

TEXAS LOTTERY COMMISSION INTERNAL AUDIT DIVISION



An Internal Audit of CHARITABLE BINGO REGULATION - AUDIT SERVICES

IA #06-022
August 2006



C. Tom Clowe, Jr.
Chairman

James A. Cox, Jr.
Commissioner

TEXAS LOTTERY COMMISSION

Anthony J. Sadberry, *Executive Director* William L. Atkins, *Director Charitable Bingo Operations*

August 2, 2006

Mr. C. Tom Clowe, Jr., Chairman
Texas Lottery Commission
P.O. Box 16630
Austin, TX 78761-6630

Dear Chairman Clowe:

The accompanying report details Internal Audit's recently completed review of Charitable Bingo Regulation – Audit Services. This audit was requested by the Charitable Bingo Operations Division Director and subsequently approved on the FY06 Internal Audit Activity Plan. The purpose of the audit was to evaluate the effectiveness of the Charitable Bingo Operations Division in achieving its statutory charge of ensuring that bingo conducted in this state is fairly conducted and that proceeds derived from bingo are used for an authorized purpose. Specifically, we focused our review on the activities and responsibilities of the Audit Services Department within the Charitable Bingo Operations Division.

Overall, we found that the activities and processes of the Audit Services Department do not *effectively* ensure that charitable bingo is fairly conducted, nor that proceeds derived from bingo are used for an authorized purpose.

Fundamental changes are needed to ensure statutory objectives are effectively and efficiently met. Our report makes recommendations to assist the division in strengthening its overall processes and controls related to the Audit Services Department's role in charitable bingo regulation.

Responsible management has expressed agreement with Internal Audit's conclusions and recommendations detailed in the report and has included corrective actions in its responses. If you desire further information concerning this review, please do not hesitate to contact me at 512/344-5488.

Respectfully submitted,

A handwritten signature in black ink that reads "Catherine A. Melvin".

Catherine A. Melvin, CIA, CPA
Director, Internal Audit Division

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EXECUTIVE SUMMARY

Charitable bingo provides non-profit organizations in Texas an opportunity to raise money for charitable activities. The Charitable Bingo Operations Division (CBOD) of the Texas Lottery Commission (TLC) is responsible for regulating charitable bingo games in the state of Texas.

The Charitable Bingo Operations Division faces significant challenges in administering their statutory responsibilities. The charitable bingo industry is comprised of both large high-volume bingo halls and small volunteer-based halls. Bingo game operations are largely a cash-based business and dissenting opinions exist as to the need for bingo gaming and the extent of necessary regulation in Texas. In addition, several areas in the enabling statute itself lack consistency, clarity, and/or relevancy. These elements combine to create a complex and challenging regulatory environment.

The purpose of our audit was to evaluate the effectiveness of the Charitable Bingo Operations Division in achieving its statutory charge of ensuring that bingo conducted in this state is fairly conducted and that proceeds derived from bingo are used for an authorized purpose. Specifically, we focused our review on the activities and responsibilities of the Audit Services Department within the Charitable Bingo Operations Division. In addition, based on risk, we further limited our scope to examining the regulation of organizations licensed to conduct charitable bingo.

Overall, we found that the activities and processes of the Audit Services Department do not *effectively* ensure that charitable bingo is fairly conducted, nor that proceeds derived from bingo are used for an authorized purpose.

Fundamental changes are needed to ensure that statutory charges are met. These include defining and articulating the regulatory objective and focus for the division, providing for a more fair, open and consistent regulatory experience for licensees, adopting an audit methodology and protocol which will ensure adequate coverage and audit quality, and ensuring adequate independence for the auditors.

Detailed results and recommendations of Internal Audit's review are presented in the "Detailed Review Results" section of this report.

Internal Audit would like to express our appreciation to the Charitable Bingo Operations Division and other agency staff for their cooperation and assistance during this engagement. Their courtesy and responsiveness extended to Internal Audit allowed us to complete our work effectively and efficiently.

**MANAGEMENT’S OVERALL
RESPONSE**

Charitable Bingo Operations Division management has expressed full agreement as detailed in this report.

Internal Audit’s Overall Comment to Management Responses:

Internal Audit recognizes the long-term strategic efforts necessary to address the conditions noted in this report; in particular, the efforts needed to ensure statutory objectives are effectively and efficiently met, and to strengthen overall processes and controls related to the Audit Services Department’s role in charitable bingo regulation. We encourage and support Charitable Bingo Operations Division management in its endeavors to achieve earlier implementation than those dates noted in their responses.

DETAILED REVIEW RESULTS

The following review results and recommendations represent opportunities for the Charitable Bingo Operations Division (CBOD) to strengthen its overall processes and controls related to the Audit Services Department’s role in charitable bingo regulation.

1

Regulatory Objective and Approach –*The Charitable Bingo Operations Division should develop a defined and articulated regulatory objective to effectively address its statutory charge.*

The statutory charge for the Charitable Bingo Operations Division (CBOD) under the Bingo Enabling Act (the Act) reads as follows:

The Commission has broad authority and shall exercise strict control and close supervision over all bingo conducted in this state so that bingo is fairly conducted and the proceeds derived from bingo are used for an authorized purpose.¹

During our review, we were not always able to tie activities and processes of the Audit Services Department to the statutory charge. As this report further details, CBOD auditors perform minimal assessment of licensees as to the fair conduct of the games and as to determining the proceeds derived from the games.

In further examining the efforts of the Audit Services Department, it became evident that many of the actions of the department do not clearly represent a consistent regulatory objective or approach. In some matters it appeared the department enforced a strict, almost zero-tolerance approach to regulatory compliance; yet in other matters the department appeared to assist or foster licensees in coming into compliance. These disparities in approach, however, did not appear to be based on relative risk or impact to the statutory charge. Ultimately, we believe the lack of a defined and articulated regulatory objective has led to an overall lack of focus on higher areas of risk as opposed to lower areas of risk.

An example of this is reflected in the Audit Services Department’s examination procedures. Violations of seemingly less impact to the statutory charge are pursued, while apparently more significant violations are not addressed. Specifically, CBOD auditors will assess whether the licensee adheres to “licensed times” citing a licensee for exceeding this time by as little as 15 minutes, yet not verify the amount of proceeds derived from the games.

