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An Audit Report on

# **Lotto Texas Activities at the Texas Lottery Commission**

July 2006

Report No. 06-046



An Audit Report on

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## Overall Conclusion

The Texas Lottery Commission (Agency) has not always accurately advertised Lotto Texas jackpot amounts. The failure to accurately advertise Lotto Texas jackpot amounts may contribute to a lack of public confidence in the Lotto Texas game and the Texas Lottery Commission.

The State Auditor's Office identified seven instances in which the Agency advertised Lotto Texas jackpot amounts that exceeded estimated sales. In these instances, the advertised Lotto Texas jackpot amounts exceeded estimated sales by a total of approximately \$4.4 million. In two other instances, the Agency did not have documentation enabling us to determine whether advertised Lotto Texas jackpot amounts exceeded estimated sales. Specifically:

- We verified Agency management's assertion that there were four instances between May 4, 2003, and June 11, 2005, in which advertised Lotto Texas jackpot amounts exceeded estimated sales.
- We cannot determine whether advertised Lotto Texas jackpot amounts exceeded estimated sales for two other Lotto Texas drawings between May 4, 2003, and June 11, 2005. We cannot make this determination because the Agency did not prepare an estimate for one drawing associated with a holiday, and its original approved jackpot estimation worksheet for the other drawing is missing.

Instances in Which Advertised Lotto Texas Jackpot Amounts Exceeded Sales Estimates (Between May 4, 2003, and March 31, 2006) <sup>a</sup>		
Drawing Date	Advertised Jackpot Amount	High-End Estimated Lotto Texas Sales
November 3, 2004	\$ 8,000,000	\$ 7,220,457
February 12, 2005	\$ 8,000,000	\$ 7,687,688
June 8, 2005	\$ 8,000,000	\$ 6,592,226
June 11, 2005	\$ 8,000,000	\$ 7,976,543
February 25, 2006 <sup>b</sup>	\$ 8,000,000	\$ 6,910,140
March 1, 2006 <sup>b</sup>	\$ 9,000,000	\$ 8,214,836
March 4, 2006 <sup>b</sup>	\$10,000,000	\$ 9,921,297
Sales estimate information was unavailable for the following drawings:		
June 9, 2004	\$87,000,000	(unknown)
December 1, 2004	\$20,000,000	(unknown)
<sup>a</sup> Our analysis focused on Lotto Texas drawings for which there were five or more "rolls." There were 232 such drawings during this time period. <sup>b</sup> For these drawings, the Texas Administrative Code required that, for all drawings, the jackpot prize amount actually paid to winners must be the higher of the advertised jackpot amount or a percentage of actual sales.		

The Texas Lottery Commission directed the Agency to increase estimated jackpot amounts by at least \$1 million for each drawing to increase sales. This directive was made because, according to the Agency and members of the Texas Lottery Commission, ticket sales are partially driven by advertised jackpot amounts. In November 2005, the Commission also amended the Texas Administrative Code to require that, for all winning drawings, the jackpot prize amount actually paid to winners must be the higher of the advertised jackpot amount or a percentage of actual sales.

We identified three additional instances in which advertised Lotto Texas jackpot amounts exceeded estimated sales after the Commission adopted the above changes. In each instance, Agency management and the members of the Texas Lottery Commission were aware that advertised amounts had exceeded estimated sales.

Advertising Lotto Texas jackpot amounts that are within estimates of sales helps to ensure that jackpot amounts that must be paid are supported by actual sales. If the amount of a jackpot the Agency is required to pay exceeds actual sales, the Agency would be required to pay the jackpot using proceeds from other sources (including the General Revenue dedicated Lottery Account), and the amount transferred to the Foundation School Fund could be reduced.

**Agency management does not adequately fulfill its role in addressing and/or complying with processes that are significant to promoting accountability.**

Auditors identified several issues that indicate Agency management does not adequately fulfill its role. Specifically:

- Auditors identified a significant number of instances in which Agency management did not comply with policies and procedures to review or approve documentation related to jackpot estimations, jackpot prize payment calculations, and transfers to the Foundation School Fund. We did not identify any errors made by Agency staff performing these functions, and Agency management has made improvements in these areas. Consistent management reviews and approvals are critical to ensuring that Agency management enforces policies and procedures and that correct amounts are distributed to all required parties.
- The Agency could not substantiate the effective dates of policies and procedures in areas such as jackpot estimations, jackpot prize payment calculations, and Foundation School Fund transfers. Verifying the effective dates of policies and

#### Key Observations

- The Texas Lottery Commission has not always accurately advertised Lotto Texas jackpot amounts.
- Agency management did not consistently comply with policies and procedures to review or approve documentation related to jackpot estimations, jackpot prize payment calculations, and transfers to the Foundation School Fund.
- The Agency could not substantiate the effective dates of policies and procedures in areas such as jackpot estimations, jackpot prize payment calculations, and Foundation School Fund transfers.
- The Agency accurately calculates and pays Lotto Texas jackpot prizes and transfers funds to the Foundation School Fund.

procedures helps ensure that staff (1) understand the processes it is responsible for and (2) comply with policies and procedures. Agency management recently adopted a policy related to the preparation and implementation of new policies and recognizes that further revision of this policy is necessary to clarify effective dates.

