues identified in the 1995 audit (see Finding I, pages 7 through 16).

Audit Scope and Methodology

Audit work focused on the Lottery Commission's ability to fulfill its statutory role of maximizing revenues. As such, the audit examined the Lottery's business practices and overall business environment, including its financial and computer internal control systems, its relationship with Lottery retailers, and its overall approach to increasing Lottery revenues. The audit team used a combination of methods to conduct the review, including:

- Conducting a comprehensive internal control review of Lottery financial and computer structures, including the evaluation of policies and procedures and test work of Lottery expenditures, reconciliations, prize distribution, and inventory;
- Attending four Lottery Commission meetings and reviewing Commission meeting minutes from 1994 through 1996;
- Interviewing representatives from selected Lottery retailers, such as Bashas', Safeway, and Circle K.
- Interviewing 8 vendors who provide on-line and/or instant ticket services in other states and countries;
- Reviewing the Lottery's process for planning and implementing games including relevant documentation;

- Reviewing the Lottery's 3 major contracts including its advertising, instant ticket, and on-line procurements;
- Contacting 21 states operating lotteries as well as national lottery organizations such as the National Association of State and Provincial Lotteries (NASPL);
- Conducting a review of literature, including journal articles and reports from other states, such as national lottery advertising, sales, retailer distribution, and financial comparison data located in *Lafleur's 1996 World Lottery Almanac.*

As a result of this audit work, findings and recommendations are presented in four areas:

- The Lottery could implement better practices to increase sales;
- The Lottery does not use sound practices in its relationships with Lottery retailers, which hinders its ability to maximize sales;
- Lottery financial internal controls are weak, subjecting the State to an increased likelihood of fraud, waste, and abuse; and
- The Lottery's EDP internal control environment has flaws that could potentially result in millions of dollars lost in revenues in the event of a disaster.

The audit was conducted in accordance with government auditing standards.

The Auditor General and staff express appreciation to the Arizona Lottery Commissioners, the Lottery Executive Director, and Lottery staff for their cooperation and assistance throughout the audit.

FINDING I

POOR LOTTERY SALES LIMIT MONIES AVAILABLE FOR STATE PROGRAMS

The Arizona Lottery should take action to increase sales that currently rank among the lowest in the nation on a per capita basis. Due to low revenues, less money is generated for state programs. Many factors contribute to poor Lottery sales, including high management turnover, poorly planned or promoted games, and inadequate use of staff. Additionally, other issues affect the Lottery's sales, such as competition from Indian gaming, problems with a previous on-line vendor, and the federal Americans with Disabilities Act (ADA) inspection requirements. The Lottery should adopt sound business practices and implement techniques being used by other states or recommended by industry experts to better maximize revenues.

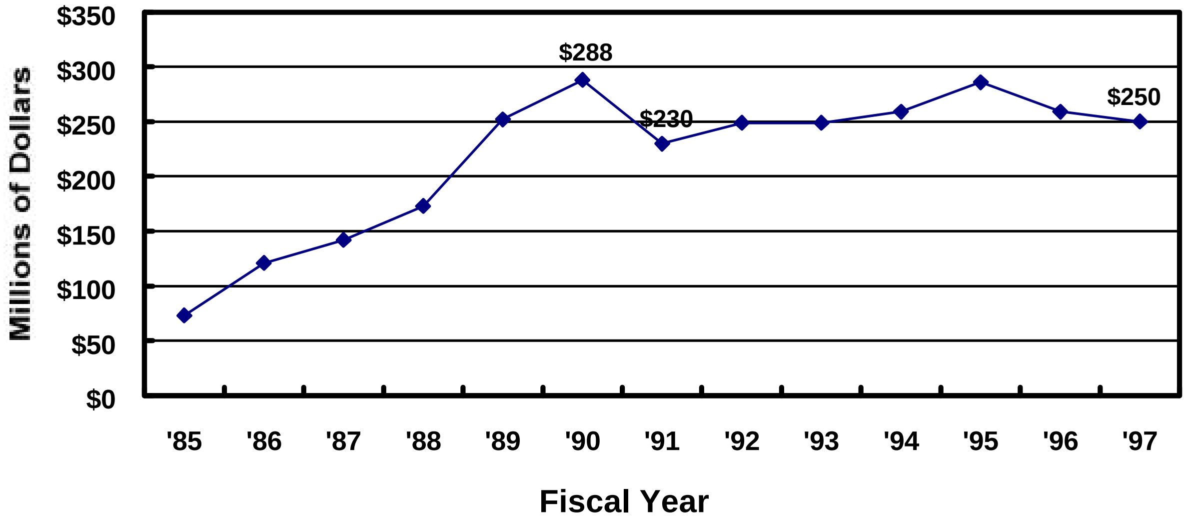
Lottery Sales Poor Compared to Other States

The Arizona Lottery does not appear to be effectively meeting its statutory charge of maximizing revenues. Lottery sales, which have never been high compared to other states, remain stagnant, resulting in less money for state programs. As a result of the Lottery's poor performance, the State may not obtain the revenues necessary to fund certain programs.

Poor Lottery sales limit returns to the State**—**As illustrated in Figure 1 (see page 8), Arizona Lottery sales have remained fairly constant since fiscal year 1989, limiting the amount of monies available for state programs. From fiscal year 1989 through fiscal year 1996, Lottery sales averaged approximately $259 million annually with a high of $288 million (1990) and a low of $230 million (1991). For fiscal year 1997, the Lottery generated approximately $250 million in sales. Further, Lottery projections presented to the 1997 Legislature forecast that fiscal year 1998 sales could be as low as $214 million. As a result of declining sales, the Joint Legislative Budget Committee (JLBC) expects that the Healthy Arizona and Mass Transit programs will not receive funding in fiscal year 1998 since they have a lower statutory priority than other programs receiving Lottery monies.

Figure 1

Arizona State Lottery Commission
Lottery Sales
Years Ended June 30, 1985 through 1997
(Unaudited)



Source: Arizona State Lottery Commission.

Arizona Lottery ranks near the bottom in per capita sales**—**The Lottery is a poor performer compared to other state lotteries. In fiscal year 1996, the Lottery ranked 35th out of 38 state lotteries in per capita sales. During that year, Arizona had per capita sales of $63, compared to the national average of $159 and a national high of $505 (Massachusetts). When compared with 8 other states having populations similar in size to Arizona's (Washington, Colorado, Oregon, Wisconsin, Minnesota, Kentucky, Maryland, and Connecticut), the Lottery ranked lowest in per capita sales in fiscal year 1996. Table 3 (see page 9) ranks U.S. lotteries based on per capita sales in 1996.

Table 3

State Lotteries
Ranked by Per Capita Sales
Year Ended June 30, 1996

	State	Per Capita Sales		State	Per Capita Sales
1.	Massachusetts	$505	20.	New Hampshire	$128
2.	Rhode Island	455	21.	Vermont	128
3.	District of Columbia	352	22.	Maine	122
4.	South Dakota	285	23.	West Virginia	117
5.	Delaware	269	24.	Indiana	113
6.	Georgia	245	25.	Wisconsin	93
7.	Oregon	226	26.	Colorado	88
8.	Maryland	218	27.	Minnesota	85
9.	Connecticut	215	28.	Idaho	83
10.	Ohio	214	29.	Missouri	81
11.	New Jersey	206	30.	Kansas	73
12.	New York	199	31.	Washington	72
13.	Texas	180	32.	California	72
14.	Michigan	152	33.	Iowa	68
15.	Florida	150	34.	Louisiana	67
16.	Kentucky	141	**35.**	**Arizona**	**63**
17.	Virginia	139	36.	Nebraska	50
18.	Pennsylvania	139	37.	Montana	40
19.	Illinois	138	38.	New Mexico	18

Source: *Lafleur's 1996 World Lottery Almanac*. Boyds, MD: TLF Publications, 1996.

A Number of Factors Contribute to Poor Overall Lottery Sales

Several factors contribute to poor Lottery sales. First, constant turnover of Lottery management during the past five years has resulted in a lack of continuity, which in turn has prevented the Lottery from conducting meaningful long-term strategic planning and from setting and reaching measurable goals. Second, the Lottery's attempt to plan, promote, and update its games have been hampered by inefficiency and, in some cases, wasted resources. Further, the Lottery poorly utilizes its sales force. Finally, sales are affected by some factors outside of the Lottery's direct control, such as contractual problems with the Lottery's former on-line vendor and competition from Indian gaming.

Turnover in executive management hinders sales performance**—**Frequent changes in the Lottery's leadership have prevented long-term planning and have had an adverse impact on Lottery sales. The Arizona Lottery has operated under five different Executive Directors in the last four years. Additionally, between August 1996 and April 1997, the Lottery also experienced turnover in all four of the Division Director positions and four primary mid-level management spots that directly affect or support sales, including the Directors of Administration, Management Information Systems, Security, and Sales and Marketing, as well as the Attorney General Representative and the Promotions, Advertising, and Corporate Marketing Managers.

Lottery practices contribute to poor Lottery sales performance**—**This turnover has led to inadequate planning and promotion of both on-line and instant games which has, in turn, resulted in poor sales, and in some cases, wasted resources. Additionally, Lottery sales personnel are not being used efficiently. The following are examples of problems with the Lottery's business practices:

- **Stale games not updated**—On-line game sales, which traditionally generate a majority of the Lottery's sales, are eroding. According to Lottery officials, these games are old and no longer generate player interest. Experts suggest that on-line games should be reexamined and enhanced every 18 months. However, the Lottery has not made any significant changes to the Lotto game since 1989. Further, the Lottery has not made any changes to the Fantasy Five since its inception in 1991. As a result, sales are decreasing. In fiscal year 1996, Lotto, Fantasy 5, and Powerball on-line games generated approximately $171 million in sales, as opposed to an average of $200 million per year over the previous 6 years and a high of $239 million in 1990. Despite decreasing sales, on-line games still accounted for 58 percent of total Lottery sales in fiscal year 1997.