Another example is apparent in how licensees are selected for examination. To ensure all licensees are subject to some type of examination, CBOD management has chosen to utilize a methodology which places all playing locations on an annual cycle for Assessment & Assistance Inspections (A&A’s) and a minimum four year cycle for reviews and audits of licensees.

¹ Occupations Code §2001.051(b)

However, because of the limited number of resources available to conduct examinations of licensees, this approach has necessitated a restricted depth of coverage. While there is value in achieving a regulatory “presence” among licensees, this value can be readily diminished once licensees become aware of the lack of depth of coverage. Selecting licensees for examination based on a risk assessment process which is tied to the division’s regulatory objective helps to ensure limited resources are most effectively and efficiently utilized.

While CBOD has a mission statement in place, the mission statement is necessarily presented in very broad terms. As typical of mission statements, it provides general statements of the organization’s purpose. CBOD’s mission statement reads as follows:

Provide authorized organizations the opportunity to raise funds for their charitable purposes by conducting bingo. Determine that all charitable bingo funds are used for a lawful purpose. Promote and maintain the integrity of the charitable bingo industry throughout Texas.²

A regulatory objective is distinct from an organization’s mission statement. A regulatory objective is a statement of the underlying principles that guide the work of the division. It should serve as a framework within which all charitable bingo regulation activities are conducted, ensuring the achievement of the statutory charge. It should recognize that the interaction of CBOD with its licensees and the playing public represents a regulatory continuum that balances service, facilitation and enforcement activities. The regulatory objective should direct CBOD’s approach in its regulatory activities, in determining to what extent to foster licensees or strictly enforce statutory provisions.

This report further details additional conditions that we believe are ultimately attributable to the lack of a defined regulatory objective. Without a defined and articulated regulatory objective, the Charitable Bingo Operations Division is limited in its ability to effectively address its statutory charge.

Recommendation: We recommend CBOD develop a regulatory objective that meets its statutory charge. The objective should define the division’s focus in ensuring bingo is fairly conducted and all proceeds derived from bingo are used for an authorized purpose. The CBOD Director should present this objective for the review and approval by the Texas Lottery Commissioners. Upon approval, the regulatory objective should be adequately communicated to all licensees. The division should then set priorities in line with this objective to maximize the limited resources available.

The Audit Services Department should utilize a risk-based approach in determining the extent of audit and review coverage of licensees. The determination of risk factors should be aligned with the established regulatory objective and approach. Based on a prioritization of risk, and aligned with the established regulatory philosophy, we further recommend the Audit Services Department expand the extent of analysis performed in-office in assessing risk. Currently, CBOD collects fairly detailed self-reported quarterly financial information from licensees. Further analysis of this data can assist the department in targeting its limited resources.

² TLC Strategic Plan Fiscal Years 2005 - 2009

Management's Response:

Management agrees with the recommendations and will develop a regulatory objective to meet our statutory charge. Management has already held individual meetings with the Commissioners related to this recommendation. Management has also started a detailed process with the Legal Division and Enforcement Division to carefully review existing statute and administrative rules for needed additions or changes.

Once the regulatory objective has been defined and approved by the Commissioners, the Audit Services Department will make revisions to the current risk analysis to be consistent with the regulatory objective.

The development of the regulatory objective will seek input from the Legal Division and Enforcement Division. The development of the risk analysis will seek input from the Internal Audit staff. If there is a need for any programming changes in performing the risk analysis, then Information Resource will be looked to for assistance.

Target date: January 2007 for regulatory objective. December 2007 for risk analysis.

Responsible Departments:

Regulatory Objective--Director, Charitable Bingo Operations Division

Risk Analysis—Audit Services Department

2 Licensee Experience – Current processes require significant improvements to better ensure licensees a fair, consistent, and open regulatory experience.

Fundamental to a fair, consistent, and open regulatory experience for licensees is ensuring the licensee is adequately apprised of the regulatory criteria, of the audit process, and of the availability of dispute resolution.

Transparency of Criteria

As the regulator, the Charitable Bingo Operations Division has an inherent responsibility to clarify and communicate requirements expected of those whom it regulates. These same requirements must be equally communicated to the auditors conducting regulatory audits and reviews. However, we found that organizations licensed to conduct bingo did not always know the specific requirements and criteria to which they are held. Further, CBOD auditors could not consistently nor clearly substantiate certain criteria used in audits and reviews. For example:

- *Allowability of Expenditures:* Our review disclosed significant differences and inconsistencies among auditors regarding the allowability of certain expenditures. Most notably, we found auditors were applying certain criteria which were no longer

in effect. In 2003, the Bingo Enabling Act underwent significant revisions, including an expansion of allowable items of expense. These changes were effective September 1, 2003. CBOD management did not identify the impact of the revision, and consequently, did not communicate the change to the audit staff. During our audit, we found CBOD auditors were continuing to limit the allowability of expenditures based on the old law.

Specifically challenging is the term “reasonable or necessary”. Since September 1, 2003, the Act has allowed all expenses that are “...reasonable or necessary to conduct bingo...”³ This language is challenging to enforce because CBOD management has issued limited to no guidance to either the licensee or its auditors in assessing whether expenses are reasonable or necessary. In the absence of written guidelines, CBOD auditors have assessed the allowability of licensee expenses, basing their decisions on past practices of the Audit Services Department and individual auditor judgment. We also found CBOD auditors utilized outdated criteria, for example administrative rules which had been adopted in September 1983 when Charitable Bingo was a division at the Comptroller of Public Accounts, and were now no longer enforceable.

- *Books and Records Requirements:* Our review also disclosed audit violations for record keeping requirements that are neither specified in the Act, nor have been formally adopted by the Commission in rule. For example, CBOD auditors have cited licensees with violations for not maintaining a “Sales Journal” and/or a “Cash Disbursement Journal” to support quarterly reports submitted by the licensee. The auditors cite the licensee for violating the provision in the Act which states, “A license holder shall: (1) maintain records to substantiate the contents of each report....”⁴. However, there is no further requirement in the Act or in the administrative rules specifying that these two journals be maintained, nor what the contents of such journals must include. The licensee could argue that, regardless of the maintenance of the specific journals, other available records could substantiate the contents of the quarterly reports. While CBOD makes available to licensees templates of a “Sales Journal” and a “Cash Disbursement Journal”, Internal Audit was unable to find any formal communication to licensees requiring the use of these templates.