- The Agency does not appropriately oversee and monitor transactions that are created when a ticket does not print at a retailer (for example, because of a power outage), but the numbers selected for that ticket are still recorded in the contracted lottery operator's central computer system (these transactions are referred to as incomplete transactions). Although incomplete transactions are rarely created and none was associated with a high-tier (\$600 or more) or jackpot prize during our test period, we identified issues with the Agency's oversight and monitoring of these transactions. Inadequate oversight and monitoring increases the risk that the Agency could erroneously conclude that there had been a game winner and transfer the associated prize to "unclaimed prizes" instead of putting the prize back into the jackpot for the next drawing. This could diminish the public's confidence in the integrity of online games. It could also affect sales because, according to the Agency and members of the Texas Lottery Commission, ticket sales are partially driven by jackpot amounts.

**The Agency accurately calculates and pays Lotto Texas jackpot prizes and transfers funds to the Foundation School Fund.**

After a Lotto Texas jackpot prize winner is identified, the Agency accurately calculates and pays Lotto Texas jackpot prizes in accordance with rules, policies, and procedures. In addition, the Agency accurately calculates and transfers proceeds from all games to the Foundation School Fund in accordance with Texas Government Code, Section 466.355.

## ***Selected Recommendations***

The Agency should:

- Publish proposed policies that affect Lotto Texas players in the *Texas Register* and on its Web site. It should then present these proposed policies to the Texas Lottery Commission at public Commission meetings and request that the Commission publicly approve the policies. After these policies are approved, the Agency should make them available to the public by publishing them in the *Texas Register* and on its Web site.
- Document (1) the effective date of all policies and procedures and (2) which policies and procedures are being replaced or revised by new policies and procedures. The Agency should also establish a formal, documented process to communicate revised or new policies and procedures and their effective dates to staff.

- Comply with policies and procedures and ensure that all required approvals are obtained and documented for jackpot estimations, jackpot prize payment calculations, and transfers to the Foundation School Fund. The Agency should obtain written and signed approval from the Executive Director for any exceptions to policies and procedures.
- Provide all final and approved jackpot estimation worksheets to the Legislative Budget Board and the Governor's Office and continue to publish all jackpot estimation worksheets on its Web site.

### ***Summary of Management's Response***

The Agency fully agrees with our recommendations.

### ***Summary of Information Technology Review***

The Agency does not always ensure that access to certain automated administration systems is limited to only those individuals who require access. This increases the risk that critical information could be accidentally or intentionally altered. Although no evidence of alteration was identified during our audit, auditors identified access weaknesses for certain Microsoft Excel spreadsheets, the Agency's internal accounting system, and the system it uses to maintain information on Lotto Texas prize winners.

Although auditors identified the access issues described above, the Agency has properly established security and access rights to the Uniform Statewide Accounting System (USAS) and the Automated Clearing House system it uses to make direct deposits of prize amounts.

### ***Summary of Objective, Scope, and Methodology***

The audit objective was to determine whether selected Lotto Texas activities are conducted in accordance with rules and policies and procedures, including determining whether:

- All instances in which advertised jackpot amounts exceeded estimated sales amounts have been identified.
- Prize payments were calculated and paid in accordance with rules and policies and procedures.
- Amounts transferred to the Foundation School Fund were calculated accurately and in accordance with Texas Government Code, Section 466.355.

An additional objective was to follow up on audit findings related to the Lotto Texas prize reserve fund included in *An Audit Report on Management Controls at the Texas Lottery Commission* (State Auditor's Office Report No. 97-092, August 1997).

The audit scope covered (1) jackpot estimation worksheets prepared between May 4, 2003, and March 31, 2006; (2) jackpot prize payments calculated and paid between July 1, 1997, and February 8, 2006; (3) transfers to the Foundation School Fund made for the time period from September 1, 1997, through December 31, 2005; and (4) incomplete transactions that occurred between January 1, 2005, and March 31, 2006.

The audit methodology included interviewing Texas Lottery Commissioners and Agency management and staff, reviewing jackpot estimation worksheets, recalculating jackpot prize payments, recalculating Foundation School Fund transfers, and reviewing the contracted lottery operator's process for identifying incomplete transactions.

*An Audit Report on  
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SAO Report No. 06-046*

Recent SAO Work		
Number	Product Name	Release Date
06-047	An Audit Report on Workforce Management at the Texas Lottery Commission	July 2006
06-035	An Audit Report on Security at the Texas Lottery Commission	May 2006
06-017	A Report on an Audit of the Texas Lottery Commission's Annual Financial Report for the Fiscal year Ended August 31, 2005	December 2005
05-041	A Special Investigations Unit Report Regarding the Texas Lottery Commission	July 2005
04-046	An Audit Report on Selected Controls Over Instant Tickets at the Texas Lottery Commission	August 2004

# Contents

## *Detailed Results*

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Chapter 1	
The Texas Lottery Commission Has Not Always Accurately Advertised Lotto Texas Jackpot Amounts .....	1
Chapter 2	
Agency Management Did Not Consistently Comply With Policies and Procedures for Review and Approval of Lotto Texas Jackpot Estimates .....	4
Chapter 3	
Agency Management Could Not Substantiate the Effective Dates of Policies and Procedures .....	7
Chapter 4	
After a Lotto Texas Jackpot Prize Winner is Identified, the Agency Accurately Calculates and Pays Lotto Texas Jackpot Prizes in Accordance with Rules, Policies, and Procedures.....	9
Chapter 5	
The Agency Accurately Calculates and Transfers Proceeds from All Games to the Foundation School Fund in Accordance with Statute .....	11
Chapter 6	
The Agency Does Not Appropriately Oversee and Monitor Incomplete Online Game Ticket Transactions That Are Recorded in the Lottery Operator’s Computer System.....	14
Chapter 7	
The Agency Does Not Always Ensure that Access to Certain Administrative Systems is Limited to the Appropriate Individuals.....	17

## *Appendix*

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Objective, Scope, and Methodology.....	18
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# Detailed Results

Chapter 1

## The Texas Lottery Commission Has Not Always Accurately Advertised Lotto Texas Jackpot Amounts

The State Auditor's Office identified nine instances in which the Texas Lottery Commission (Agency) either (1) advertised Lotto Texas jackpot amounts that exceeded estimated sales or (2) did not have documentation enabling us to determine whether advertised Lotto Texas jackpot amounts exceeded estimated sales. The advertised Lotto Texas jackpot amounts exceeded estimated sales by a total of approximately \$4.4 million (see Table 1).