  Introducing new on-line games may not result in an overall increase in on-line sales because, historically, new on-line games gain sales at the expense of older on-line games. For example, Powerball generated approximately $19 million in sales when it was introduced in 1994. However, Lotto and Fantasy 5 experienced over a $26 million decrease in sales that same year. Therefore, overall on-line sales actually decreased by $7 million that year. Consequently, enhancing older, established games may have a greater impact on sales than simply introducing new games.

- **Problems with instant ticket games**—Lottery management of instant ticket games displays its own set of problems. Though many instant games have been successful, the Lottery has generally done a poor job of planning for instant games' production and scheduling. The Lottery orders too many tickets and runs games for excessive periods of time. For example, in fiscal year 1995, the Lottery's instant games ran for an average of 41 weeks. Some experts believe sales reach a point of diminishing return around 19 weeks or less. As a result of poor planning, 51 million tickets went unsold over a 2-year period. These tickets were destroyed, representing a loss of more than $1 million in printing costs alone, and there were additional costs associated with disposal.

- **Poorly planned games**—Along with its failure to address general problems with both on-line and instant ticket games that affect sales, the Lottery has done a poor job of planning and promoting some specific games. For one instant ticket game, the Lottery spent $30,000 in promotions to generate only $52,000 in sales, and had $154,000 in prize inventory left at the end of the game. In another instance, the Lottery worked seven months and spent over $15,000 for an on-line game that was eventually canceled because of planning problems.

- **Sales representatives could be better used**—Finally, Lottery sales representatives do not spend enough time selling the Lottery's products. For example, a Lottery review found that sales representatives spend only 10 percent of their time in direct sales, such as introducing or selling new games and recruiting new accounts. In fact, at least 45 percent of their time is spent simply delivering tickets and additional time is spent inspecting retailers for compliance with federal Americans with Disabilities Act requirements.[1] Retailers interviewed believed that Lottery sales staff do not spend adequate time selling its products. One retailer stated that the Lottery needs to get their sales staff "out of the delivery business and into the sales business."

Other factors contribute to poor sales—Other factors also influence poor Lottery sales. Most notably, in 1996, the Lottery's on-line vendor defaulted on its contract resulting in lost sales and damaged relations with players and retailers. Between November 1995 and January 1996, the vendor's computer software was unable to tally how much each store owed for tickets sold. The vendor eventually agreed, through a negotiated settlement with the Lottery, to pay the State approximately $11 million for damages. Additionally, the Lottery competes for dollars with other gaming enterprises, such as Indian casinos. This competition is not unique to Arizona, since 21 other lottery states, most of which have higher per capita sales than Arizona, experience competition from Indian gaming. However, the State's compacts with Indian tribes restrict the Lottery's ability to implement some types of games, such as Keno or video lottery. Other states, such as Delaware, Oregon, and West Virginia, dramatically increased sales by operating these types of games.

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[1] In 1996, the Superior Court of Arizona ruled that the Arizona Lottery must inspect all retailers selling Lottery products for compliance with the federal Americans with Disabilities Act.

Lottery Should Improve Practices to Increase Sales

The Lottery should employ better business practices and innovative sales techniques to better maximize revenues. The Lottery could generate higher sales by addressing problems with its current games and by using technology and advertising techniques known to increase sales in a short period of time. Further, the Lottery should incorporate sound planning and other innovative techniques that will allow the Lottery to operate more effectively and, thereby, return more monies to the State. Finally, the Lottery should implement retailer incentive programs that are tied directly to increased sales.

***Changes to games are necessary to increase sales*—**The Lottery should rejuvenate established on-line games to increase sales instead of relying solely on new games that may not succeed. In addition, the Lottery should add a variety of games to its mix and consider running them for shorter periods. Further, the Lottery should consider offering games with different prices and prize structures that ensure more winners and repeat players instead of relying solely on higher prize payouts to increase sales.

- **Revamp on-line games**—Many methods are readily available to stimulate sagging on-line games. Common tactics include changing the game matrix (for example, changing from 45 numbers to 41 numbers), adding smaller prizes with better chances for winning, running short-term promotions, holding second chance drawings, and emphasizing local winners to generate game interest. For example, the Connecticut Lottery gives players an extra number for an additional 50 cents on a $1 wager in their Lotto games.

- **Add to the current game mix**—Many successful games other state lotteries use have not been incorporated into Arizona's game mix. Examples include instant ticket pull-tab games, where players pull a perforated section on the ticket to determine if they are a winner; and three- or four-number on-line daily games, where players match three or four numbers for smaller jackpots. Of eight states with populations similar to Arizona's, three operate pull-tab games and seven have three- or four-digit games. All of these states have higher per capita sales than Arizona.

- **Consider shorter-term games**—Arizona should run its instant ticket games for shorter periods to minimize losses from poorly performing games. Nationally, lotteries are releasing their instant ticket games for shorter periods to reduce printing costs and the waste that results from unsold tickets. For example, the Idaho Lottery now operates games for 11-week periods and the Indiana Lottery prints only half the tickets per game that it did in the past.

- **Use variety in game price and prize structures**—Arizona should consider using differently priced instant ticket games with varied prize structures in order to generate better sales. Other states offer a variety of differently priced instant ticket games that are designed to increase sales and player interest by offering options. For example, 17 other state lotteries operate $5 games, while 16 states have $3 games. Some states have even offered $10 games. Altering game prize structures can also increase sales. For example, prizes for a game can be structured so that there are many lower-level prize winners instead of only a few players who win the entire jackpot. Experts suggest that low-level prize winners are likely to reinvest their small winnings back into more lottery tickets. Lottery officials from states using these techniques report that using differently priced and structured games offers players options, which increases their interest and, therefore, sales, without increasing the amount of money lottery officials must use for prizes.

***Self-service technology can improve sales*—**The Lottery should consider using self-service lottery vending machines, preferred by retailers and players, to increase sales. Representatives from Bashas', Safeway, and Circle K, three of the Lottery's major retailers, informed auditors that retailers prefer these machines because they do not place a great demand on staff resources and require only limited floor space. In fact, one estimated that these machines save retailers as much as 20 percent in labor time. Also, players enjoy these machines because they can purchase tickets quickly and easily.

Arizona should consider using more Individual Ticket Vending Machines (ITVMs) to increase sales. ITVMs are customer-operated lottery vending machines that hold up to a dozen games at one time. They lease for approximately $2,400 annually and are proven to increase sales. For example, the Texas Lottery recently experienced a 43 percent jump in ticket sales after adding ITVMs, an average incremental increase in sales of $794,000 per week. The Missouri Lottery installed ITVMs and realized a 62 percent sales increase. Further, nearly 30 percent of Kentucky's and Virginia's ticket machine networks consisted of ITVMs, as opposed to only 7 percent in Arizona. Additionally, some states, such as California and Pennsylvania, use other types of self-service machines similar to ITVMs, such as in-counter dispensers and kiosks, to increase sales.

***Point-of-sales advertising helps to increase sales*—**In-store advertising in the form of signs, banners, stickers, and other promotional items helps to increase sales by drawing customers' attention to Lottery products while they are in a store. Currently, the Lottery expends only a minimal amount of its advertising budget for point-of-sale advertising. However, according to Arizona retailers, lottery tickets are impulse purchase items, so in-store advertising, such as logos on grocery bags, can have a substantial impact on sales. Some states focus heavily on in-store advertising to increase sales. Massachusetts, the state with the highest per capita sales, commits 100 percent of its advertising budget to in-store advertising. Michigan and West Virginia allocate approximately 25 percent of their advertising budgets to in-store advertising.

Management and marketing changes are needed to increase sales**—**The Lottery could increase sales by adopting better management and marketing techniques. The Lottery should implement long-term planning models focused on goals that would increase sales. Additionally, the Lottery should consider alternate methods of instant ticket delivery. Further, the Lottery could increase sales by using direct mailing and copromotions.

- **Effective long-term planning**—The importance of long-term planning is widely recognized because it helps to ensure that goals can be set and worked toward regardless of turnover and other factors. Arizona should adopt planning models that are focused on increasing sales. Other state lotteries have adopted planning models that may be of use to the Arizona Lottery. For instance, the Maryland Lottery has formed an instant ticket planning committee to develop games. The California Lottery is required to conduct demographic studies of lottery players and the effectiveness of lottery communications.

- **More production from sales staff**—Instead of relying on sales staff to deliver tickets, the Lottery should examine other approaches that would free staff to increase their sales time with retailers. Retailers indicated that Lottery sales staff spend too much time delivering tickets and not enough time selling product. Further, over 70 percent of other states use a combination of courier and sales staff to deliver tickets. Only eight other lotteries besides Arizona use sales representatives as their primary way to deliver tickets. Some states, like Florida and Pennsylvania, have recently required the instant ticket vendor to deliver tickets to retailers.

- **Direct mail promotions**—Direct mail allows lotteries to send players and potential players information at their residences about features such as discounts, promotions, and new products. Many lotteries use direct mail to increase sales and to gather information. For example, the Ohio Lottery annually receives approximately 400,000 survey responses from residents discussing lottery products. Ohio Lottery officials believe direct mail allows them to reach all types of players. Delaware sends coupons to players with surveys on the back. Further, Massachusetts, Oregon, and West Virginia use the mail to offer players one free ticket for every ticket purchased.