Fairness of Process

The role of the CBOD auditors extends beyond assessing compliance. The auditor is in a position to make final determinations as to the resolution of reported issues, including the adequacy of any corrective actions taken. This is particularly concerning in light of the limited published guidance which is available to the licensee regarding criteria against which they will be audited.

- *“Coming into Compliance”:* Upon completion of reviews and audits, CBOD auditors prepare violation reports. The auditors then receive the licensee’s responses to the report and make determinations on the appropriateness and sufficiency of the

³ Occupations Code §2001.458

⁴ Occupations Code §2001.505(b)(1)

corrective actions taken by the licensee. If the auditor determines the corrective action taken is sufficient to correct the violation cited, no further action is taken. However, if the auditor determines the corrective action is not sufficient, a violation report is forwarded to headquarters (Austin) with a recommendation for administrative action. Administrative actions can include monetary sanctions, as well as revoking or denying a license. For example, if the auditor cites a licensee for unallowable expenditures, the licensee can redeposit the amount of unallowable expenditures into their bingo-designated account. The licensee will then be considered to have “come into compliance” and no further administrative action is taken, regardless of the dollar value in question. Whereas, if a licensee either disagrees with the auditor’s conclusion or does not have the funds available to redeposit, a recommendation is forwarded to Austin to pursue administrative action.

- *Final vs. Draft Report:* We found that at the completion of a compliance review or audit, the licensee does not receive a final report. At the exit conference, the licensee is provided a draft report to which they must respond in writing within 15 working days. In interview, CBOD management indicated that a final report is prepared but maintained in the division’s files. A final, issued report is not provided to the licensee. The licensee must respond in writing and provide proof of corrective measures taken to address the findings of a draft report. At this stage, draft reports provided at exit conferences have not received any type of quality or supervisory review by any member of CBOD management, including the Audit Services Manager, and may not have received a first-level review at the field office level.

The sequence of events is understandably concerning from the licensee’s perspective. At an exit conference, the licensee is provided a document which is stamped as “draft”. They are informed that they must respond in writing to this “draft” report and show evidence of adequate corrective actions. If the licensee does not agree, does not respond in time, and/or is unable to show adequate corrective action, the next item of correspondence the licensee receives will be a letter from the CBOD Director, sent via certified mail, either providing notice of renewal application denial (“notice of denial”) or requesting the licensee to show compliance or risk revocation of their license (“show compliance letter”).

The concern as to whether a final report is issued is also significant to determine whether CBOD adequately complies with the Act regarding written notices of violations and penalties. While the Act does not explicitly require the issuance of a violation report, stating, “...the director may issue a violation report...”⁵; the Act does require, “Not later than the 14th day after the date on which the report is issued, the director shall give written notice of the report to the person alleged to have committed the violation.”⁶ In interview, the Audit Services Manager stated the notices of denial and the show compliance letters serve as both the issued violation report and the written notice concurrently. In our opinion, this practice is unclear and confusing to

⁵ Occupations Code §2001.603(a)

⁶ Occupations Code §2001.603(b)

- the licensee and does not adequately address the intent of the related statutory provisions.
- *Dispute Resolution Process:* Per the administrative rules⁷, the licensee must respond in writing within 15 working days of the exit conference and must provide proof of corrective measures taken within 30 days of the exit conference. The administrative rules do not address instances in which the licensee disagrees with the auditor's conclusions and either does not intend to, or is unable to, take corrective action. Outside of the formal administrative hearings process, no apparent process exists or is provided for the licensee to dispute or appeal the auditor's conclusion. While there is no requirement for a separate process, the only apparent option available to the licensee is the administrative hearing process. Licensees have expressed concern and lack of familiarity with this process, assuming that they must hire a lawyer. The administrative hearing process can be both time-consuming and resource-intensive to both the agency and the licensee. Faced with the potential burden and uncertain outcome of the administrative hearing, it is conceivable that many licensees opt to settle their cases by signing an agreed order.

Clarity of Scope

During our audit, we noted a lack of clarity regarding the scope of audits, reviews, and inspections conducted by CBOD auditors. Appendix A of this report provides additional information from CBOD regarding the types of examinations conducted by the Audit Services Department.

- *Licensees' Expectation and Understanding of Audit Coverage:* Some licensees have expressed confusion regarding the scope covered by CBOD auditors in their performance of audits, reviews, and inspections of licensees. The Audit Services Department does not provide licensees a clear and accurate representation as to the scope covered during these examinations. For example, while the notification letter to the licensee may state the period to be audited is one year, only one quarter is in fact reviewed if the auditor conducts a compliance review.

Some licensees have expressed concern when violations are cited at the conclusion of an examination. Because CBOD auditors may have examined a licensee multiple times in the past and violations had not been cited, the licensee might have assumed they were in compliance. This is especially concerning when the audit period reaches back four years, during which time CBOD auditors may have performed one or more examinations.

The scope paragraph contained in the draft audit or review report provided to the licensee typically reads as follows,

We conducted our audit in accordance with the procedures set forth in the Audit Procedures Manual, issued by the Texas Lottery Commission. Those procedures require that we plan and perform the audit to verify financial

⁷ Texas Administrative Code §402.500(g)-(h)

records and accounts comply with the Bingo Enabling Act and the Charitable Bingo Administrative Rules.

However, other than requesting a copy through an Open Records request, licensees do not have ready access to the Audit Procedures Manual utilized by the Audit Services Department. Only very general information regarding the scope of coverage is available in other CBOD publications and in the agency's administrative rules.

The agency's administrative rules do not specifically address all of the types of examinations conducted by the Audit Services Department. The vast majority of examinations conducted by CBOD auditors are Assessment & Assistance Inspections (A&A's), which are not specifically addressed in the agency's administrative rules. These on-site visits are extremely limited in their scope and do not include an examination of the licensee's books and records.

