

**STATE OF NEW HAMPSHIRE
LOTTERY COMMISSION**

**MANAGEMENT LETTER
FOR THE FISCAL YEAR ENDED JUNE 30, 2005**

To The Fiscal Committee Of The General Court:

We have audited the financial statements of the New Hampshire Lottery Commission, a department of the State of New Hampshire, as of and for the year ended June 30, 2005 and have issued our report thereon dated December 19, 2005.

This management letter, a byproduct of the audit of the New Hampshire Lottery Commission for the year ended June 30, 2005, contains an auditor's report on internal control over financial reporting and on compliance and other matters. The appendix, included as an attachment to the management letter, provides a summary of the status of observations presented in the fiscal year 2004 management letter of the Lottery Commission.

The Lottery is again submitting its comprehensive annual financial report (CAFR) to the Government Finance Officers Association (GFOA) for consideration for the GFOA's Certificate of Achievement for Excellence in Financial Reporting. A certificate of achievement is a prestigious national award for CAFRs that are prepared in accordance with program standards. The program standards are intended to promote easily readable and understandable financial reports that demonstrate financial accountability and comparability. The Lottery received GFOA certification for its 2004 CAFR, and it is believed that the 2005 CAFR also conforms to the certificate of achievement program requirements. A copy of the Commission's 2005 CAFR can be obtained from the New Hampshire Lottery Commission, 14 Integra Drive, Concord, NH 03301.

Office Of Legislative Budget Assistant
Office Of Legislative Budget Assistant

December 19, 2005

**STATE OF NEW HAMPSHIRE
LOTTERY COMMISSION
2005 MANAGEMENT LETTER**

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

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

To The Fiscal Committee Of The General Court:

We have audited the financial statements of the business-type activities of the New Hampshire Lottery Commission, a department of the State of New Hampshire, as of and for the year ended June 30, 2005 and have issued our report thereon dated December 19, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Lottery Commission's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Lottery Commission's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in Observations No. 1 through No. 4 of this report.

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

Compliance And Other Matters

As part of obtaining reasonable assurance about whether the Lottery Commission's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, rules, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. However, we noted a certain matter which is described in Observation No. 5 of this report.

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

Office Of Legislative Budget Assistant
Office Of Legislative Budget Assistant

December 19, 2005

Internal Control Comments
Reportable Conditions

Observation No. 1: Policies And Procedures Should Be Established For Handling Delinquent Agent Accounts

Observation:

The Lottery has not established policies and procedures for handling delinquent agent accounts. The Lottery employees responsible for controlling delinquent accounts rely upon experience and circumstances to make these decisions. This issue was also noted in the fiscal year 2004 audit of the Lottery.

As noted in the fiscal year 2004 observation, there are no policies and procedures to guide the employee in making decisions as to:

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

Decisions made without established policies and procedures are subject to increased risk of inconsistent application, and application not in conformance with management's intention. The lack of policies and procedures contributes to inefficiencies when functions have to be performed in the absence of the employees regularly assigned these responsibilities, places the organization at risk of a disruption of operations if the responsible employee terminates employment on short notice, and also increases the risk that Lottery decisions affecting the handling of delinquent agent accounts could be challenged as arbitrary.

Recommendation:

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

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

Auditee Response:

We concur. This process has been in progress and will incorporate all the concerns of this observation.

Observation No. 2: Critical Computer Equipment Should Be Adequately Secured

Observation:

Access to the Lottery's servers and restricted computer equipment is not adequately limited to only those employees who have job responsibilities requiring access to the equipment. The equipment is not secured in lockable racks or closets to limit the potential for unauthorized access or other mishap from occurring. This issue was also noted in the fiscal year 2004 Lottery Management Letter.

The Lottery's computer equipment is located in a limited-access data room. While access to the data room requires keypad and card key access privileges, because the data room is utilized for purposes in addition to housing the computer equipment, other non-authorized employees responsible for those ancillary functions also have physical access to the equipment. Although employees' job responsibilities currently require them to have access to the data room, it is not clear that these employees should have physical access to the Lottery's servers and other restricted computer equipment.