- **Copromotions**—Copromotions can also be used to increase sales. In copromotions, lotteries and private companies share costs for advertising and promoting lottery games. Some lotteries use copromotions to offset high advertising costs for Lottery products. For example, the Ontario Lottery recently ran a successful copromotion in which McDonald’s bought $2.5 million in tickets as promotions and supplied $1.5 million in advertising. Similarly, in 1997, the Illinois Lottery worked with two Las Vegas hotels (MGM and Caesar’s Palace) to copromote a lottery game.

Lottery retailer program should be monitored**—**The Lottery should monitor the effect of a recent change in its retailer incentive program, and consider alternatives used in other states if the current plan does not have the desired effect of increasing sales. In 1997, the Legislature raised retailer commissions from 6 percent to 6.5 percent as a means of improving its relationship with retailers and thereby, sales. While the increased commission will probably improve retailers' satisfaction with the Lottery, evidence suggests it may do little to boost sales. For example, a representative from a large retail chain states that the commission would have to match or exceed those of other consumer products, which is as high as 25 percent, before they would change the way lottery products are marketed in their stores. Further, in 1996, prior to the increase, Arizona had one of the highest commission rates of the 38 states operating lotteries, yet it ranked 35th in per capita sales. Therefore, the Lottery should closely monitor the effect of the change over the next two years. If the increased commission does not result in increased marketing efforts on the part of the retailers, or if sales continue to decline, the Lottery should return to the Legislature with a proposal for a restructured incentive plan. This plan should begin with a lower base commission rate but provide other incentives tied more closely to sales, such as those used in other states with higher per capita sales.

- **Sales goal bonuses**—Many states offer retailers bonuses for reaching sales goals. For example, Kentucky offers retailers a 5 percent bonus on incremental sales over retailers' annual quota. Colorado, Delaware, Georgia, Idaho, and Oregon all offer bonuses to retailers for exceeding sales goals.

- **Incentive contests**—Some states offer bonuses to retailers who win sales incentive contests. Michigan held a four-month incentive contest awarding cash prizes to retailers with the highest sales increase over the previous year. Kentucky holds quarterly incentive contests for instant games. Minnesota holds an annual incentive program targeting premium lottery products.

- **Cashing bonuses**—States such as California, Colorado, Idaho, Indiana, Kansas, Louisiana, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, Ohio, South Dakota, and West Virginia offer cashing bonuses ranging from 1 to 3 percent of the total dollar amount of winning tickets redeemed by a retailer. Cashing bonuses compensate retailers in these states for taking the time to cash and process winning lottery tickets.

Lottery is making plans intended to increase sales**—**The 1998 Lottery Marketing Plan contains preliminary plans that may increase sales. While the plan lacks specific and clear objectives and time lines to measure actual performance, it does address the need to rejuvenate older on-line games, change the current game mix, and build the player base through the introduction of new games. However, the success of any plan will be determined by the Lottery's improvement in general business methods and appropriate long-term management.

Recommendations

1. The Lottery should update current on-line games like Lotto and Fantasy 5, instead of solely relying on new on-line games, in order to boost sales.

2. The Arizona Lottery should implement long-term planning to increase sales and evaluate actual Lottery performance.

3. The Lottery should consider better utilizing sales staff, including finding ways to better handle ticket delivery and the Americans with Disabilities Act compliance issues, which would allow sales staff more time to increase sales.

4. The Lottery should consider utilizing innovative practices proven to increase sales, such as adding games to its current game mix; shortening the time specific games are offered; using direct mail, copromotions, and in-store advertising materials; introducing multiple priced games; and redesigning prize payout structures so that there are more lower-tier winners and repeat players.

5. The Lottery should consider obtaining additional ITVMs through lease or purchase, and acquire other technologically advanced equipment.

6. The Lottery should monitor the effect of a recent change in its retailer incentive program and be prepared to propose a restructured incentive program to the Legislature if the current plan does not help to increase sales within two years.

FINDING II

LOTTERY POORLY MANAGES ITS RETAIL NETWORK

The Lottery does not use effective business practices in managing its retailer distribution system. Similar to private sector wholesalers, the Lottery works with a network of retail stores to sell lottery tickets to the public. However, the Lottery does not adequately ensure that its retailers pay for the tickets they sell. Further, the Lottery has failed to remove unprofitable retailers from its retail network, even though it incurs costs for maintaining them in the network.

Background

The Lottery's retailer distribution system is critical to its sales success. The Lottery depends on a network of approximately 2,500 retailers, 100 of which sell only instant tickets, to sell lottery tickets to the public. These 2,500 retailers include convenience, grocery, and drug stores; gas stations; and a variety of other small businesses. To become a lottery retailer, a business must obtain a lottery retailer license and pass a criminal background and financial credit check. In return for selling lottery tickets, a retailer is allowed to keep 6.5 cents of every dollar sold. The Lottery receives most of its portion of ticket revenue from retailers by weekly collecting monies owed through electronic fund transfers. The Lottery receives revenue from tickets sold less retailer commissions earned.

Lottery Has Not Collected Money from Retailers Who Fail to Pay Their Bills

The Lottery's efforts to collect money retailers owe have been ineffective. As of February 28, 1997, 266 retailers owed the Lottery a total of more than $800,000 for tickets sold. However, the Lottery continued to deliver new tickets to these retailers, although its retailer agreement provides that retailers who fail to pay their bills can be barred from selling additional tickets. Further, the Lottery does not use the kinds of collections efforts used by other state agencies. Finally, in addition to the initial background checks already performed, the Lottery should develop guidelines for conducting routine credit checks and taking actions, such as requiring a bond from retailers with poor credit, to protect itself from losses to insolvent retailers.

Numerous retailers owe money for tickets sold—Many retailers owe the Lottery money earned from tickets sold because they have not had sufficient monies in their accounts to pay for sold tickets. As a result, amounts owed by retailers have been accumulating. As of February 28, 1997, 266 retailers owed more than $800,000. Fourteen retailers owed more than $10,000 each, including 2 owing approximately $32,000 and $64,000, respectively.

Retailers who do not pay continue to be allowed to sell—Even though many retailers fail to pay for the tickets they sell, the Arizona Lottery did nothing to stop them from continuing to sell tickets until April 1997. As of February 28, 1997, 106 retailers had failed 3 or more times to have enough money in their bank accounts to pay for the lottery tickets they sold. In fact, 3 retailers failed to have enough money in their accounts every week for 52 weeks or more. However, none of these retailers had their selling privileges revoked until April 1997 when, during the course of this audit, the Lottery, for the first time, began efforts to collect debts. As of July 1997, the Lottery had suspended or revoked the licenses of 13 retailers and collected approximately $173,000 in debts owed for tickets sold. The Lottery should better enforce its rule for revoking the licenses of retailers who continually fail to have sufficient monies in their accounts to pay their bills.

Lottery has not made adequate efforts to collect amounts owed—Even though some retailers owe the Lottery substantial amounts of money for tickets sold, the Lottery does little to collect these amounts. For example, until recently, the Lottery failed to send out notices to retailers warning them that their selling privileges might be canceled if they fail to pay the amounts owed. In addition to sending out warnings, the Lottery could also require retailers who owe the Lottery money to pay for tickets on delivery until they have satisfied their debt.

The Lottery also does not use collection methods used by other state agencies. Agencies such as the Department of Real Estate, the Attorney General's Office, and the Department of Building and Fire Safety contract with collections agencies to collect amounts owed to them. In addition, A.R.S. §42-133 states that any debt owed to a state agency can be subject to an offset of any tax refund owed. The Lottery could request that the Department of Revenue intercept individual tax refunds to owners of sole proprietorships or partnerships whose retail establishments owe debts to the Lottery.

Lottery does not ensure retailers are creditworthy—In addition to collecting amounts owed, the Lottery should do more to ensure existing retailers are creditworthy. The Lottery currently performs a credit check on retailers only when they first apply to become a lottery retailer. In the past, such credit checks were also performed on an annual basis during the license renewal process. However, the Lottery has not renewed retailer licenses since 1991. Therefore, only first-time retailers have had credit checks performed in the past six years. The Lottery should consider reinstituting routine credit checks which could be performed annually, as was done in the past, or every 3 years, as the Lottery Director is currently proposing. The Lottery should develop guidelines to assist in determining the creditworthiness of applying retailers. Such guidelines could require that retailers deemed a high credit risk provide surety bonds or other guarantees of payment.

Lottery Has Failed to Ensure That Retailer Distribution System Is Cost-Effective

In addition to not making sure that retailers pay their bills, the Lottery has also not ensured that its retailers are profitable to the Lottery. Even though Lottery rules set sales minimums that retailers must meet, the Lottery has done nothing to enforce those rules. The Lottery needs to enforce minimum sales requirements to ensure that the cost of servicing a retailer does not exceed the revenue generated from that retailer. By eliminating unprofitable retailers, the Lottery also could add new, potentially lucrative retailers to its distribution network.

***Sales minimums not met*—**The Lottery does little to ensure that lottery retailers meet its minimum on-line ticket sales requirement. As of February 28, 1997, 27 percent of the retailers did not meet Lottery administrative rules that require sales of at least 400 on-line tickets per week during the preceding 10-week period. Some retailers' sales fell far below the minimum. For example, a market in Chandler sells an average of only $33 in on-line tickets per week, and a check-cashing store in Phoenix sells an average of only $15 in on-line tickets per week.

Many retailers also perform very poorly in instant ticket sales. Twenty-six percent of retailers who sell instant tickets failed to sell more than an average of $250 worth of tickets per week during the same 10-week period for *all* instant games they offered, which is far below the Lottery's minimum for instant ticket sales. The Lottery's rule requires retailers to sell $250 worth of tickets on average per week during the same 10-week period for *every* instant ticket game offered.