- *Terms Used for Examinations:* We found little difference exists between the Compliance Reviews, the Compliance Audits, and the Financial Audits conducted by CBOD auditors. In reviewing the actual procedures performed during these engagements, the terms appear to be somewhat of a misnomer, in particular "financial audits". Each principally consists of reconciling the organization's self-reported data to the organization's bank account balance and testing the allowability of reported expenses. The primary difference appears to be the time period covered – one quarter, four quarters, and up to four years, respectively. As discussed previously, this can and has lead to confusion and misunderstanding on the part of licensees regarding the scope of coverage.

Recommendation: We recommend CBOD adopt processes to better ensure licensees a fair, consistent, and open regulatory experience. These processes should ensure the licensee is adequately apprised of the regulatory criteria, of the audit process, and of the availability of dispute resolution. We recommend the following:

- a) All criteria against which the licensee is assessed must be clearly and consistently substantiated. CBOD should develop and publish guidelines for compliance complete with criteria to which the licensee is expected to adhere. The necessity for rulemaking to accomplish these guidelines should be considered in consultation with the Legal Division. The requirements should then be clearly and adequately communicated to the licensees and the auditors. Requirements should include definitions of reasonable or necessary expenses, and any books and records requirements.
- b) The Audit Services Department should issue a clearly identified final report to the licensee upon the conclusion of an examination. The report should be subject to adequate quality review prior to issuance.
- c) CBOD management should review all reports to determine whether administrative actions should be taken regardless of the licensee's ability to come into compliance. Some violations may be so egregious that administrative penalties should always be assessed.

- d) CBOD management should consider a rule change that gives licensees an opportunity to provide proof of corrective measures taken for noted violations within 30 days of receiving a final report, rather than 30 days after the exit conference.
- e) CBOD should segregate the audit and final determination processes. The auditor's role should not include the authority to determine resolution or the adequacy of corrective action for outstanding issues. The audit function should be discrete from any final determination functions.
- f) CBOD should develop an audit dispute resolution process to allow licensees a chance to discuss their views with someone within CBOD that is independent from the audit function. The licensee should be afforded an adequate venue to disagree with the auditor's conclusions prior to the administrative hearing process. This would provide an opportunity to resolve disputes before the administrative action and hearings process begins.
- g) To ensure clear understanding, CBOD should provide a guideline of the audit, dispute resolution, determination, and administrative processes in layman's terms for licensees.
- h) CBOD management should reconsider the types of examinations it currently conducts and ensure the efforts of the Audit Services Department are appropriately aligned with identified risk. The types of examinations conducted by the Audit Services Department should then be clearly defined and communicated to the licensees. This information should clearly state the scope of each examination. Notification letters, reports and other correspondence related to the conduct of examinations should clearly annotate the exact scope covered during the examination, including pertinent information regarding elements not covered in the examination.
- i) CBOD management should consider the potential impact the practices noted within this finding may have had on certain regulatory enforcement actions taken and decisions made in the past. CBOD management should promptly consider the need to address certain past actions taken and decisions made based on these conditions.

Management's Response:

Management agrees with the recommendations and will take the following action:

- 1) *CBOD will develop or revise existing rules and procedures with input from the Legal Division and Enforcement Division to ensure licensees a more fair, consistent, and open regulatory experience and to meet our regulatory objective. Management has started a detailed process with the Legal Division and Enforcement Division to carefully review existing statute and administrative rules for needed additions or changes. Through the rule making process, the public and licensees will be afforded the opportunity to review and comment on proposed revisions or new rules.*
- 2) *Audit Services will develop procedures and processes consistent with the division's regulatory objective that would clearly identify the issuance of a final audit report, the measures licensees must take to provide proof of corrective action and a process to dispute any findings. Informational materials for licensees regarding these matters will be developed and disseminated. The Director and Audit Services will identify ways to*

separate the audit and final determination processes including developing a process for all reports to be reviewed.

- 3) *CBOD will evaluate and define the types of audit activities to be conducted to ensure audit efforts are appropriately aligned with the regulatory objective, identified risk and available resources. CBOD management is currently reviewing past audits and will review those decisions and their potential impact.*

The development or revision to existing rules will seek input from the Legal Division and Enforcement Division.

Target date: Review of past audit reports and associated decisions Summer 2007. The remaining actions December 2007.

Responsible Departments: Director and All Departments in CBOD

3 **Audit Methodology and Protocol** – *The audit methodology and protocol used by the Audit Services Department does not ensure adequate audit coverage and quality.*

Audit Methodology

In reviewing the methodology utilized by CBOD auditors in their performance of compliance reviews, audits, and other activities, we noted the following concerns:

- *Determining Proceeds:* The current methodology for compliance reviews, compliance audits and financial audits does not focus on verifying the actual proceeds generated from bingo. The current methodology does not verify the total sales nor the actual prizes awarded, but rather reconciles the organization’s self-reported quarterly figures to the organization’s bank account balance. If the amounts agree, the auditor then focuses testwork on the allowability of expenses paid out of the organization’s bingo account. However, by not verifying total sales or prizes awarded, the auditors can not meet the statutory charge of determining whether “...*the proceeds derived from bingo are used for an authorized purpose...*”⁸ because the auditors have not determined what the proceeds should be.

During our review, a CBOD audit came to our attention in which the auditors concluded that the licensee did not deposit all of its funds as required. Based on the auditors’ description of their work performed and our review of the audit working papers, we found that the auditors had neither verified nor determined the amount of gross sales nor the amount of prizes awarded, but rather relied upon the licensee’s self-reported figures for these amounts. In relying upon potentially erroneous self-reported amounts, the auditors concluded that the ending deposits were short.

⁸ Occupations Code §2001.051(b)

However, by not determining the amount that should be there to begin with, it is impossible to conclude that any amount is missing.