Table 1

Instances in Which Advertised Lotto Texas Jackpot Amounts Exceeded Sales Estimates (Between May 4, 2003, and March 31, 2006) <sup>a</sup>			
Drawing Date	Advertised Jackpot Amount	High-End Estimated Lotto Texas Sales	Difference Between Advertised and Estimated Amounts
November 3, 2004	\$ 8,000,000	\$ 7,220,457	\$ 779,543
February 12, 2005	\$ 8,000,000	\$ 7,687,688	312,312
June 8, 2005	\$ 8,000,000	\$ 6,592,226	1,407,774
June 11, 2005	\$ 8,000,000	\$ 7,976,543	23,457
February 25, 2006 <sup>b</sup>	\$ 8,000,000	\$ 6,910,140	1,089,860
March 1, 2006 <sup>b</sup>	\$ 9,000,000	\$ 8,214,836	785,164
March 4, 2006 <sup>b</sup>	\$10,000,000	\$ 9,921,297	78,703
<b>Total</b>			<b>\$4,476,813</b>
Sales estimate information was unavailable for the following drawings:			
June 9, 2004	\$87,000,000	(unknown)	(unknown)
December 1, 2004	\$20,000,000	(unknown)	(unknown)
<sup>a</sup> Our analysis focused on Lotto Texas drawings for which there were five or more "rolls." There were 232 such drawings during this time period. <sup>b</sup> For these drawings, the Texas Administrative Code required that, for all drawings, the jackpot prize amount actually paid to winners must be the higher of the advertised jackpot amount or a percentage of actual sales.			

Advertising Lotto Texas jackpot amounts that are within *estimates* of sales helps to ensure that jackpot amounts that must be paid are supported by *actual* sales. If the amount of a jackpot the Agency is required to pay exceeds actual sales, the Agency would be required to pay the jackpot using proceeds from

other sources (including the General Revenue dedicated Lottery Account), and the amount transferred to the Foundation School Fund could be reduced.

The failure to accurately advertise Lotto Texas jackpot amounts may contribute to a lack of public confidence in the Lotto Texas game and the Texas Lottery Commission.

Agency management previously asserted there were four instances between May 4, 2003, and June 11, 2005, in which advertised Lotto Texas jackpot amounts exceeded estimated sales.

Based on available information, auditors verified Agency management's assertion that there were four instances in which advertised jackpot amounts exceeded estimated "high-end" sales during the time period from May 4, 2003, through June 11, 2005.

The State Auditor's Office cannot determine whether advertised Lotto Texas jackpot amounts exceeded estimated sales for two other Lotto Texas drawings between May 4, 2003, and June 11, 2005.

We cannot make this determination because the Agency did not prepare an estimate for one drawing associated with a holiday<sup>1</sup>, and its original approved jackpot estimation worksheet for the other drawing is missing. These two drawings occurred during the same time period as the four instances described above.

The State Auditor's Office identified three additional instances in which advertised Lotto Texas jackpot amounts exceeded estimated sales between June 12, 2005, and March 31, 2006.

Between June 12, 2005, and March 31, 2006, there were three instances in which advertised jackpots exceeded the Agency's "high-end" estimated sales. In each instance, Agency management and the members of the Texas Lottery Commission were aware that advertised amounts had exceeded estimated sales.

These three instances occurred after Commissioners had changed the Texas Administrative Code to require that, for all winning drawings, the jackpot prize amount actually paid to winners must be the higher of either (1) the advertised jackpot amount or (2) a percentage of actual sales. Commissioners made this change to the Texas Administrative Code in November 2005.

During a Texas Lottery Commission Meeting in October 2005, Agency staff presented information that showed Lotto Texas ticket sales increase at a

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<sup>1</sup> The Agency typically prepares estimates on Wednesdays and Fridays. In this instance, the estimation worksheet prepared on the Wednesday before Thanksgiving included a note that said the advertised jackpot amount will roll to \$20 million if there is no winner for the next drawing. The Agency did not prepare a jackpot estimate for the Friday after Thanksgiving. Policies and procedures do not address this situation.

greater rate when the jackpot increases by at least \$1 million between drawings. At that meeting, the members of the Commission decided to increase advertised jackpots in increments of \$1 million, regardless of whether Lotto Texas ticket sales supported such an increase.

Although Agency management implemented the Commission's decision, it did not update policies and procedures to reflect this change. Since September 2005, policies and procedures have required that the advertised jackpot amount be held constant until ticket sales could support at least a \$1 million increase in the advertised jackpot.

### Recommendations

The Agency should:

- Provide all final and approved jackpot estimation worksheets to the Legislative Budget Board and the Governor's Office.
- Continue to publish all jackpot estimation worksheets on its Web site.
- Update policies and procedures to reflect its current practices.