Management has a responsibility for implementing controls sufficient to protect the Lottery's resources against unauthorized access or damage, whether intentional or unintentional. Physical security over Lottery's servers and restricted computer equipment is the most basic of those controls. Management has indicated in its response to a similar prior comment that, in its opinion, installing lockable racks or closets is not cost effective. However, it is not clear that the Lottery has considered other measures to mitigate the risks associated with unauthorized access to its critical computer equipment.

Recommendation:

The Lottery should again consider and evaluate options for further securing its servers and restricted computer equipment against unauthorized access and damage. Installing a physical barrier such as a wall or cage similar to those used to secure the instant ticket inventory may be a less costly option that could effectively segregate the computer equipment from unauthorized access. Other options could include relocating the work areas of unauthorized employees to areas outside of the data room.

Regardless of the options used, the Lottery should implement and monitor physical security measures over its servers and restricted computer equipment sufficient to protect its resources and operational integrity.

Auditee Response:

We concur. There is a request for a price proposal in process concerning the building security that will address the physical issues within the building including the computer room. Currently the Chief of Security is using the computer room as his office with a clear view of employees entering and exiting the room. New cameras in this location will add to the building's overall

security. Also the Office of Information Technology is preparing a request for proposal on intrusion detection software and other computer room security issues.

These two items are subject to funding and may have to be added to the next budget cycle.

Observation No. 3: Security Of Subscription Information Should Be Resolved

Observation:

A security issue noted in a Multi-State Lottery Association (MUSL) security audit of the Lottery's Powerball subscription process remains unresolved, reportedly due to technical difficulties.

Prior to Lottery being allowed to offer subscriptions for the Powerball game in November 2004, MUSL required an audit to be conducted of the Lottery's subscription system to ensure that adequate controls were in place to secure the subscription process and data. Subscription information received by the Lottery is entered into the Games Management System (GMS). The security audit report issued by MUSL indicated improvements should be made to increase the security of the data in that system.

As a result of the audit, the Lottery implemented a mitigating procedure, which was accepted by MUSL as a temporary solution.

As of the date of this letter, the Lottery has not been able to comply with the original MUSL solution to the noted system weakness and is considering requesting approval from MUSL of an alternative permanent control procedure.

Recommendation:

The Lottery should seek to resolve this security issue to the satisfaction of MUSL in a timely manner to ensure the continued integrity of the Lottery subscription process.

As part of its risk assessment processes, the Lottery should also consider whether the weakness noted in the Lottery's system related to the MUSL subscription process also poses a risk to the Lottery's other operations and data processed through the GMS.

Auditee Response:

We concur. The Lottery has been working with our vendor, Scientific Games (the vendor) and the MUSL staff to address these issues. The vendor has developed the necessary software. Gaming Laboratory International has performed a comprehensive code review and the testing on the software. The Lottery will be doing independent testing and will make this part of the risk management process.

Observation No. 4: Policies And Procedures Should Be Established For Subscription Over-Payments Received By The Lottery

Observation:

The Lottery does not have a formal policy for handling minor overpayments from customers transacting business through the mail. The Lottery does not pay refunds or provide additional game plays to customers who make minor overpayment for mail-ordered subscriptions. In fiscal year 2005, the Lottery retained hundreds of dollars from customers who made over-payments on mail-ordered subscriptions.

During November 2004, the Lottery began offering discounts on subscriptions for the Powerball and Megabucks games. Customers were able to purchase 26 plays for either game for \$25, a discount of \$1 off of the regular price. However, some subscribers mailed in payment at the regular undiscounted price, even though the discounted price was evident on the subscription application and renewal forms. Lottery accepted the overpayments as revenue without crediting the customers with extended plays or other refunds. The Lottery has not established a policy and procedure and has not communicated this practice to its customers.

The Lottery compensates minor prizewinners (\$5 or less) on subscription game plays by extending the winners' subscriptions by equivalent number of plays. According to the Lottery, system limitations do not allow a customer's subscription to be extended as a result of an overpayment. Because the Lottery is inconsistent with its practices on how it processes minor amounts owed to customers (extending plays for minor subscription winners and not extending plays for overpayments) without fully notifying its customers of its practices, the Lottery exposes itself to the risk of an unforeseen claim if the play numbers of a subscription customer who overpaid for a subscription are drawn in a game immediately subsequent to the expiration of the subscription.