- *Fairness of Games:* While agency administrative rules address manufacturing requirements of bingo paper and pull-tabs to ensure fairness, limited rules exist which address the fair conduct of a bingo game. Consequently, CBOD auditors perform limited review in this area. The Audit Services Department does perform testing of electronic bingo devices to ensure fairness and conformance to requirements, however, limited work is performed on-site in addressing the statutory charge of ensuring "... bingo is fairly conducted..."⁹ We did find, however, that auditors made informal recommendations to licensees regarding ways to help ensure the fairness and integrity of bingo games.
- *Use of Proceeds by Recipients:* We found CBOD auditors also performed limited review regarding the charitable use of proceeds. In addition to requiring proper charitable distributions by licensees, the Act also addresses the use of those proceeds by recipients. The Act limits the use of such donations; however, the auditors' methodology does not include testing donations made by licensees to third parties. Specifically the Act states, "A person given bingo proceeds for a charitable purpose may not use the donation: (1) to pay for services rendered or materials purchased in connection with the conduct of bingo by the donor organization; or (2) for a purpose that would not constitute a charitable purpose if the activity were conducted by the donor organization."¹⁰

Audit Protocol

An adopted audit protocol is a framework which helps to ensure the accuracy, consistency, and verifiability of the auditor's actions and reports. This includes ensuring that all audit work is conducted with due professional care, that adequate supervisory review occurs, and that audit conclusions are sufficiently and competently supported and fairly reported. While some guidance is available to the CBOD auditors in the form of policies and procedures, we found that the guidance was often lacking or outdated. Ultimately, existing guidance did not adequately ensure proper evidential matter was obtained, adequate supervisory review occurred, or due professional care was exercised.

- *Proper Evidential Matter:* Internal Audit's testwork disclosed audit working papers did not always adequately support the audit reports, nor the administrative actions ultimately taken based on those reports. Internal Audit could not always come to the same conclusions as the CBOD auditors when reviewing the evidence presented in the working papers.

In reviewing a sample of reviews and audits to determine if the auditors' working papers adequately supported the conclusions in those reports, we found the following:

- Instances in which no supporting documentation was available.

⁹ Occupations Code §2001.051(b)

¹⁰ Occupations Code §2001.455

- Instances in which documentation was available, but the documentation did not support the finding (e.g., amounts cited in working papers did not match amount cited in report).
- Instances in which documentation was available, but Internal Audit disagrees with the auditor's conclusion as to the interpretation of the documentation.
- Instances in which findings were adequately supported.

Some of the weaknesses in sufficiency and competency of evidence were attributable to the following:

- Relying upon self-reported documentation prepared by licensees as factual evidence.
- Not obtaining copies of licensee source documentation.
- Confining audit findings to predetermined violation categories.

Overall, our review of the reports and the supporting working papers lead us to conclude that proper evidential matter is not always obtained to support the auditor's conclusions.

- *Adequate Supervisory Review:* All CBOD auditors report directly to the Audit Services Department Manager. Individuals at the field office level have been designated as "coordinators" but are not supervisory. As discussed previously in this report, draft audit reports are presented to licensees and licensees are expected to take corrective actions based on those draft reports. At this stage, while the field office coordinators may have some involvement and may have performed a first-level review, the audit working papers and reports have not been subjected to a second-level, supervisory review.
- *Due Professional Care:* In auditing, due professional care calls for the application of the care and skill expected of a reasonably prudent and competent auditor in the same or similar circumstances. It implies reasonable care and competence, not infallibility or extraordinary performance. Central to the concept of due professional care is assessing the extent of audit work needed. This assessment is based on a number of factors, all tied to risk, but fundamentally grounded in the auditor's assessment of the adequacy and effectiveness of the auditee's internal control environment. During our review, we did not find that CBOD auditors performed such an assessment.

While some questions are asked of the licensee related to internal controls, CBOD auditors perform limited audit work in assessing the adequacy and effectiveness of controls. We found minimal requirements and guidance have been provided to the licensee regarding necessary and appropriate internal controls. Accordingly, CBOD audits, reviews, and inspections do not address the licensee's control environment, and do not adjust the extent of audit work performed based on an assessment of the control environment.

Recommendation:

The Audit Services Department should adopt a methodology and an audit protocol which will ensure adequate coverage and audit quality. We recommend the following:

- a) The Audit Services Department should reconsider their licensee examination efforts to ensure they address the statutory charge. Specifically, the department should be able to link their methodology directly to ensuring that bingo conducted in this state is fairly conducted and that proceeds derived from bingo are used for an authorized purpose. The methodology should also be aligned with the division's overarching regulatory objective recommended earlier in this report.
- b) The audit methodology should include determining the actual proceeds generated from bingo and verify that the proceeds have been accurately reported. To accomplish this, the Audit Services Department should include procedures to conduct inventory analysis related to bingo paper and pull-tabs. The Audit Services Department should obtain sales information from the manufacturers and distributors to assist in this process.

The audit methodology should also include validating the total prize payouts to ensure accurate fees have been forwarded to the State. This, in addition to verifying authorized expenses, will help determine the net proceeds that should be available for charitable distributions.

Additionally, CBOD management should address how to better ensure charitable distributions are made, and ultimately used, in accordance with the Act and agency administrative rules. The Audit Services Department should then ensure that examination procedures are updated accordingly.

- c) In lieu of developing and promulgating their own audit protocol, the Audit Services Department should voluntarily adopt the standards and guidance contained in the Generally Accepted Government Auditing Standards (GAGAS)¹¹ to help ensure the accuracy, consistency, and verifiability of the auditor's actions and reports. Until such time the Audit Services Department can develop and promulgate their own audit protocol, voluntarily adopting existing guidance for auditors should help ensure an appropriate framework for the conduct of all engagements. Specifically, we recommend the Audit Services Department adopt the GAGAS general standards and fieldwork and reporting standards for performance audits. These standards should assist the department in ensuring proper evidential matter is obtained, adequate supervisory review occurs, and that due professional care is exercised.
- d) CBOD management should consider posting the Audit Services Department's examination methodology, procedures and protocol on the agency's website and ensure that such information is available to licensees.
- e) In exercising due professional care, the Audit Services Department should ensure each auditor considers the following prior to each engagement:
 - The extent of audit work needed to achieve audit objectives.

¹¹ Government Auditing Standards published by the United States General Accounting Office

- The relative materiality or significance of matters to which audit procedures are applied.
- The adequacy and effectiveness of internal controls.
- Probability of significant errors, irregularities, or noncompliance.
- The cost of auditing in relation to potential benefits.