Other states, such as Florida, Missouri, New Jersey, and Ohio, not only set but enforce sales minimums for lottery retailers. Ohio sends poorly performing retailers a notice that they must meet sales minimums within six weeks or lose their selling privileges. Florida revokes on-line machines from retailers who fail to meet minimums except for retailers in rural areas of the state, where customer accessibility may be an issue. Missouri and New Jersey are more reluctant to revoke the licenses of retailers who do not meet sales minimums. Instead, lottery sales representatives in these states work with poorly performing retailers to increase their sales to meet established minimums.

Lottery incurs costs for unproductive retailers—The Lottery needs to ensure that its retail outlets generate a minimum level of sales since it incurs several types of costs by allowing a retailer to operate. For example, it costs the Lottery $58 per month in phone charges, on average, to let a retailer operate an on-line ticket machine (actual costs vary according to location). Nonetheless, during the 10-week period prior to February 28, 1997, the average ticket sales of 35 on-line retailers did not even cover these phone costs.

The Lottery assumes additional costs from installing and operating on-line machines. However, the Lottery has not determined what these costs are and, therefore, does not know what the break-even amount is for operating an on-line retailer. Finally, the Lottery incurs additional costs associated with the delivery of instant tickets and promotional materials to lottery retailers. Almost all such deliveries are made in person by sales staff, thus costing the Lottery travel expenses and staff time.

In addition to direct costs, the Lottery may incur an opportunity cost in the future by allowing unproductive retailers to operate. The Lottery's current contract with its on-line machine supplier limits the number of on-line ticket machines available to 2,560, thus limiting the number of potential retail outlets. As a result, the Lottery will not be able to issue new licenses once the maximum number of outlets is reached. Thus, applicants with high sales potential or large chains with new locations could be denied licenses in the future unless unprofitable retailers' licenses are canceled.

Some other states charge their retailers fees to cover costs associated with allowing retailers to operate. For example, the Maryland Lottery requires retailers to pay for the on-line installation fee and a monthly administration fee of $90. The Idaho Lottery requires retailers to pay $50 monthly to cover on-line charges. Additionally, Florida and Ohio charge retailers weekly administration fees of $10 and $12, respectively. The Arizona Lottery could impose such fees if it determines what its break-even costs are for operating on-line retailers.

Unproductive retailers' licenses should be revoked—To ensure that resources are used efficiently, the Lottery should cancel licenses of retailers who fail to meet minimum sales requirements. However, when this audit ended, the Lottery had failed to take any such action.

Recommendations

1. The Lottery should better enforce its rule for revoking the licenses of retailers who continually have insufficient monies to pay for Lottery tickets they have sold.

2. The Lottery should attempt to collect the money retailers owe for tickets they have sold. The Lottery should do this by:

   - Sending out notices to retailers informing them that their licenses will be canceled if they fail to pay the amount owed;

   - Requesting the Department of Revenue to intercept tax refunds for individuals who own sole proprietorships or partnerships that owe money for tickets sold; and

   - Referring retailers who fail to pay their bills to collection agencies.

3. The Lottery should routinely conduct credit checks of retailers as part of its licensing process and develop guidelines to assist in determining the creditworthiness of applying retailers. Such guidelines could require that retailers deemed a high credit risk provide surety bonds or other guarantees of payment.

4. The Lottery should revoke the licenses of retailers who fail to meet minimum sales levels for on-line and instant ticket sales as required by its administrative rules.

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FINDING III

LOTTERY DOES NOT ADEQUATELY PROTECT CASH ON HAND AND OTHER STATE ASSETS

The Lottery can help prevent loss and theft of cash and assets by instituting and enforcing an adequate system of internal controls. Currently, the Lottery lacks a good system of internal controls, which increases the risk of fraud, waste, and abuse of state assets. Further, poor management practices contribute to a waste of state assets. The Lottery should correct several factors that contribute to poor internal controls.

Lottery Fails to Sufficiently Protect State Assets

The Lottery does not have adequate managerial and procedural controls to protect state revenues and assets against potential fraud, waste, or abuse. Specifically, the Lottery fails to protect cash, prizes, and inventory, which could result in loss or theft. Further, the Lottery uses poor management practices, including inadequate oversight of its advertising contract, which decreases its ability to operate efficiently.

Due to the high volume of Lottery activities involving cash and inventory, it is important that the Lottery maintain adequate internal controls. Internal controls are measures adopted within an organization to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. Without adequate internal controls, the likelihood of the Lottery losing cash, inventory, or other assets to fraud, waste, or abuse greatly increases.

Lottery fails to protect cash, prizes, and other inventory—The Lottery's current internal controls do not sufficiently protect cash, prizes, and promotional inventory. The lack of adequate internal controls could result in loss, theft, or inefficient use of these resources. A review of the Lottery's internal controls revealed the following weaknesses:

- **Cash on hand not protected**—The Lottery fails to adequately protect cash in its retail stores and vaults. The Lottery operates retail stores in both Phoenix and Tucson, which sell Lottery tickets and merchandise, validate winning tickets, and pay cash prizes over $600 by check. These retail stores' cash vaults contain excessive amounts of cash. For example, the retail stores only need a daily cash balance of approximately $10,000 to operate. However, the Phoenix vault had an average balance of $30,000 and Auditor General staff counted as much as $58,000 in the vault. Further, in the Tucson store, employees have unlimited access to cash drawers and the vaults during the day. The Tucson store does not maintain a log identifying which employees accessed the vault or the amount of each withdrawal or deposit. Although the Lottery has not discovered any loss or theft of cash, the Lottery could not readily determine if it did occur due to the lack of internal controls.

- **Lack of control over revolving fund**—The Lottery does not maintain adequate control over its revolving fund bank account. The Lottery maintains the revolving fund to make payments for postage, shipping, subscriptions, and miscellaneous expenses, and to replenish its petty cash fund. Although the revolving fund is maintained with an average balance of $30,000, a fund balance of $5,000 would be sufficient for Lottery needs. When Auditor General staff examined revolving fund expenditures for their appropriateness, supporting documents for 12 of 30 expenditures could not be located. In addition, the revolving fund has a balance discrepancy of approximately $4,600, which cannot be explained since supporting documentation has not been maintained.

- **Prizes and promotional items mismanaged—**The Lottery does not properly control and distribute its prizes and promotional items. As of December 1996, the Lottery had more than $200,000 in promotional items (shirts and hats) and approximately $150,000 in prizes in its warehouse. Prizes include $100 baseball bats and $200 autographed sports jerseys, which were part of a sports-themed Lottery game. Auditor General staff inventoried 10 types of promotional merchandise, such as shirts and hats, and found that none of the inventory counts agreed with the Lottery's records. Lottery inventory records either over- or under-counted seven of the ten types of promotional items, while three of the types of items inventoried were not even listed on the Lottery's records. Without accurate inventory control, the Lottery cannot plan for the effective use of its promotional items or detect any loss or theft problems. In addition, Lottery staff have inappropriately distributed game prizes to retailers and others as incentives or promotional items. For example, Lottery employees gave away more than $6,000 in prizes, such as autographed bats and baseballs, to individuals and companies who are unaffiliated with the Lottery or its retailers. These gifts violated A.R.S. §5-523 because they were purchased with monies designated for prizes. However, the Lottery is allowed to give promotional items, if it uses appropriate monies designated specifically for that purpose. When auditors informed Lottery officials of the specific provisions governing promotional items, the Lottery transferred monies from the promotions account to correct the problem.

- **No segregation of duties**—The Lottery does not properly segregate its employees' duties. Lottery employees who sell and redeem tickets are also responsible for reconciling monies contained in the cash vaults. These employees use the same cash drawer for all transactions and have unlimited access to both cash drawers and vaults during the day. In addition to physical security problems, one employee has inappropriate electronic security access on the Arizona Financial Information System (AFIS) to enter new vendor information and release payments for processing, which could lead to fraudulent activity. Further, the duties of receiving, issuing, accounting, and storing inventories are not segregated, which could lead to undetected loss.

- **Payroll not checked**—The Lottery does not have written internal policies and procedures to address the preparation and processing of payroll, journal entries, and transfers of cash between accounts. Calculations of employee wages and associated deductions are not periodically checked by either the payroll or internal audit departments. Although Auditor General staff discovered only a few minor problems with the Lottery's payroll, employee turnover and a lack of sufficient training may contribute to future payroll problems.

Lottery does not ensure its advertising money is effectively spent—The Lottery does not provide sufficient oversight of its advertising contract, even though it pays $8 million annually to a firm that acts as the principal advertising and marketing planner for all Lottery games. The Lottery does not have written policies and procedures for administering the contract and has never performed compliance reviews. By using written policies and procedures and compliance reviews, the Lottery can ensure that advertising charges are appropriately authorized and that contract obligations are consistently met.

Further, during August 1995, the contract was modified to allow the Lottery to pay for actual services provided plus a 10 percent markup instead of paying a flat 10 percent of its budget for contracted advertising. Although this amendment would have decreased the amount of compensation paid to the firm for the same services, the Lottery never enforced the amended terms. Additionally, the Lottery sometimes bases its payments on estimated charges instead of actual billing invoices. However, the Lottery has no authority to pay in advance or prior to receiving an invoice. Without actual invoices, the Lottery cannot determine if advertising spots it paid for were ever broadcast by media companies.

Finally, the Lottery's advertising contract language does not establish limits on the types or amounts of the advertising agency's travel costs that will be reimbursed. The contract also allows the firm to mark up administrative costs to which the agency has added no value, such as postage, telephone calls, and deliveries.