### Management's Response

*Management agrees with the recommendations and will provide copies of all final and approved jackpot estimation worksheets to the Legislative Budget Board and the Governor's Office.*

*Effective July 2005 the Agency implemented a practice of publishing all jackpot estimation worksheets on its Web site and will continue this practice. This practice was incorporated in the Agency's Jackpot Estimation Procedure in September 2005.*

*Additionally, the Agency will update the Jackpot Estimation Procedure to reflect current practices.*

*Target date: August 1, 2006*

*Responsible Divisions: Executive Administration and Office of the Controller*

## ***Agency Management Did Not Consistently Comply With Policies and Procedures for Review and Approval of Lotto Texas Jackpot Estimates***

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Agency management did not consistently comply with policies and procedures requiring review and approval of Lotto Texas jackpot estimates, and additional procedures should be implemented to strengthen the validity of the estimation process. Auditors identified the following issues:

- Sixty-three (24 percent) of the 263 jackpot estimations we reviewed (dated between May 2003 and March 2006) were not signed or approved in accordance with policies and procedures. The most recent instance in which an estimation worksheet was not approved occurred in May 2005. Ten (16 percent) of these 63 estimation worksheets were not approved by the Agency's Executive Director at that time. The estimations for these ten worksheets totaled \$253 million. All policies and procedures regarding estimate approvals required the Executive Director's approval.
- The Executive Director's approval for seven (3 percent) of the 263 jackpot estimations we reviewed was documented in the form of a "post-it" note attached to the estimation worksheet. Agency staff confirmed that the Executive Director at that time approved these estimates verbally, and then staff prepared the post-it notes. Preparing estimations is a significant part of the Agency's responsibility. Obtaining approvals in this manner does not promote an environment of accountability.
- Many of the jackpot estimation worksheets contained the signatures of designees. The policies and procedures authorize regular reviewers to use designees. However, the policies and procedures do not specify who the designees can be or explain the Agency's expectations regarding a designee's knowledge of the jackpot estimation process. As a result, it was difficult to determine the appropriateness of some jackpot estimates approved by designees. For example, staff in the Agency's Governmental Affairs Division served as a designee for the Executive Director at that time and approved a jackpot estimation worksheet.
- For all estimations we reviewed, the Agency provided its contracted lottery operator with jackpot amounts it approved to advertise and recorded this information in relevant systems. However, the forms the Agency used to communicate that information to the lottery operator did not always include all the required information such as the name of the contracted lottery operator employee that received the information and/or the date and time the contracted lottery operator received the information.

Although we determined that the Agency did not consistently comply with policies and procedures requiring review and approval of Lotto Texas jackpot

estimations, we concluded that the Agency estimates Lotto Texas sales accurately and conservatively, and the formula it uses to estimate low-end and high-end sales is accurate and used consistently. Our determination regarding the accuracy of sales estimations addresses a 1997 State Auditor's Office recommendation to improve the accuracy of jackpot estimates.<sup>2</sup> In addition, the Agency is implementing a checklist to use in the preparation of the jackpot estimation. Once implemented, this checklist should help to ensure that all required steps in the process are completed, documented, and reviewed.

## Recommendations

The Agency should:

- Ensure that all required approvals are obtained and documented on jackpot estimation worksheets and, within policies and procedures, assign responsibility for approving estimates to individual(s) in specific position(s). Individuals who approve estimates should have sufficient knowledge of the jackpot estimation process to be able to make an informed and responsible decision. The Agency should obtain a written and signed approval from the Executive Director for any exceptions to policies and procedures.
- Ensure that it always completes the forms it uses to communicate approved advertised jackpots to the lottery operator.
- Fully implement its process for using the checklist to document the completion and review of significant steps in the jackpot estimation process. The Agency should incorporate this checklist into policies and procedures. Agency management should ensure that staff consistently complete the checklist or document why items on the checklist are not completed.

## Management's Response

*Management agrees with the recommendations.*

*Effective late June 2005 the Agency revised its Jackpot Estimation process requiring each jackpot estimation worksheet be formally approved by four representatives from the Office of the Controller and Lottery Operations divisions with final approval from the Deputy Executive Director, Executive Director and one Lottery Commissioner.*

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<sup>2</sup> See *An Audit Report on Management Controls at the Texas Lottery Commission*, State Auditor's Office Report No. 97-092, August 1997.

*Since this process was implemented, there have not been any exceptions noted to this approval process. This approval process was incorporated in the Agency Jackpot Estimation Procedure dated September 2005. The Agency will further update the current Jackpot Estimation Procedure to reflect the role and authority of specific signature designees within the Agency and to also incorporate the recently implemented jackpot estimation process checklist. Any exceptions to the Agency's policies and procedures will be obtained from the Executive Director.*

*The Agency will also ensure that forms used to communicate approved advertised jackpots to the lottery operator are completed.*

*Target date: August 1, 2006*

*Responsible Divisions: Executive Administration, Office of the Controller, and Lottery Operations*

## ***Agency Management Could Not Substantiate the Effective Dates of Policies and Procedures***

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Although the Agency provided auditors with a number of policies and procedures, Agency management could not substantiate the effective dates of policies and procedures in areas such as jackpot estimations, jackpot prize payment calculations, and Foundation School Fund transfers.

Verifying the effective dates of policies and procedures helps ensure that staff (1) understand the processes they are responsible for and (2) comply with policies and procedures.<sup>3</sup>

In December 2004, the Agency's Internal Audit Division recommended that management strengthen current documentation and management of policies and procedures. This recommendation included annotating all policies and procedures with an effective date and the date of the policy that is superseded.