Ultimately, the audit protocol and methodology should include evaluating the internal control structure of the licensees in order to gain assurance that the games are fairly conducted, that the licensee is in conformance with the Act, agency rules and guidance, and that the licensee's records are accurate, complete, and reliable. The Audit Services Department should develop a standard methodology that considers the extent of procedures performed based on an assessment of the strength and reliability of the internal control structure.

- f) To aid in the ultimate implementation of these recommendations and to better assist licensees in regulatory compliance, CBOD should consider establishing minimum internal control standards for licensees. Examples of minimum internal control standards implemented in other states include the following requirements: 1) bingo reports sent in to the division must be signed by the operator and a ranking officer of the licensee, 2) the bingo balls must be inspected and counted prior to the start of each occasion, 3) the inventory must be counted and records verified at least quarterly by an organization member who is not associated with bingo operations, 4) the authenticity of each payout is verified by at least two persons, and 5) someone other than the person(s) authorized to sign checks on the account must reconcile the bingo bank account monthly.¹²
- g) As in the previous finding, CBOD management should consider the potential impact the practices noted within this finding may have had on certain regulatory enforcement actions taken and decisions made in the past. CBOD management should promptly consider the need to address certain past actions taken and decisions made based on these conditions.

Management's Response:

Management agrees with the recommendations and will take the following action:

- 1) CBOD will evaluate and define the types of audit activities and methodology to ensure audit efforts address the statutory charge and regulatory objective. Management has also started a detailed process with the Legal Division and Enforcement Division to carefully review existing statute and administrative rules for needed additions or changes.*
- 2) CBOD will voluntarily adopt the general standards and fieldwork and reporting standards contained in GAGAS. Additionally, the audit protocol, examination methodology, and procedures will be placed on the Division's website once developed.*

¹² State of Connecticut Division of Special Revenue, The State of Rhode Island and Providence Plantations Division of State Police, The Mississippi Gaming Commission, and The Nevada Gaming Control Board.

3) *CBOD management is currently reviewing past audits and will review those decisions and their potential impact.*

The development of the audit types, methodology, internal controls and adoption of the GAGAS will seek input from the Legal Division, Enforcement Division and Internal Audit. If there is a need for any programming changes, then Information Resources will be looked to for assistance.

Target date: Review of past audit reports and associated decisions Summer 2007. December 2007 for identifying minimum internal control standards for licensees. January 2008 for identifying appropriate courses and training of audit staff on GAGAS. May 2008 for defining audit activities and methodology and adopting the general standards and fieldwork and reporting standards contained in GAGAS.

Responsible Departments: Director, Audit Services and Accounting Services

4

Organizational Structure and Responsibilities – *The current organizational placement and responsibilities of the Audit Services Department do not ensure the auditors adequate independence.*

Auditors of charitable bingo licensees are housed in the Audit Services Department of the Charitable Bingo Operations Division (*Figure 1*). This department is one of the three departments which report directly to the CBOD Assistant Director. The auditors are primarily located in field offices throughout the state, with some Audit Services staff housed in the Austin headquarters.

The role and responsibilities of the auditors have expanded in recent years. In addition to conducting audits, reviews, and inspections, the auditors also provide required training to licensees, provide technical assistance to licensees, and perform investigations of jurisdictional bingo-related complaints.

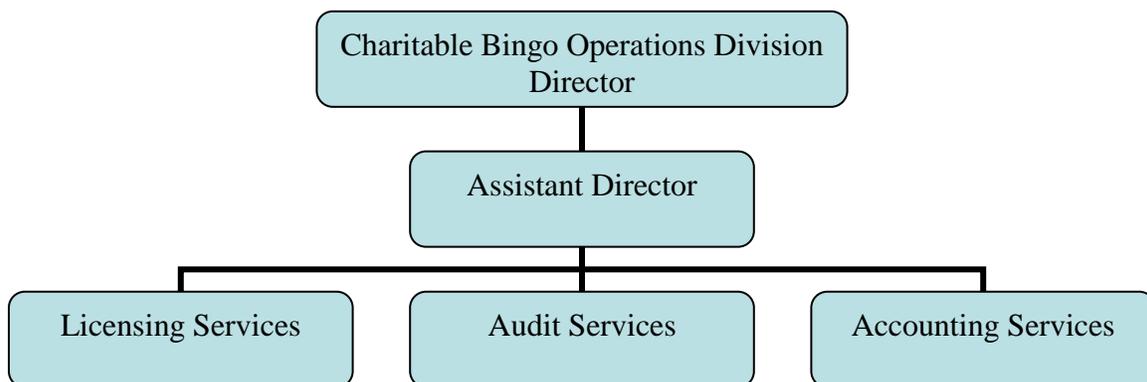


Figure 1

Incompatibility of Duties

As described above, CBOD auditors perform multiple roles including auditor, investigator, trainer, and advisor. These roles call on the auditor to provide guidance and assistance to licensees, in addition to assessing the licensee's compliance. The guidance and assistance that auditors provide is understandably perceived by licensees as directives. This then places the auditors in the incompatible role of assessing the licensee's actions and activities against criteria set by the auditor.

The wide scope of roles also places the auditors further from their core charge of assessing compliance. The auditors' responsibilities expand beyond assessing compliance into making final determinations as to the resolution of reported issues, including the adequacy of any corrective actions taken. As detailed under "Licensee Experience", this expansion does not adequately provide for a fair process for licensees.

Reporting Structure

The CBOD auditors' organizational placement also limits optimal independence. The auditors should be as independent as possible from other functions within the division which have licensing determination and other programmatic responsibilities. Currently, all of these functions report to the Assistant Director. This reporting structure can limit, whether in fact or in appearance, the independence of the auditors in objectively reporting their conclusions.