A 1995 special audit conducted by the Auditor General identified most of the problems with the Lottery's advertising contract discussed above. However, as of the end of this audit, the Lottery had still not resolved many of the outstanding issues identified with its advertising contract.

Lottery Should Correct Several Factors That Contribute to a Poor Internal Control Environment

To ensure state cash and assets are adequately safeguarded, the Lottery needs to improve its internal controls. **First**, the Lottery needs to ensure that effective internal control policies and procedures are developed for all functions and are distributed to all employees. **Second**, the Lottery needs to provide training so that employees can effectively perform their duties. **Third**, high turnover and job vacancies, which can adversely affect internal controls, should be addressed by the Lottery. In addition, the Lottery can use its internal audit staff to ensure compliance with policies and procedures and provide management with important decision-making information. Finally, the Lottery needs to better monitor its advertising contract. Although the Lottery has begun to improve its internal controls and business practices, more can be done.

***Lottery needs written policies and procedures*—**The Lottery needs written policies and procedures to guide its employees in the performance of their duties. Policies and procedures should clearly outline individual employees' specific authority and responsibility, thus establishing employee accountability. Policies and procedures also guide employees on the proper handling of less-frequently encountered transactions and situations. Further, a policies and procedures manual lessens the threat to continuity posed by employee turnover. Currently, the Lottery lacks written policies and procedures in several areas. In order to strengthen the internal control environment, the Lottery needs to ensure the following areas are addressed:

- Cash-handling procedures limiting access to cash drawers and vaults, as well as recording information related to the movement of cash within Lottery retail stores. Duties involving cash should be segregated, so that employees responsible for ticket sales and redemptions do not also reconcile cash accounts.

- Inventory procedures ensuring employees know how to record and process various items including tickets, prizes, and promotional items. Further, employees should recognize limitations placed on prize and promotional item giveaways. Planning and written policies and procedures could help the Lottery properly and effectively use promotional items and instant tickets so that resources are not wasted.

***Employee training needs to be increased*—**The Lottery needs to ensure that its employees are properly trained. Training, both formal and on-the-job, is essential to ensure employees are properly prepared to perform all aspects of their jobs. During the audit, several employees stated that they have received little or no training directly relating to the duties they are currently performing. Although the Lottery may hire individuals with the appropriate skills, employees' responsibilities have expanded beyond their areas of expertise.

***Turnover needs to be addressed*—**Several lower- and mid-level vacant positions have not been filled by the Lottery. Specifically, the Lottery has vacancies in several positions including computer programming manager, accounting supervisor, retailer promotions, warehouse operations, and retailer licensing investigators. Job vacancies such as these can increase the responsibilities of other employees, who may not have been adequately trained for them. Some Lottery managers stated that several job vacancies have limited the Lottery's ability to appropriately segregate its employees' duties. This situation decreases oversight of employees and increases the risk of loss or theft.

***Internal audits important*—**Lottery internal audits are inadequate due to their limited use. Internal audits help ensure that an agency is operating properly, and detect and reduce the risk of loss or theft. Further, internal audits could address the Lottery's internal control problems and provide management with more information for effective decision-making. Although the Lottery has an internal audit staff, internal auditors rarely review Lottery activities. Currently, internal auditors inventory instant tickets after the end of each Lottery game and perform limited reviews of contractor billings. However, internal auditors have never reviewed the Lottery's advertising contract, for example, to determine if the advertiser is following proper procurement practices. Finally, internal auditors should conduct follow-up reviews to ensure that problems identified are subsequently corrected.

***Lottery has begun implementing changes*—**In response to discussions with Auditor General staff, the Lottery has begun efforts to improve its internal control environment. For example, Lottery staff recently organized the warehouse, separating instant tickets from prizes and promotional items. One Lottery manager has been assigned direct responsibility for promotional items, which can be used as incentives for retailers. Although such a change is a step in the right direction, the Lottery should review all aspects of its internal control environment and continue implementing changes as needed.

Recommendations

1. The Lottery should improve internal controls to safeguard cash and inventories, and access to vaults should be limited. The Lottery should also ensure that fund and vault balances are not excessive.

2. The Lottery should review its management of the revolving fund, including more frequent reconciliations. Further, the revolving fund's balance should be consistent with the Lottery's actual needs.

3. The Lottery should emphasize job-specific and internal control training for all employees. Adequate oversight should be provided to ensure procedures are consistently followed.

4. The Lottery should ensure that adequate policies and procedures are developed regarding all aspects of internal controls, particularly those relating to cash-handling, inventory, and segregation of duties.

5. The Lottery's internal audit unit should conduct more audits, including adherence to policies and procedures, internal control compliance, and review of Lottery contracts and payments to vendors. The unit should give special attention to the Lottery's advertising contract, which involves millions of dollars each year and which has a history of problems and poor oversight.

FINDING IV

SIGNIFICANT WEAKNESSES EXIST IN LOTTERY COMPUTER SYSTEM

Significant weaknesses exist in the Lottery's computer system, which may compromise the system and adversely affect the Lottery's ability to operate. Weak computer access controls expose the Lottery to potential fraud. Further, the Lottery's computer system lacks critical elements that would ensure operations continue in the event of a disruption.

Background

The Lottery relies on electronic data processing for many operations. For example, retailers selling tickets for on-line games, such as Lotto and Powerball, scan players' number selections into a computer that transmits them by phone line to the Lottery's contractor and ultimately the Lottery's own computer. Information about player picks, as well as the total value of tickets sold, is used after the official drawing to determine the prize amount paid to each player who holds a ticket containing numbers matching the number drawn. The Lottery also uses computers for several other functions, including verifying winning tickets, calculating and collecting sales revenue from retailers, telemarketing, and accounting.

Lottery Computer System Lacks Adequate Security

Despite the importance of its computer system, the Lottery does not adequately protect the system from unauthorized access. Lack of adequate control over the computer system creates a high exposure to potential fraud and abuse by employees and outside parties. Several aspects of the Lottery's computer system contribute to the lack of adequate security, including:

- **Staff have inappropriate access**—Some computer operators have inappropriate access to the Lottery's computer system. These employees have the security administrator level of authority, which allows them to manipulate data and add or delete other computer users. Further, software connecting employees' computers to the Lottery's AS400 computer system contains a file transfer program, which allows employees to upload and download files regardless of access rights. Thus, employees with access to the AS400 computer system have the ability to make major alterations to Lottery data. Although a planned computer system upgrade will not include this program, the present system does not adequately protect some important data. Further, until recently, employees who were transferred or resigned could still access the computer system and alter or delete computer data and files. Computer users should have more limited access to the Lottery system, restricting them to data and information that is required for their duties. Only computer system management and administrators should have unlimited security administrator authority.

- **Access information is not documented**—The Lottery does not record employee access to its computer system. Although the Lottery has forms for recording computer access, as well as forms that employees sign indicating they will not divulge confidential information, neither form is currently used. Because these forms are not used, Lottery staff may not be aware that the information they are accessing is confidential.

- **Policies and procedures are inadequate**—The Lottery lacks written policies and procedures regarding its computer system. For example, software program instruction and problem-solving manuals have not been maintained since a new contractor took over in 1996. Further, Auditor General staff noted a general lack of policies and procedures regarding computer system basics, such as security, operations, and system failures. Due to this lack of documentation, Auditor General staff were unable to determine if losses have occurred as a result of inappropriate security on the Lottery's computer system.

- **No security administrator for computer system**—The Lottery's computer system, local area network, and financial management system security is not centralized into one security administrator position. This lack of centralized security can lead to security gaps that could allow unauthorized access to the computer systems.

Moreover, turnover in a key Lottery management position has contributed to inadequate Lottery computer security and has adversely affected long-term planning. Since 1982, the Lottery has had nine different Management Information Systems Directors, who have responsibility for computer system security, operations, coordination of resources among departments, and strategic planning. This lack of continuity prevents the Lottery from developing and implementing comprehensive strategic plans for the Lottery's computer systems and personnel. Lottery employees indicated that high management turnover has adversely affected long-term planning and has contributed to inadequate Lottery computer security.

Computer System Lacks Adequate Backup Capabilities and Disaster Recovery Planning

Although the Lottery relies heavily on electronic information, its computer system lacks adequate contingency elements, such as backup capabilities and disaster recovery planning, that would help it continue operations in the event of a system failure. **First**, the Lottery's computer system lacks capabilities for backing up critical electronic data. **Second**, although the Lottery has a disaster recovery plan, the plan has never been tested. **Finally**, the Lottery relies on a single data line, instead of obtaining a second line that would allow the Lottery to continue operations should the primary data line fail.

- **No backup processor**—Although a backup processor is required for participation in the multi-state Powerball game, the Lottery currently has only a single processor on its computer system. Should a disruption occur, the Lottery would be unable to continue operations, such as instant ticket validations and on-line game sales, for possibly days or even weeks, until the processor is repaired. Further, a disruption to the Arizona Lottery computer system would disable the entire Powerball game, adversely impacting 20 participating states and thousands of players. Should the computer system fail, Arizona could be subject to lawsuits from the multi-state association that oversees Powerball, other states, retailers, and individual players. Despite the importance of a backup processor, funding was not provided for one when the Lottery purchased and installed its computer system. To help address this problem, the fiscal year 1998-99 executive budget recommends $607,000 for a backup processor and improvements to protect ticket validations and the Lottery's business operations.

- **Disaster recovery plan untested**—Currently, the Lottery relies on an untested plan written by its contractor, which has never been updated by Lottery staff. Disaster recovery plans help ensure that business can continue in the event of a disastrous event such as a fire, a natural catastrophe like a flood, or acts of negligence, such as dropping a disk pack. Planning is necessary to ensure that adequate security measures and controls are maintained both during and following a computer disruption. However, the Lottery has never tested its plan or simulated a catastrophe that would disrupt Lottery operations. Further, there is no copy of the plan stored off-site, and several critical employees do not know the disaster recovery plan exists.