Recommendation:

The Lottery should establish policies and procedures to address minor amounts owed subscription customers. The policies and procedures should be effectively communicated to customers to ensure that customers are treated fairly and equitably and to limit the risk of unforeseen claims.

Auditee Response:

We concur; the Lottery recently implemented a procedure to issue a credit (via a gift certificate) to the customer so that they may redeem it at any lottery retailer. This policy has been documented.

State Compliance Comment

Observation No. 5: The Triple Play Game Structure Should Be Consistent With Statutes In Form And Function

Observation:

The Lottery redesigned its participation in a new Tri-State game to avoid a statutory limitation. The redesign served no purpose other than to allow for a prize payout structure higher than the maximum payout percentage currently allowed by statute. While the redesign of the game allowed the Lottery to maintain compliance with statute in form, it appears that the true structure of the game is contrary to statute.

The Lottery introduced the Triple Play game at the end of June 2005. The game was originally intended to be a Tri-State game; however, the prize structure resulted in a payout of approximately 57%, exceeding the Tri-State games statutory maximum of 50% payout. Reportedly to avoid the statutory limits, the Lottery entered into a Memorandum of Understanding (MOU) with Tri-State to offer Triple Play as a joint venture, with a 50/50 split of the sales on the game. The MOU, approved at the June 17, 2005 Tri-State meeting, provided the Lottery portion of the game would have a 64% prize pool, while the Tri-State portion would have a 50% prize pool, for a combined prize pool of 57%. The Lottery has not submitted the MOU to legal counsel for review. No other Lottery game is offered as a “joint venture” and no other on-line Lottery game prize pool exceeds 50%.

Per RSA 287-F:3 and 287-F:9, II, Tri-State party states pay moneys as are necessary for the payment of prizes, less actual prizes paid, but not to exceed 50% of sales, into the Tri-State prize pool.

The Maine State Lottery was successful in passing legislation prior to the start of the Triple Play game to allow for the larger payout, and therefore offers Triple Play as a 100% Tri-State game, illustrating the original intent of the game. The Lottery did not seek legislative action to change the relevant statute prior to the start of the Triple Play game. It appears that the same situation occurred with the Vermont Lottery, the third Tri-State partner.

Recommendation:

The Lottery should seek legal counsel review of the MOU and the structure of the Triple Play game to ensure they conform to applicable statute.

If the Lottery determines that the statute reflects neither current industry conditions nor the intent of the Tri-State Lotto Compact, then legislation should be sought to amend the statute. The Lottery should not restructure the form of games to avoid statutory constraints.

Auditee Response:

Legislation has been introduced in the current session to address this issue.

APPENDIX

Current Status Of Prior Audit Findings

The following is a summary of the status, as of December 19, 2005, of the observations contained in the New Hampshire Sweepstakes Commission Management Letter for the year ended June 30, 2004. A copy of the prior management letter can be obtained from the Office of Legislative Budget Assistant, Audit Division, 107 North Main Street, State House, Room 102, Concord, NH 03301-4906.

Internal Control Comments

Reportable Conditions

	<u>Status</u>		
1. The Lottery Should Establish Formal Risk Assessment Policies And Procedures	●	○	○
2. Comprehensive Manual Of Policies And Procedures Should Be Established Covering Lottery Operations	●	○	○
3. Incident Handling And Reporting Policies And Procedures Should Be Established For Significant Control Processes	●	●	●
4. Statutes And Administrative Rules Should Be Reviewed For Continued Applicability	●	●	○
5. Accountability For Cash Collected In The Sales Office Should Be Improved	●	●	●
6. Policies And Procedures Should Be Established For Calculating Unclaimed Prize Liabilities	●	●	●
7. Disaster Recovery Plan Should Be Completed And Periodically Tested	●	●	○
8. Audits Of The Gaming System Vendor Should Include Tests Of The Effectiveness Of Controls	●	●	○
9. General And Information Technology Security Measures Should Be Reviewed <i>(See Current Observation No. 2)</i>	●	○	○
10. Policies And Procedures Should Be Established For Handling Delinquent Agent Accounts <i>(See Current Observation No. 1)</i>	●	○	○

Status Key

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

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