Recommendation: We recommend organizational structure changes occur which would allow for greater independence of the Audit Services Department. We further recommend CBOD management clarify the roles and the responsibilities of the department to include only those duties appropriately carried out by an audit function. Specifically, we recommend management consider the following:

- a) Place the Audit Services Department as a direct report to the CBOD Director. CBOD management, in consultation with the Commissioners and the TLC Executive Director, should also consider the appropriateness and feasibility of separating the Audit Services Department from CBOD entirely.
- b) Implement recommendations related to segregating certain duties and processes from the Audit Services Department detailed under "Licensee Experience".
- c) Discontinue the practice of having auditors perform licensee training and other assistance efforts. Such assistance activities are more appropriately performed by individuals outside of the audit process.

Management's Response:

Management agrees with the recommendation related to segregating certain duties and processes from the Audit Services Department. Additionally, management will consider organizational structure changes to accomplish the charge and will take the following action:

CBOD will review the job function and responsibilities of each employee in the CBOD. Based on the results of this review a recommendation will be made to the Commissioners on the appropriate organizational structure changes.

The review of the job function and responsibilities of each employee in the CBOD will seek input and assistance from the Human Resource Division.

Target date: December 2007.

Responsible Departments: Director and All Departments in CBOD

5 Additional Concerns

In conducting our review, additional items came to our attention. However, due to the scope of our audit, we performed limited audit work and analysis of these items. Accordingly, we do not present these items as audit findings. We present these items for management's consideration.

Integrity and Reliability of the Automated Charitable Bingo System

The Automated Charitable Bingo System (ACBS) contains extensive financial and operational performance data for licensees, in addition to other licensee information. During our review, we came across information that led us to question the data integrity of ACBS. While much of the information is self-reported by licensees, we learned that CBOD makes direct "corrections" to prior period figures based on reviews and audits, including instances in which the licensee disagrees with the review or audit results. We also found instances in which data retrieved was inconsistent. The agency's Controller also shared concerns regarding summary data not matching the detailed record data. The need for the integrity and reliability of ACBS is significant. The system is the primary database for all licensee information and tracking. The division prepares public reports based on the data, performs licensee tracking and risk assessment utilizing the system, and audits licensees against the data contained within ACBS.

Unimplemented Provisions in the Bingo Enabling Act

There are provisions in the Act that CBOD has not implemented. These provisions could enhance and strengthen regulation of charitable bingo. Examples include requiring licensees to submit and maintain prize award information and card pricing information. More examples are listed in Appendix B to this report. We recommend management consider the value and need to implement such provisions.

Clarity Needed within the Bingo Enabling Act:

During our audit, we noted several areas in the Act which lacked consistency, clarity, and/or relevance. These discrepancies present a challenge for CBOD to ensure it is effectively and

efficiently administering the Act. We noted agency staff and external entities (both oversight and interest groups) have also identified needed clarification.

Paradigm – Operator vs. Organization

During our review and observation of examinations and other activities performed by CBOD auditors, we noted much of the focus is directed to the designated operator for the licensee, as opposed to the organization who is the actual license holder. While the operator is the organization's representative at bingo games, it is the organization that is ultimately responsible for compliance with the Act and agency administrative rules. The attention and focus on the operator seems to detract from the ultimate accountability of the organization.

AUDIT PURPOSE, SCOPE AND METHODOLOGY

Purpose: Internal Audit completed a review of charitable bingo regulation as specified in the approved Fiscal Year 2006 Internal Audit Activity Plan. The objective of our audit was to evaluate the effectiveness of Charitable Bingo regulation in achieving the statutory purpose as articulated under Occupations Code §2001.051(b).

Scope: The scope of this audit was limited to the activities performed by the Charitable Bingo Operations Division - Audit Services Department. In addition, based on risk, we further limited our scope to examining the regulation of organizations licensed to conduct charitable bingo.

Methodology: In accomplishing our objective, Internal Audit researched legislation, rules and prior audits of Charitable Bingo. We observed CBOD auditors perform compliance reviews, a game observation, assessment and assistance inspections, complaint investigations, books and records inspections, a location verification inspection, and operator training. We performed testing of sufficiency of evidence contained in CBOD working papers. We reviewed licensing files and interviewed enforcement, accounting, and licensing personnel. We reviewed files supporting administrative actions taken against licensees. We also conducted research of other states' bingo regulatory programs and interviewed sales tax audit management from the Texas Office of the Comptroller. Internal Audit interviewed responsible management and staff, assessed management controls, examined and reviewed supporting documentation and electronic files, and performed selected testwork as deemed necessary. Source documentation was examined to the extent available. Internal Audit's review did not include verifying the reliability and integrity of financial and other operating systems. We relied upon other independent audit work as relevant and appropriate.

Auditor's Consideration of Fraud: In accordance with our professional standards, Internal Audit considered risks due to fraud that could significantly affect our audit objectives and the results of our audit. Accordingly, we designed our procedures to provide reasonable assurance of detecting fraud significant to the audit objectives. During the course of the audit, we were also alert to situations or transactions that could be indicative of fraud. We conducted our audit to provide reasonable assurance of detecting illegal acts or fraud that could significantly affect the audit results; however, it does not guarantee the discovery of illegal acts or fraud.

Professional Standards: Internal Audit conducted its review in accordance with the International Standards for the Professional Practice of Internal Auditing as promulgated by the Institute of Internal Auditors (IIA), and the generally accepted government auditing standards (GAGAS) as promulgated by the U.S. Government Accountability Office (GAO).

BACKGROUND

The following is a discussion of the activities of the Audit Services Department as presented in the Charitable Bingo Operations Division 2005 Annual Report:

The Audit Services Department of the Charitable Bingo Operations Division conducts a variety of audit activities including audits, reviews and inspections. Assessment and Assistance Inspections are performed to verify that licensed organizations are conducting bingo occasions in compliance with the Bingo Enabling Act and Charitable Bingo Administrative Rules. An auditor attends a bingo session at a conductor's licensed location and observes a reasonable portion of the game session. In addition to verifying compliance the inspection is an opportunity to insure that every location will be visited at least once a year. The inspection provides an opportunity for the licensee to become acquainted with personnel of the Charitable Bingo Operations Division, ask questions and receive guidance. The inspection provides an opportunity to promote customer goodwill by opening avenues of communication, providing assistance and helping organizations to identify and solve problems.