- **Data line lacks backup**—The Lottery uses a high-speed computer data line between its office and its contractor to transfer data and to validate instant tickets. Currently, the Lottery has only one-high speed data line to its contractor and if it fails, instant tickets could not be validated. A second high-speed data line would allow the Lottery to shut off the primary data line and easily continue operations. Lottery officials plan to add a second data line, which would cost approximately $450 to install and $400 per month to operate.

Recommendations

1. The Lottery should develop and distribute written policies and procedures regarding its computer system.

2. The Lottery should improve security on its computer system by:

    a. Reviewing access to the system to ensure employees' access rights are appropriate to the duties they perform;

    b. Ensuring that when upgraded, the AS400 computer system does not include software that gives all employees the ability to download, alter, and upload data regardless of user access rights; and

    c. Consolidating its computer system's security and administration into a single staff position.

3. The Lottery should enhance its computer system to address problems associated with disruptions by:

    a. Installing a backup, or redundant, processor on its computer system;

    b. Testing and revising the disaster recovery plan; and

    c. Installing a second high-speed data line between the Lottery and its contractor.

SUNSET FACTORS

In accordance with Arizona Revised Statutes (A.R.S.) §41-2354, the Legislature should consider the following 12 factors in determining whether the Arizona Lottery Commission should be continued or terminated.

1. The objective and purpose in establishing the Lottery.

The Arizona Lottery Commission was proposed by initiative petition and approved by voters in the November 1980 general election. The Lottery Commission's purpose is "to produce the maximum amount of net revenue consonant with the dignity of the state." The Lottery attempts to meet its mission by offering the public instant ticket games and on-line games.

2. The effectiveness with which the Lottery has met its objective and purpose and the efficiency with which it has operated.

Though it has not produced "the maximum amount of revenue" possible, the Lottery has generated almost $3 billion in revenue since it began operations in 1981, and contributed over $1 billion in net revenue to the State. Nonetheless, Lottery revenues fare poorly when compared to other states. In fiscal year 1996, the Lottery ranked 35th out of 38 state lotteries in per capita sales. While some factors affecting sales have been outside of the Lottery's control, reduced management turnover, better planning and promoting of games, more productive use of staff time, and a variety of innovative sales techniques could lead to higher sales (see Finding I, pages 7 through 16).

While the Lottery could improve its sales revenue, it has made strides in reducing its administrative costs over the years. As a result of an Auditor General recommendation from a 1987 performance audit (Auditor General Report 87-3), statute was changed, requiring the Lottery to spend no more than 18.5 percent of total revenues on administration, as opposed to the 25 percent limit that was previously allowed. The Lottery complied with the statutory change, and has maintained administrative expenses within the allowable limit.

3. The extent to which the Lottery has operated within the public interest.

Determining the extent to which the Lottery operates within the public interest depends on individual beliefs regarding public-sponsored gambling. Proponents argue that the Lottery has operated within the public interest by generating substantial net revenues that are apportioned to a variety of designated funds used for public services. However, critics maintain that the Lottery is a form of state-sponsored and state-advertised gambling. Such critics maintain that social costs associated with raising such revenue are unknown, and may in fact exceed the public benefit gained from lottery sales.

4. The extent to which rules and regulation promulgated by the Lottery are consistent with the legislative mandate.

According to the Governor's Regulatory Review Council, the Lottery's current rules are within the Lottery's broad statutory parameters. However, the Executive Director has not adopted one rule required by statute. No rule exists regarding the manner in which a licensed retailer displays a license, even though A.R.S. §5-512(G) requires such a rule.

In addition to this rule deficiency, two Lottery rules contain flaws regarding the number of days given for requesting review or rehearing. Currently, Lottery rules only give a person 10 days to file a written request of a Commission decision to revoke, suspend, or deny a retailer license. Similarly, Lottery rules only give "any party who is aggrieved by a decision of the Director concerning a contract claim or controversy" 10 days to file a written request for rehearing. In both cases, these rules are inconsistent with <u>Dioguardi v. Superior Court of Arizona</u>. The Court held that 15 days be provided for requesting a review or rehearing.

5. The extent to which the Lottery has encouraged input from the public before promulgating its rules and regulations and the extent to which it has informed the public as to its actions and their expected impact on the public.

The Commission has adequately encouraged input from the public before promulgating its rules and regulations. Proposed rules are summarized in the Administrative Register. Any proposed rule is placed on a regular Commission meeting agenda for consideration. Meeting notices are posted at the Lottery's offices in Phoenix and Tucson.

6. The extent to which the agency has been able to investigate and resolve complaints that are within its jurisdiction.

The Lottery is not a regulatory agency. Therefore, it does not receive formal complaints. However, the Lottery does receive and respond to a variety of informal complaints, such as complaints about lottery terminals from retailers.

7. The extent to which the Attorney General or any other applicable agency of state government has the authority to prosecute actions under enabling legislation.

A.R.S. §5-512.01 provides both the Attorney General and county attorneys concurrent prosecution authority for an offense arising out of or in connection with the formation, management, operation, or conduct of the State Lottery.

8. The extent to which the agency has addressed deficiencies in the enabling statutes which prevent it from fulfilling its statutory mandate.

In 1997, Lottery officials requested the introduction of legislation that they believed would allow the Lottery to operate more like a "business" and generate higher sales. The proposed legislation sought broad exemptions from state budgetary, rule-making, and personnel restrictions. Since only limited changes were enacted during the 1997 session, the Lottery Director plans to seek similarly broad legislative changes in the future. While some proposed statutory changes may be beneficial because they increase flexibility in Lottery operations, the Legislature should consider how such changes could benefit Lottery operations in light of this report and the possibility of abuse of public trust (see Sunset Factor 12, page 37, for further information).

Other statutory changes did occur during the 1997 legislative session. Among other provisions, Laws 1997, Chapter 1 increased the prize percentage amount that the Lottery can return to players, eliminated certain rule-making requirements, increased the commission rate paid to retailers, and exempted Lottery sales staff from state personnel rules.

One provision of Laws 1997, Chapter 1 increased the prize payout percentage of total revenues that the Lottery can return to players. Lottery officials believe that increasing this percentage will generate higher sales. However, the correlation between increased prize payout percentage and higher sales is unknown. In fact, seven of the Lottery's top ten performing instant ticket games over the past two years had lower percentages devoted to payout than the percentage requested by the Lottery. Additionally, one-third of states with higher per capita sales than Arizona have lower prize payout percentages than Arizona. If sales do not increase as a result of a higher prize payout, less monies will be generated for state programs since a higher percentage of sales will be distributed to players.

9. The extent to which changes are necessary in the laws of the agency to adequately comply with the factors listed in the sunset law.

Statutes outlining the distribution of Lottery fund proceeds need to be clarified. Current statutes are ambiguous as to whether net revenue from the Powerball game should be distributed to the General Fund only or should be lumped with other Lottery game revenues and distributed to different fund recipients.

The confusion exists due to two ambiguous statutory provisions. The first, A.R.S. §5-504(D), states that multi-state Lottery game monies (such as Powerball) "shall be accounted for separately as nearly as practicable in the lottery commission's general accounting system." The language "shall be accounted for separately" could be interpreted as a mere bookkeeping requirement. However, the Joint Legislative Budget Committee staff have interpreted it to mean that Powerball net revenue should go directly to the General Fund, while other Lottery revenue should be deposited to the State Lottery Fund, where it can subsequently be distributed to other state and local funds. Adding to the confusion, statute states that Lottery proceeds shall be deposited in the State Lottery Fund, yet the statute is silent regarding which fund should receive multi-state lottery game monies.

The Legislature should clarify language concerning the distribution of the Lottery's net revenues to ensure that distribution reflects legislative intent.

10. The extent to which the termination would significantly harm the public health, safety, or welfare.

Terminating the Lottery would not have a detrimental effect on the public health, safety, or welfare. However, terminating the Lottery would eliminate a significant amount of revenue made available to the State. The Arizona Lottery has generated an average of approximately $72 million annually for state programs since its inception.

11. The extent to which the level of regulation exercised by the agency is appropriate and whether less of more stringent levels of regulation would be appropriate.

The Lottery is not a regulatory agency. However, statute requires the Lottery to license lottery retailers, giving retailers the right to sell on-line and instant lottery tickets. Lottery licenses currently expire at the end of one year. Since 1991, the Lottery has issued licenses only to new retailers, and has not issued any renewal licenses to existing retailers. As a result, the vast majority of lottery retailer licenses are currently expired.

The Lottery is proposing changing its rules so that the retailer licenses are valid for two years. If implemented, two-year licenses would enable the Lottery to catch up and keep current with license renewals. Retailer licenses such as those granted by Wisconsin (three years) and Florida (four years) last for longer periods of time than proposed for Arizona. It is important to note that such license duration should not be indefinite, since functions tied to license renewal, such as criminal background and credit checks, are performed at the time a license is issued or reissued.

12. The extent to which the agency has used private contractors in their performance of its duties and how effective use of private contractors could be accomplished.

Current Contracts

The Arizona Lottery makes extensive use of private contractors in the performance of its duties. Private contractors provide instant game tickets; on-line game systems, services, and tickets; annuities to fund grand prizes; advertising; sponsorships; and promotional materials. Additionally, the Arizona Lottery is using a private contractor to develop its most recent request-for-proposal for an on-line game system. Private contractors also perform auditing and lobbying functions for the Lottery.