According to Agency management, it recently adopted a policy related to the preparation and implementation of new policies. However, Agency management recognizes that further revision of this policy is necessary to clarify effective dates.

### **Recommendations**

The Agency should:

- Document the effective date of all policies and procedures.
- Document which policies and procedures are being replaced or revised by new policies and procedures.
- Establish a formal, documented process to communicate revised or new policies and procedures and their effective dates to staff.
- Publish proposed policies and procedures that affect Lotto Texas players in the *Texas Register* and on its Web site. It should then present these proposed policies and procedures to the Texas Lottery Commission at public Commission meetings and request that the Commission publicly approve the policies and procedures. After these policies and procedures are approved, the Agency should make them available to the public by publishing them in the *Texas Register* and on its Web site.

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<sup>3</sup> In its *Codification of Auditing Standards, AU Section 319.41*, the American Institute of Certified Public Accountants (AICPA) defines control activities as the policies and procedures that help ensure that management directives are carried out.

## Management's Response

*Management agrees with the recommendations. The Agency will further revise its procedure related to the preparation and implementation of new policies.*

*In addition, all current procedures will be reviewed for compliance with these recommendations.*

*Target date: January 1, 2007*

*Responsible Divisions: Executive Administration, Administration, and Legal Services*



## ***After a Lotto Texas Jackpot Prize Winner is Identified, the Agency Accurately Calculates and Pays Lotto Texas Jackpot Prizes in Accordance with Rules, Policies, and Procedures***

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Since April 5, 2000, the Agency has made all Lotto Texas jackpot prize payments in accordance with the Texas Administrative Code and policies and procedures. In addition, effective April 26, 2006, the Prize Reserve Fund will no longer be funded by a percentage of sales. The Agency will continue to use the Prize Reserve Fund to pay prizes until this fund is depleted. This addresses a 1997 State Auditor's Office recommendation regarding how and when to use the Prize Reserve Fund.<sup>4</sup>

We determined that the Agency used inconsistent methodologies to calculate Lotto Texas jackpot prize payments from July 1, 1997, through April 4, 2000. Three policies regarding Lotto Texas jackpot prize amounts were in effect during that time period. One of the policies "required" the Agency to pay the advertised jackpot, while the remaining two "preferred" that the Agency pay the advertised jackpot. These policies were consistent with the rules in the Texas Administrative Code during this time period because these rules allowed the Agency's Executive Director to exercise discretion in the calculation of jackpot prize payments. For seven (8 percent) of 90 Lotto Texas winning jackpots during this time period, the Agency paid a percentage of sales instead of the advertised jackpot amount as required or preferred by the policies in effect at the time of the drawings. The Agency could not explain why it chose one methodology over another and did not comply with policies. For these seven instances, the difference between the advertised jackpot amount and a percentage of sales resulted in the winners' receiving an additional \$4,806,919.

We sent letters to 208 Lotto Texas jackpot winners asking them to confirm whether they had received the prize amounts we independently calculated they should have received. All but one of the 51 winners who responded agreed that they had received the jackpot amount we recalculated; the remaining winner who responded asserted the prize received was \$883 less than the prize amount we calculated. We provided the Agency with this information for further research.

We also determined that information maintained in hard copy Lotto Texas jackpot winners' files is consistent with information maintained in electronic databases or spreadsheets the Agency uses.

Although we determined that the Agency accurately calculates and pays Lotto Texas jackpot prizes, we also determined that Agency management did not

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<sup>4</sup> See *An Audit Report on Management Controls at the Texas Lottery Commission*, State Auditor's Office Report No. 97-092, August 1997.

always comply with policies and procedures regarding the review and approval of prize annuity schedules prepared by the Texas Treasury Safekeeping Trust Company. The Agency uses this information to calculate jackpot prize payments. Agency management did not review or approve 50 percent of the annuity schedules we tested. The most recent instance in which an annuity schedule was not reviewed and approved occurred in May 2003.

## Recommendations

The Agency should:

- Comply with policies and procedures regarding the calculation and payment of Lotto Texas jackpot prizes and obtain written and signed approval from the Executive Director for any exceptions.
- Ensure that appropriate members of management consistently review and approve prize annuity schedules provided by the Texas Treasury Safekeeping Trust Company.

## Management's Response

*Management agrees with the recommendations. The Agency will continue to comply with policies and procedures regarding the calculation and payment of Lotto Texas jackpot prizes. Any exceptions to the Agency's policies and procedures will be obtained in writing from the Executive Director. Appropriate Agency management will continue to review and approve prize annuity schedules from the Texas Treasury Safekeeping Trust Company.*

*Target date: Completed*

*Responsible Divisions: Executive Administration and Office of the Controller*

***The Agency Accurately Calculates and Transfers Proceeds from All Games to the Foundation School Fund in Accordance with Statute***