Auditors investigate bingo related complaints filed with the Commission and possible violations of the Bingo Enabling Act and/or Administrative Rules of the Commission.

The Bingo Enabling Act and Charitable Bingo Administrative Rules require certain records be maintained. Licensees are not required to maintain records in a specific format but they are required to maintain the information that is included on the forms suggested by the Commission. Books and Records Inspections are conducted to determine if the required records and information are being maintained. These inspections are a limited review of a licensee's records. The inspections are limited to a minimum of one quarter and are designed to be an education-based review to train a licensee on how to properly maintain books and records.

Pre-licensing Interviews are conducted for organizations prior to the issuance of the organization's original license to conduct charitable bingo in Texas. The purpose of the interview is to ensure the individual designated as the primary operator of the organization's bingo activities has read and is familiar with the requirements of the Bingo Enabling Act and the Charitable Bingo Administrative Rules.

Site Inspections include conductor location verification inspections, lessor location verification inspections, and inspections of manufacturers and distributors licensed to sell bingo equipment and supplies in Texas.

Compliance Audits, Compliance Reviews, and Financial Audits are conducted to determine whether the records, books and accounts of the organization accurately

reflect financial and fiscal operations and whether effective accounting controls are maintained and to determine whether funds are received and used for purposes authorized by the Bingo Enabling Act and Charitable Bingo Administrative Rules. Compliance Reviews are conducted on one quarter of the organization's records, Compliance Audits are conducted on four quarters of the organization's records and Financial Audits may cover four years of an organization's records and are more comprehensive in nature.

APPENDIX A

The following is an excerpt from the Bingo Operations Manual, revised November 1, 2005, prepared by the Charitable Bingo Operations Division. In this excerpt, CBOD describes the various types of examinations conducted by the Audit Services Department.

Audits, Reviews and Inspections

Audits and Reviews

When an audit or compliance review is conducted, the organization will be notified in advance in writing. The letter will state the period to be audited, and will include a list of the records that will be required to be presented. Also included with this letter will be a questionnaire about the bingo operation and the organization. As stated in Rule 402.500(e)(1), the licensee must complete this form.

After the audit or review has been completed an exit conference will be scheduled. The exit conference is an informal meeting between the representative(s) of the licensee and the auditor(s). This meeting gives each side the opportunity to discuss the specific facts related to the issues of the audit and how the laws and rules apply to those facts. The draft report with the audit findings and violations will be presented at this exit conference. The licensee will have 15 working days after the exit conference to respond in writing to all relevant audit finding and recommendations. Proof of corrective measures taken to address any alleged audit violations must be submitted in writing to the commission within 30 working days of the exit conference. Any funds that are required to be redeposited into the bingo account may not be made from funds derived from the conduct of bingo.

Inspections

The audit division conducts several types of inspections. Types of inspections conducted are:

Books and Records Inspection

- Limited review of licensee's records*
- Education-based review to train a licensee how to maintain records*
- The review period will be a minimum of one quarter*
- The licensee will be notified in writing in advance of the inspection*
- An operator or business contact must attend the inspection*
- At the conclusion, the auditor will communicate compliance issues, and make recommendations on how to correct any deficiencies*

Tax Review Inspection

- *Purpose is to obtain delinquent quarterly reports and/or delinquent prize fees or rental taxes*
- *A Charitable Bingo Audit Violations form will be issued documenting violations of Bingo Enabling Act*

Location Verification Inspection

- *To provide assistance with licensing process and to review the business records*
- *To verify the location listed is where the applicant is conducting their primary business*
- *To verify the location listed is where the applicant maintains their business records*
- *To verify the county listed is where the applicant is principally located*
- *To obtain items that were requested by the licensing examiner*
- *If inspection is of a lessor, to determine that there is only one bingo hall under the same roof or over a common foundation*

Assessment & Assistance Inspection

- *Conducted during the licensed occasion to verify that conductors are in compliance with the Bingo Enabling Act and Administrative Rules*
- *Auditor will usually arrive unannounced*
- *The conductor will be notified in writing of any compliance issues noted during the occasion*

APPENDIX B

The following are examples of provisions within the Bingo Enabling Act that CBOD has not implemented.

Occupations Code §2001.505(a):

A licensed authorized organization conducting bingo shall submit quarterly to the commission and to the comptroller a report under oath stating:

(3) Each item of expenditure made or to be made, the name and address of each person to whom each item has been paid or is to be paid, and a detailed description of the merchandise purchased or the services rendered.

(6) A list of prizes offered and given, with their respective values

Occupations Code §2001.056(e):

The commission by rule may require a licensed authorized organization to notify the commission of the price for bingo cards the organization will use for one or more reporting periods.

Occupations Code §2001.506:

The commission by rule may require a licensed authorized organization to maintain records relating to each person to whom a prize is awarded at a bingo occasion.

Occupations Code §2001.414(a):

The commission by rule may provide for different recordkeeping procedures for licensed authorized organizations by class based on the amount of gross receipts of the organization.

Occupations Code §2001.411(d):

The commission, without regard to a person's membership status in a licensed authorized organization, by rule may restrict involvement in the conduct, promotion, or administration of bingo by:

(1) A licensed commercial lessor

(2) A person having an interest in or who is active in a licensed commercial lessor

(3) A person related in the first degree by consanguinity or affinity...to a person having an interest in or active in a licensed commercial lessor.

STATE OF TEXAS
TEXAS LOTTERY COMMISSION

INTERNAL AUDIT DIVISION

An Internal Audit of
CHARITABLE BINGO REGULATION - AUDIT SERVICES

IA #06-022

August 2006

This report has been provided to the following:

Mr. C. Tom Clowe, Jr., Chair
Mr. James A. Cox, Jr., Commissioner

Mr. Anthony J. Sadberry, Executive Director
Mr. William L. Atkins, Charitable Bingo Operations Director

This report is also provided to the following for appropriate distribution in accordance with
Government Code §2102.009:

Mr. Mike Morrissey, Director, Governor's Office of Budget, Planning and Policy
Mr. John O'Brien, Deputy Director, Legislative Budget Board
Mr. Joey Longley, Director, Sunset Advisory Commission
Mr. John Keel, CPA, State Auditor