Considerations on Regarding Efforts to Privatize the Lottery

Some states have privatized their entire lotteries. States such as Connecticut, Georgia, Kentucky, Louisiana, and New Mexico have created "quasi-governmental" agencies, allowing these state lotteries to operate with no or limited budgetary oversight by the legislature. In many of these states, the lotteries are also exempt from state rule-making, personnel, and procurement restrictions. Lottery directors in these states report that such exemptions allow them to respond more quickly to changing market conditions, and operate more like revenue-generating businesses.

Though Arizona is prohibited by the Arizona Constitution from creating a "quasi-governmental" corporation, some of the alleged restrictions on operations could be modified through statutory change. The Lottery could become more like these quasi-governmental entities if statute freed the Lottery from budgetary, rule making, and personnel restrictions. If enacted, these statutory changes could allow the Lottery to respond more quickly to changing market conditions. For example, it could allow the Lottery to enact new on-line games more quickly, and to purchase new equipment, such as scanners for validating instant tickets.

While statutory changes may make it easier for the Lottery to operate more like a "business," it is also important for the State to maintain control and oversight mechanisms. Abuse of the public trust is possible. In both private and public state lotteries, scandals have occurred in recent years involving kickback schemes by contractors and nepotism. Scandal has also been associated with the Lottery's current on-line contractor, which provides 70 percent of the on-line services to lotteries worldwide. In October of 1996, the company's former national sales manager was convicted of orchestrating a kickback scheme using inflated payments to state-level political consultants. According to a November 11, 1996, *Fortune Magazine* article, this contractor is also under investigation by the Securities and Exchange Commission and federal prosecutors in Texas.

Agency Response

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PERFORMANCE AUDIT/SUNSET REVIEW RESPONSES

Finding I Recommendations:

Audit Statement: *The Lottery should update current on-line games like Lotto and Fantasy 5, instead of solely relying on new on-line games, in order to boost sales.*

Response: *The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented*.

- It has been public policy in recent years that the Lottery implement or change new and existing games very slowly. Recently the Lottery has been given the authority to make changes in the current games, i.e. Lotto, Fantasy 5.

- The Lottery will be making changes to Fantasy 5 this year and MUSL-mandated changes to Powerball take effect November 2, 1997. These changes are designed to create higher jackpots, attract additional players and increase play from current players. Research demonstrates players are resistant to major changes in Lotto; minimal modifications may be made later this year.

Audit Statement: *The Arizona Lottery should implement long-term planning to increase sales and evaluate actual Lottery performance.*

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented**.***

- In an effort to increase long range planning, the Marketing Department completed and distributed to all departments the 1998 Fiscal Year marketing plan in April. In addition, the new on-line contract will require the selected vendor to compile a five year long range plan that will set forth goals to increase sales and measure effectiveness. A rough draft of this plan should be completed by February 1, 1998.

Audit Statement: *The Lottery should consider better utilizing sales staff, including finding ways to better handle ticket delivery and the Americans with Disabilities Act compliance issues, which would allow sales staff more time to increase sales**.***

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented**.***

- Past Lottery Directors have been reluctant to staff sales representative positions at a level that would better support an increasing retailer base and an ever-growing complement of game products. The responsibility of implementing and monitoring retailer compliance with the American with Disabilities Act (ADA) has limited the sales staff effectiveness. Most lotteries assign each rep 50 to 60 retailers; our staff must serve 90 to 160 retailer locations.

Finding I Recommendations (continued):

- Current management has committed to implementing courier delivery service for retailer distribution of Instant game tickets in the near future. This will enable the sales representatives to use their time on other activities that will promote additional product sales in their assigned retailers.

Audit Statement: *The Lottery should consider utilizing innovative practices proven to increase sales, such as adding games to its current game mix; shortening the time specific games are offered; using direct mail, co-promotions, and in-store advertising materials; introducing multiple priced games; and redesigning prize payout structures so that there are more lower-tier winners and repeat players.*

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- Many of the suggestions detailed in the Auditor General's findings have already been recognized by Lottery staff:
- The Lottery has introduced Arizona Bingo, a new on-line game. An additional on-line game and pull-tabs may be added to refresh the current game mix. In the private sector, new ideas can be implemented on an aggressive schedule. Because each Arizona citizen is a stakeholder in our 'business' we must address a wide variance of supporters and detractors with every attempt to broaden our market. This lengthens the process, and our ability to respond quickly.
- Scratcher tickets are now being marketed with a strategy that offers more games (with wider appeal) to our customers for a shorter play time. Keeping the product mix entertaining is a key element for increased Scratcher sales.
- Scratcher and on-line games will benefit from multiple-pricing levels, with $2 and $3 tickets added as alternatives to $1 games. The Scratcher prize payout percentage has gone from 50% to an average of 60%, and increased the number of low-tier winners.
- Direct marketing to players is an option many lotteries employ. Marketing staff are researching the effectiveness of this in other states. A program tailored to Arizona players may be introduced if the effectiveness can be proven.
- Co-promotions with retailers were tested in March 1997. The success of these programs, with the resulting increased awareness, ensures that similar programs will be implemented in the future. Promotion samples are available upon request.
- The retailer incentive program now being developed includes an aggressive in-store advertising plan. Participating retailers will be required to post additional point-of-sale (POS) advertising materials as part of the program.

Finding I Recommendations (continued):

Audit Statement: *The Lottery should consider obtaining additional ITVMs through lease or purchase, and acquire other technologically advanced equipment.*

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- Self-service vending machines (ITVM) were budgeted and installed in December, 1993. In the first year, additional units brought the total to 221 installed in high volume customer locations. These units are designed for supplemental sales, especially in supermarket locations that have high on-line, but much lower instant ticket sales. In locations with more than one entrance and multiple checkout areas, the units provide a way for the player to purchase a wider variety of instant tickets without a lengthy wait in line. Winning tickets must be redeemed at customer service counters where additional ticket dispensers are located; customers can purchase more tickets with their winnings without returning to the ITVM.

  The Marketing division has requested additional ITVMs as part of the annual legislative budget process for the past three years without success.

  The new on-line contract calls for a total of 600 new 12-bin ITVMs starting January 1, 1998.

  The Lottery is now implementing in-counter ticket dispensers at selected locations. Retailers with sufficient counter space may request the dispensers, which offer a way to effectively display more instant games.

Audit Statement: *The Lottery should monitor the effect of a recent change in its retailer incentive program and be prepared to propose a restructured incentive program to the Legislature if the current plan does not help to increase sales within two years.*

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- The planned incentive program will be monitored on a regular basis to ensure retailer compliance. Quarterly reviews will be used as a tool to help the retailer meet or exceed sales quotas. During the first year, adjustments may be made to the program to better meet the needs of the retailers.

Audit Statement: *The Lottery should better enforce its rule for revoking the license of retailers who continually have insufficient monies to pay for Lottery tickets they have sold.*

Finding II Recommendations:

Audit Statement: *The Lottery should attempt to collect the money retailers owe for tickets they have sold. The Lottery should do this by:*

a. Sending out notices to retailers informing them that their licenses will be canceled if they fail to pay the amount owed;

b. Requesting the Department of Revenue to intercept tax refunds for individuals who own sole proprietorships that owe money for tickets sold; and

c. Referring retailer who fail to pay their bills to collection agencies.

Audit Statement: *The Lottery should routinely conduct credit checks of retailers as part of its licensing process and develop guidelines to assist in determining the creditworthiness of applying retailers. Such guidelines could require that retailers deemed a high credit risk provide surety bonds or other guarantees of payment.*

Audit Statement: *The Lottery should revoke the licenses of retailers who fail to meet minimum sales levels for on-line and instant ticket sales as required by its administrative rules.*

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- As a public agency, the Lottery is governed by procedures and entities that can contrast with normally accepted private sector business practices. This conflict is most evident in the Lotteries relationship with its retailer network. The partnership has been strained by attempts to recoup operating expenses by increasingretailer costs or impacting their revenue. At the same time, the Lottery has a fiduciary responsibility to the state that dictates many of our business practices. Therefore, it is within this context that the findings outlined by the Auditor General should be viewed.

  As the Auditor General noted, the Lottery has not been successful in collecting past due amounts from some retailers. Much of the problem has been out of the Lottery's direct control. In FY 1995, the Lottery's total sales were $258.8 million for the year. At the end of 1995, total monies not collected from retailers were$199,000. This represented less than 1/10 of 1% of total sales for that year.

  In FY 1996, the situation dramatically worsened because the new on-line vendor, AWI, was unable to invoice for Scratcher sales from November 1, 1995 through February 3, 1996. Scratcher sales for the period were estimated to be $30 million. The Lottery could not document the total due to many retailers' satisfaction, and uncollected monies in FY 1996 soared to almost $700,000. AWI's failure to provide a functional system put tremendous pressure on an already overburdened

Finding II Recommendations (continued):

Accounting Division, which an earlier audit by Deloitte-Touche identified as being understaffed. The Lottery's partnership with retailers was severely strained; political and public pressure thwarted attempts to continue the collection process.

In March 1997 the Lottery resumed the effort to collect past due amounts. Licenses have been suspended or revoked for non-responsive retailers, and $214,000 has already been collected. In April the Lottery enrolled in the Department of Revenue's debt setoff program, intercepting tax refunds from individual retailers. Although this does not apply to corporations or limited-liability retailers, sole proprietors and partnerships refunds can be intercepted.

A full time collections position has been created in the Accounting Division. The Security Division has implemented guidelines to determine a retailer's credit worthiness, and a surety bond requirement for high-risk retailers. These steps give the Lottery a stronger position in limiting uncollectible amounts in the future.