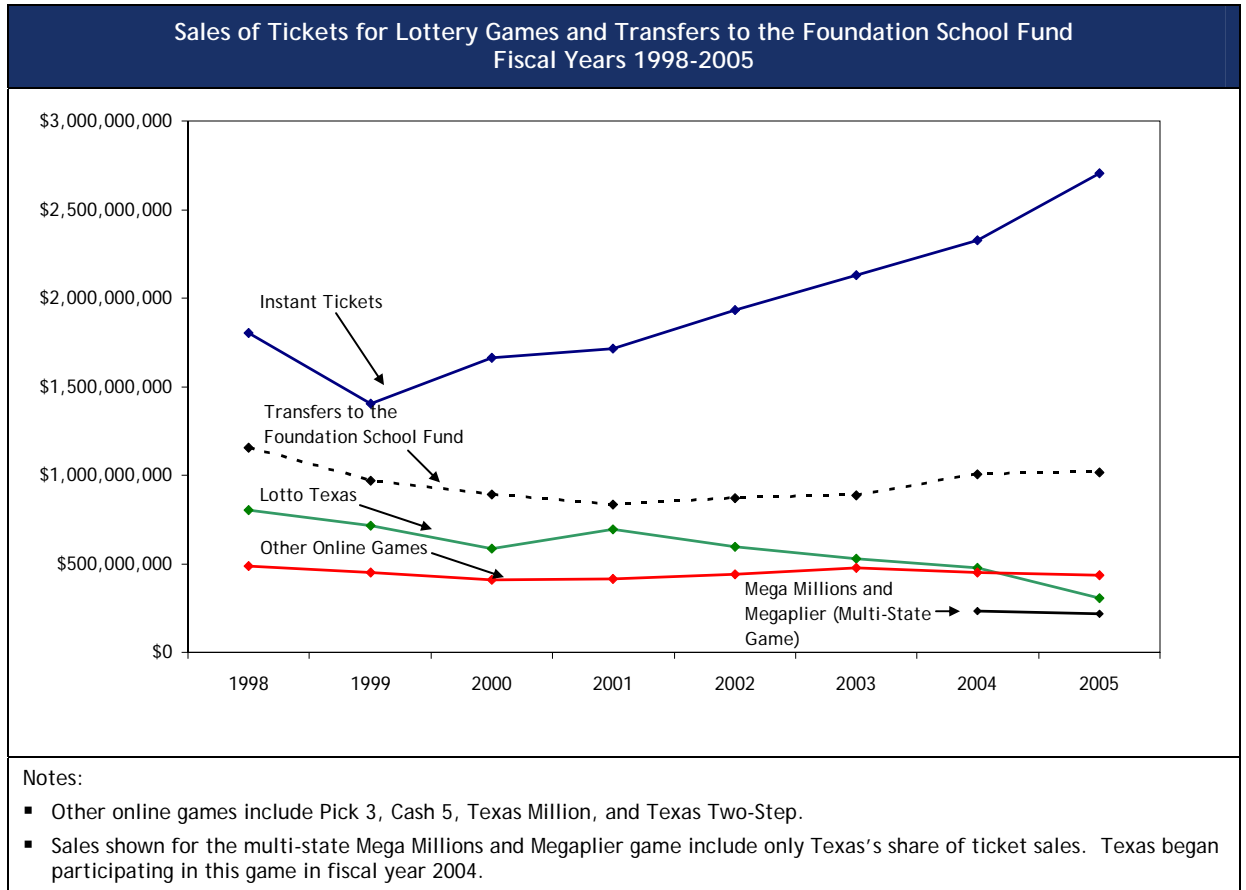
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The Agency correctly calculated and made transfers to the Foundation School Fund for all transfers we tested. The Agency makes these transfers through the Uniform Statewide Accounting System (USAS), which is maintained by the Office of the Comptroller of Public Accounts. In addition, the Agency correctly transferred all unclaimed prizes we tested to General Revenue and allocated administrative expenses in accordance with the General Appropriations Act.

The Agency accurately reports the sources of revenue transferred to the Foundation School Fund. We verified that instant ticket and online games sales have contributed more than \$8 billion to the Foundation School Fund since September 1, 1997.

Since fiscal year 1998, Lotto Texas ticket sales have declined 62 percent. Ticket sales for the multi-state Mega Millions game have declined 7 percent since Texas began participating in that game in September 2003. However, since fiscal year 1998, instant ticket sales have increased 50 percent. The net result is that transfers to the Foundation School Fund have remained relatively constant (see Figure 1 on the next page).

Figure 1



Source: Audited Texas Lottery Commission annual financial reports for fiscal years 1998 through 2005.

Although the Agency accurately calculated the Foundation School Fund transfers we tested, we identified the following issues:

- Twelve (86 percent) of the 14 transfers we tested between fiscal year 2002 and December 2005 were not reviewed, approved, or signed by Agency management as required by policies and procedures. The most recent instance in which a transfer was not reviewed, approved, or signed occurred in November 2005.
- The Agency did not comply with its records retention schedule. For 3 (21 percent) of the 14 transfers we tested, the Agency did not have documentation that it:
  - ♦ Prepared journal vouchers for USAS with proper segregation of duties. Specifically, the Agency did not have documentation indicating that these transfers were prepared and approved by different people.

- ♦ Used correct sales amounts in its calculation of the amount of the transfer to the Foundation School Fund.
- ♦ Reconciled sales with the contracted lottery operator's internal accounting system and the Agency's internal accounting system.

According to the Agency's record retention policy, the Agency should have retained the documentation listed above.

### Recommendations

The Agency should:

- Follow policies and procedures and ensure that Agency management consistently reviews, approves, and signs all transfers to the Foundation School Fund. The Agency should also obtain written and signed approval from the Executive Director for any exceptions to policies and procedures.
- Maintain all documentation related to Foundation School Fund transfers in accordance with its records retention schedule.

### Management's Response

*Management agrees with the recommendations. The Agency will continue to comply with policies and procedures regarding the review, approval and signature of all transfers to the Foundation School Fund. Any exceptions to the Agency's policies and procedures will be obtained in writing from the Executive Director. The Agency will ensure that all documentation related to Foundation School Fund transfers is maintained in accordance with its records retention schedule.*

*Target date: Completed*

*Responsible Divisions: Executive Administration and Office of the Controller*

## *The Agency Does Not Appropriately Oversee and Monitor Incomplete Online Game Ticket Transactions That Are Recorded in the Lottery Operator's Computer System*

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### Online Games

Online games are games in which a player selects numbers for a drawing. Current online games include Lotto Texas, Mega Millions (including Megaplier), Pick 3, Cash 5, and Texas Two-Step.

The Agency does not monitor incomplete online game ticket transactions (incomplete transactions) and relies solely on its contracted lottery operator to report these transactions.

Incomplete transactions are created when a ticket does not print at a retailer (for example, because of a power outage), but the numbers selected for that ticket are still recorded in the contracted lottery operator's central computer system. For the time period auditors reviewed, incomplete transactions were created 0.000044 percent of the time and none of the incomplete transactions associated with winning numbers was for a high-tier (\$600 or more) or jackpot prize.

Although incomplete transactions are rarely created and none was associated with a high-tier or jackpot prize during our test period, we identified issues with the Agency's oversight and monitoring of these transactions. Specifically:

- The only information the Agency receives from the contracted lottery operator regarding these transactions is the information necessary to credit retailers for not having sold these tickets. In addition, the Agency does not have a formal written agreement with the lottery operator that requires the lottery operator to monitor these transactions. We reviewed the lottery operator's process for identifying incomplete transactions from January 2005 through March 2006. Auditors found no errors in the contracted lottery operator's automated process for identifying these transactions. However, we determined that, for multiple draws, the lottery operator verifies whether incomplete transactions were associated with winning numbers only for the first draw. This verification is performed manually.
- Auditors reviewed a report prepared by the contracted lottery operator that included all incomplete transactions that it reported to the Agency from January 2005 through March 2006. Results of this review indicate that the Agency should oversee the lottery operator's processes associated with incomplete transactions. For example:
  - ♦ We identified three incomplete transactions that the lottery operator did not include on its report to the Agency.
  - ♦ We identified errors in the lottery operator's analysis of incomplete transactions. For example, we identified incorrect draw numbers, incorrect retailer numbers, and incorrect wager amounts.

- There are no policies and procedures that address how to proceed when numbers on incomplete transactions are associated with a high-tier or jackpot prize.

If numbers on incomplete transactions are associated with a high-tier or jackpot prize, the Agency could erroneously conclude that there had been a game winner and transfer the associated prize to “unclaimed prizes” instead of putting the prize back into the jackpot for the next drawing. In addition, a player with a legitimate winning ticket would not receive his or her full share of the prize because prize amounts for multiple winning tickets are split equally among the winners. The portion of the prize related to the incomplete transaction would erroneously be put in “unclaimed prizes.” These issues could diminish the public’s confidence in the integrity of online games. They could also affect sales because, according to the Agency and members of the Texas Lottery Commission, ticket sales are partially driven by jackpot amounts.

We did not identify any issues related to the Agency’s processes for crediting retailers that did not sell the tickets that were associated with incomplete transactions.

## Recommendations

The Agency should:

- Develop and enforce a formal agreement with the lottery operator that describes the lottery operator’s responsibilities regarding incomplete transactions and any penalties or sanctions for any errors made by the lottery operator that are associated with these transactions.
- Develop and implement policies and procedures for monitoring incomplete transactions that include (1) obtaining information from the lottery operator that identifies number combinations associated with incomplete transactions and (2) verifying whether these incomplete transactions are associated with winning number combinations.
- Develop and implement a formal policy to address situations in which the numbers on incomplete transactions win a high-tier or jackpot prize. The policy should (1) identify Agency personnel to be notified; (2) explain what happens to the prize money, including instances in which another winner with a ticket has been identified; and (3) describe what the Agency will report to the public.

## Management’s Response

*Management agrees with these recommendations and will take the following actions:*

*1) An amendment to the contract for Lottery Operations and Services will be prepared that describes the lottery operator's responsibilities regarding incomplete transactions. The amendment will include sanctions for lottery operator errors associated with monitoring or reporting these transactions.*

*2) Procedures will be revised and policies established to (a) require the lottery operator to provide information on number combinations associated with incomplete transactions and (b) require Agency staff to review the number combinations to identify possible winning number combinations. This recommendation will require software changes to the automated processes that generate incomplete transaction reports.*

*3) A policy will be established to (a) identify Agency personnel to be notified; (b) explain what happens to the prize money, and (c) describe what the Agency will report to the public when the numbers associated with an incomplete transaction match high tier or jackpot prize number combinations.*

*Target date: October 1, 2006*

*Responsible Divisions: Executive Administration, Lottery Operations, and Administration*



## ***The Agency Does Not Always Ensure that Access to Certain Administrative Systems is Limited to the Appropriate Individuals***

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The Agency does not always ensure that access to certain automated administration systems is limited to only those individuals who require access. This increases the risk that critical information could be accidentally or intentionally altered. Auditors identified the following:

- The Agency did not limit access rights to certain Microsoft Excel spreadsheets that contain information related to jackpot estimations, jackpot prize winners, and Foundation School Fund transfers. After we brought this to the Agency's attention, the Agency asserted that it began reviewing and modifying access to these spreadsheets.
- The Agency did not set up appropriate access rights to its internal accounting system or the system it uses to maintain information on Lotto Texas prize winners. After we brought this to the Agency's attention, we observed that it immediately modified some of these access rights.