- A second concern of the Auditor General is the Lottery's reluctance to enforce minimum sales requirements. Since the Lottery's inception in 1981, retailers have resisted the idea of minimum requirements. Their logic is based on several issues:

1. Small 'mom and pop' stores can't match chain resources--or the resulting sales; thus the requirement is not fair.

2. Location, especially in sparsely-populated rural locations, may limit sales. Removing the retailer location based solely on minimum sales may eliminate the area's only location for Lottery products.

3. Chain stores should be treated as a single entity, with sales averaged across the chain to ensure all locations meet the minimum.

Because requirements have not been enforced in the past, retailers assume they never will be. Chain stores, which account for 80% of our sales, are adamant in their desire to advertise Lottery products at all their locations--not just the ones meeting minimum requirements. The reaction to enforcing this policy will be vocal; the Lottery anticipates considerable political and public pressure as a result.

Audit Statement: *The Lottery should improve internal controls to safeguard cash on hand and inventories, and access to vaults should be limited. The Lottery should also ensure that fund and vault balances are not excessive.*

Audit Statement: *The Lottery should review its management of the revolving fund, including more frequent reconciliations. Further, the revolving funds balance should be consistent with the Lottery's actual needs.*

Finding III Recommendations:

Audit Statement: *The Lottery should emphasize job-specific and internal control training for all employees. Adequate oversight should be provided to ensure procedures are consistently followed.*

Audit Statement: *The Lottery should ensure that adequate policies and procedures are developed regarding all aspects of internal controls, particularly those relating to cash-handling, inventory, and segregation of duties.*

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

- The Lottery agrees that its internal controls can be improved. Since January, the Lottery has been developing policies and working with staff to correct all the deficiencies noted in the Auditor General's report. The Lottery requested that the General Accounting Office perform a financial audit of the Lottery last January in order to properly address financial internal controls.

- When the Auditor General cites that cash is not protected, it is referring to one store located at the Lottery's headquarters in Tucson. The report gives the impression that a "high volume" of the Lottery's cash is unprotected, and this is not true. That store holds an average balance of $20,000. The Auditor General did not cite any problems with the Phoenix store. Overall, the Lottery has cash over $20 million, in addition to the small amounts in the two stores, that it is managing well.

  More importantly, the Lottery disagrees that the cash is left unprotected. Alltransactions must be recorded in a vault log book. The vault is on day lock during operating hours, where only the supervisor, or the assistant when the supervisor is absent, has the key. All employees must sign the log book when using the key.

- The Lottery respectfully disagrees that there is a lack of control over the revolving fund. To access the revolving fund, a purchase request must be completed, stating the reason for the expenditure, requiring the signature of a supervisor and the division's Director. The revolving fund custodian reviews and approves the request. If the request is approved, the custodian normally informs the Director of Administration of the expenditure. If the request is above $250, the Lottery requires two signatures on the check before it is released. Finally, the Auditor General was aware of the $4,600 balance discrepancy because the Lottery reported it as a reconciling item in our FY 1996 reconciliation. The shortage was due to an accumulation of unreimbursed expenses dating back to FY 1992. The Lottery is following the GAO audit recommendation that the Lottery prepare a letter to GAO and request reimbursement for the unreconciled amount.

- The Lottery acknowledges improvement is needed in the segregation of duties for its Lottery store employees. However, it is difficult to limit access of a cash drawer

Finding III Recommendations (continued):

(the store has two) to one employee. To reconcile the cash drawer, cash, ticket sales and prize redemptions must be balanced. The Lottery store has two terminals and two ticket dispenser bins. It is logistically not practical for each employee to have a separate on-line terminal and a set of scratcher tickets (minimum of 12 games) at their disposal. Employees must be relieved for lunches, breaks, etc., and it is not feasible to stop business and reconcile while customers are waiting. We do, however, limit the number of employees working the counter to the same two persons all day, except for lunches and breaks. For security purposes, the Phoenix store has two video cameras. One is positioned to monitor the cash drawers and one to monitor employees and customers at the window.

Vault cash reconciliation is done quarterly by Internal Audit, and sometimes weekly by the Lottery store supervisor. The set up of the daily cash drawer is done by the assistant.

- The Auditor General referenced that access to AFIS to enter new vendor information and release payments for processing could lead to fraudulent activity. However, according to AFIS Security, the only restriction is that employees may not input vendor information, release claims and pick up warrants. We are in this compliance with this requirement. However, one employee as referred to by the Auditor General, does receive the warrants after pickup. The Lottery will change this procedure immediately. The Lottery plans to further separate these duties as recommended when we are fully staffed.

- The Lottery respectfully disagrees that payroll is not checked. The Lottery has a written manual detailing payroll procedures. All Lottery calculations are checked by the Accounting Manager. Internal Audit checks the payroll for every final payoff and conducts quarterly audits. However, as an extra precaution, payroll staff will periodically check calculations of employee wages done by DOA personnel using a random sample.

Response: *The Lottery agrees to improve its internal controls for the Lottery store and promotional inventories. Whereas the Lottery does not believe the vault cash on hand is excessive, we will review the balance and reduce it accordingly.*

- The Lottery will reduce its revolving fund balance to $10,000 but will maintain its authorization at $30,000 to cover emergencies.

- The Lottery will improve its internal control for all employees by providing more training and oversight to employees.

- The Lottery will review and update its manuals relating to internal controls, inventory and segregation of duties.

Finding III Recommendations (continued*):*

Audit Statement: *The Lottery's internal audit unit should conduct more audits, including adherence to policies and procedures, internal control compliance, and review of Lottery contracts and payments to vendors. The unit should give special attention to the Lottery's advertising contract, which involves millions of dollars each year and which has a history of problems and poor oversight.*

Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

- In February of 1996, the Lottery implemented a revised audit plan which includes a monthly audit of the advertising contract and invoices received from the advertising agency. Due to past staffing problems, the Lottery was never able to fully adhere to internal control compliance. We have since hired an Audit Manager to ensure compliance that is recommended by the Auditor General.

Additional Comments

Prizes and promotional items mismanaged. In the past, the Lottery inventory systems have lacked adequate supervision. Steps have been implemented to ensure proper controls of prizes and promotional items. This includes monthly inventory reports, a sign out sheet, as well as a new limited access locked promotional cage. We feel that these safeguards will ensure proper control over prize and promotional item distribution.

Finding IV Recommendations:

Audit Statement: *The Lottery should develop and distribute written policies and procedures regarding its computer system.*

Response: *The finding of the Auditor General is agreed to and the audit recommendation will be implemented*.

- The Lottery will publish existing policies and procedures for users. Training sessions for appropriate use of the system will be incorporated into the new system migration scheduled for mid-1998.

Audit Statement: *The Lottery should improve security on its computer system by:*

a. Reviewing access to the system to ensure employees' access rights are appropriate to the duties they perform;

Response*:* *The finding of the Auditor General is agreed to and the audit recommendation will be implemented.*

MIS staff will review access for current employees, and determine appropriate levels for new employees.

b. Removing software from its applications package, which gives all employees the ability to download, alter, and upload data regardless of user access rights; and

Response: *The finding of the Auditor General is not agreed to and the recommendation will not be implemented****.***

- All employees do not have the ability to perform these functions; security at the file level severely limits the potential for data manipulation. As the new application version is installed, the option to transfer files will not be routinely installed. The ability does not exist at the current version level.

c. Consolidating its computer systems' security and administration into a single staff position.

Response*:* *The finding of the Auditor General is agreed to and a different method of dealing with the finding will be implemented.*

- Current staffing levels do not permit this solution. MIS will attempt to restrict high-level functions to a limited number of staff; we will involve internal audit in developing an oversight process for these functions.

Finding IV Recommendations (continued):

PERFORMANCE AUDIT/SUNSET REVIEW RESPONSES

Audit Statement: *The Lottery should enhance its computer system to address problems associated with disruptions by:*

a. Installing a backup, or redundant, processor on its computer system;

b. Testing and revising the disaster recovery plan; and

c. Installing a second high-speed data line between the Lottery and its contractor.

Response: *The findings of the Auditor General are agreed to and the audit recommendation will be implemented.*

- A separate, redundant system has been purchased and should be installed by year end.

- A comprehensive disaster recovery plan will be developed once the redundant system is installed. Routine testing will be an element of the plan.

- A second ISDN line will be supplied by the Lottery's new contractor in mid-1998.

PERFORMANCE AUDIT/SUNSET REVIEW RESPONSES

Sunset Factors:

Audit General Finding 4. *The extent to which rules and regulations promulgated by the Lottery are consistent with the Legislative mandate.*

Response*: The finding of the Auditor General is not agreed to but the recommendation will be implemented.*

The Lottery does in fact have written procedures for the Setoff program. The form for agency participation in the program is a part of the procedures.

The license requirement is a part of the Retailer rules. They have not yet been adopted. A.R.S. 5-512(G) states *A licensed agent shall display his license or a copy of the license conspicuously in accordance with the rules prescribed by the director.* The Lottery determined that this statute was sufficiently clear such that no rule was needed to inform the licensee of the required action. Because the reference to rules is unnecessary, the Lottery intends to delete "in accordance with the rules prescribed by the director" from this statute during the upcoming legislative session as part of technical amendments to the Lottery statutes.

With the passage of A.R.S. 41-1092 et seq. (Creating the Office of Administrative Hearings and prescribing procedures for administrative hearings), the Lottery's rules concerning administrative hearings became void. Since statutes take precedence over rules, 41-1092 and not the Lottery rules, governs the administrative hearing process. The Lottery's revised retailer rules incorporate 41-1092 and therefore fully comply with all current case laws and statutes. The revised rules are in the final process of being enacted.