Although auditors identified the access issues described above, the Agency has properly established security and access rights to USAS and the Automated Clearing House system it uses to make direct deposits of prize amounts.

### **Recommendation**

The Agency should perform regular reviews of access rights to its administrative systems and ensure that access is based on current job roles and responsibilities.

### **Management's Response**

*Management agrees with the recommendations. The Agency will perform regular reviews of access rights to its administrative systems to ensure that access is based on current job roles and responsibilities.*

*Target date: Completed*

*Responsible Divisions: Executive Administration and Office of the Controller*

# Appendix

## *Objective, Scope, and Methodology*

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### Objective

The audit objective was to determine whether selected Lotto Texas activities are conducted in accordance with rules, policies, and procedures, including determining whether:

- All instances in which advertised jackpot amounts exceeded estimated sales amounts have been identified.
- Prize payments were calculated and paid in accordance with rules and policies and procedures.
- Amounts transferred to the Foundation School Fund were calculated accurately and in accordance with Texas Government Code, Section 466.355.

An additional objective was to follow up on audit findings related to the Lotto Texas prize reserve fund included in the report *An Audit Report on Management Controls at the Texas Lottery Commission* (State Auditor's Office Report No. 97-092, August 1997).

### Scope

Our scope included:

- Lotto Texas jackpot estimations prepared between May 4, 2003, and March 31, 2006
- Lotto Texas jackpot prize payments calculated between July 1, 1997, and February 8, 2006
- Foundation School Fund transfers made for the time period from September 1, 1997, through December 31, 2005
- Incomplete transaction that occurred between January 1, 2005, and March 31, 2006

### Methodology

The audit methodology included reviewing Lotto Texas jackpot estimation worksheets, recalculating jackpot prize payments and Foundation School

Fund transfers, and reviewing the contracted lottery operator's process for identifying incomplete transactions.

Information collected and reviewed included the following:

- Lotto Texas jackpot estimation worksheets
- Lotto Texas jackpot prize winners' files
- Foundation School Fund transfers worksheets
- Annuity schedules provided to the Agency by the Texas Treasury Safekeeping Trust Company
- Foundation School Fund reports presented at Commission meetings
- Lotto Texas jackpot sales information maintained in the contracted lottery operator's system
- Extract from the Agency's Winning Ticket System database
- Incomplete transaction reports
- Winning draw numbers posted on the Agency's Web site

Procedures and tests conducted included the following:

- Interviewed Texas Lottery Commissioners, Agency executive and division management, Agency staff, and staff of the Agency's contracted lottery operator
- Recalculated jackpot prize payments for compliance with rules and policies and procedures
- Recalculated Foundation School Fund transfers for compliance with laws, regulations, and policies and procedures
- Tested jackpot estimation worksheets for compliance with policies and procedures
- Compared estimated sales on jackpot estimation worksheets to actual sales recorded in the contracted lottery operator's system
- Recalculated interest rate factors used for jackpot estimation and jackpot prize payment calculations
- Sent confirmation letters to Lotto Texas jackpot prize winners
- Compared transfers made to the Foundation School Fund to transfers received by the Texas Education Agency

- Tested administrative expense calculations for compliance with the General Appropriations Act
- Tested transfers to unclaimed prizes for compliance with statute
- Compared Foundation School Fund calculation spreadsheets to information presented by Agency management to the Commission
- Performed a trend analysis for all Texas Lottery Commission ticket sales and Foundation School Fund transfers
- Analyzed incomplete transaction reports and compared number combinations on these reports to winning number combinations maintained on the Agency's Web site

Criteria used included the following:

- Texas Government Code, Chapter 466
- Texas Government Code, Chapter 467
- Texas Administrative Code, Title 16, Part 9, Chapter 401, Subchapter D, Sections 401.304 and 401.305
- General Appropriations Act (77th Legislature)
- General Appropriations Act (78th Legislature)
- General Appropriations Act (79th Legislature)
- The Agency's Lotto Texas Jackpot Payment and Investment Procedures
- The Agency's Use of the Lotto Texas Prize Reserve Fund Procedures
- The Agency's Lotto Texas Payment Procedure Memo
- The Agency's Lotto Texas Jackpot Estimation Procedures
- The Agency's Reserve For Unclaimed Prizes Procedures
- The Agency's Use of the Lotto Texas Prize Reserve Fund Procedures
- The Agency's Foundation School Fund Transfer Procedures
- The Agency's Monthly Transfers Procedures
- The Agency's Information Resources Security Manual

## Project Information

Audit fieldwork was conducted from March 2006 through May 2006. This audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor's staff performed the audit:

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- Karen Smith
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Copies of this report have been distributed to the following:

### **Legislative Audit Committee**

The Honorable David Dewhurst, Lieutenant Governor, Joint Chair  
The Honorable Tom Craddick, Speaker of the House, Joint Chair  
The Honorable Steve Ogden, Senate Finance Committee  
The Honorable Thomas “Tommy” Williams, Member, Texas Senate  
The Honorable Jim Pitts, House Appropriations Committee  
The Honorable Jim Keffer, House Ways and Means Committee

### **Office of the Governor**

The Honorable Rick Perry, Governor

### **Texas Lottery Commission**

Members of the Texas Lottery Commission  
    Mr. C. Thomas Clowe, Jr., Chairman  
    Mr. James A. Cox, Jr.  
Mr. Anthony Sadberry, Executive Director



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