

TEXAS LOTTERY COMMISSION INTERNAL AUDIT DIVISION



An Internal Audit of RETAILER ACCOUNTS

IA #09-020
October 2009

Mary Ann Williamson
Chairman

David J. Schenck
Commissioner

J. Winston Krause
Commissioner



TEXAS LOTTERY COMMISSION

Gary Grief, *Deputy Executive Director*

Philip D. Sanderson, *Charitable Bingo Operations Director*

October 1, 2009

Ms. Mary Ann Williamson
Texas Lottery Commission
P.O. Box 16630
Austin, TX 78761-6630

Dear Chair Williamson:

The accompanying report details Internal Audit's recently completed review of Retailer Accounts. The purpose of the audit was to evaluate the adequacy and effectiveness of internal controls for ensuring accurate and efficient retailer collections and adjustments. In addition, we sought to evaluate tools in place to protect the State from monetary loss in the event of retailer non-payment.

Overall, based on the results of our review and testing, controls provide reasonable assurance that the retailer sweep is performed accurately, retailer adjustments are made accurately and in accordance with agency policies and procedures, and the collection of non-sufficient funds (NSFs) is performed in a timely manner. We present management recommendations to strengthen controls and improve current processes. Additionally, opportunities may exist to further manage and minimize the State's risk of loss.

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 blue ink, appearing to read "Catherine A. Melvin".

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

TABLE OF CONTENTS

| | |
|--|-----------|
| EXECUTIVE SUMMARY | 1 |
| PROCESS OVERVIEW | 2 |
| DETAILED REVIEW RESULTS..... | 3 |
| 1. Retailer Accounts Sweep Process | 3 |
| 2. Retailer Adjustments | 5 |
| 3. Processing of Non-Sufficient Funds (NSFs) and Collections Process | 6 |
| 4. Tools for Protecting the State | 7 |
| a) <i>Pooled Bond Fund</i> | 8 |
| b) <i>Financial Securities</i> | 8 |
| ADDITIONAL ITEMS | 13 |
| 1. Agency Bad Debt Collections Policy and Rule | 13 |
| 2. Agency Bad Debt Write Off Policy..... | 14 |
| 3. Reporting of Financial Securities | 14 |
| AUDIT PURPOSE, SCOPE AND METHODOLOGY | 15 |

This page intentionally left blank.

EXECUTIVE SUMMARY

In Fiscal Year 2008, the Texas Lottery Commission (TLC) generated over \$3.6 billion through instant ticket and online game sales. The Texas Lottery Commission collects this revenue from its licensed retailers through a weekly sweep of the lottery retailers' bank accounts. The weekly sweep is performed to ensure timely deposit of retailer sales revenue and to reimburse retailers for funds owed to them for commissions earned on sales and for cashing winning tickets. In Fiscal Year 2008, on average \$30 million was swept each week from licensed retailer bank accounts totaling over \$1.5 billion for the fiscal year.

The objective of this audit was to evaluate the adequacy and effectiveness of internal controls for ensuring accurate and efficient retailer collections and adjustments. A secondary objective was to evaluate the tools in place to protect the State from monetary loss in the event of retailer non-payment.

Overall, based on the results of our review and testing, controls provide reasonable assurance that the retailer sweep is performed accurately, retailer adjustments are made accurately and in accordance with agency policies and procedures, and the collection of non-sufficient funds (NSFs) is performed in a timely manner. We present management recommendations to strengthen controls and improve current processes. Additionally, opportunities may exist to further manage and minimize the State's risk of loss.

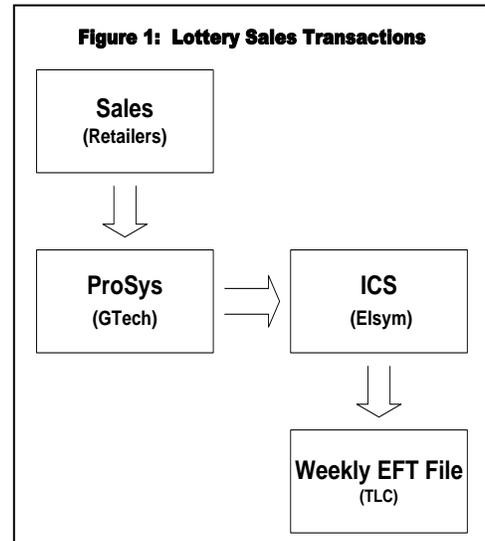
Internal Audit would like to express our appreciation to the Lottery Operations Division, the Information Resources Department, and the Office of the Controller for their cooperation and assistance during this engagement. Their courtesy and responsiveness extended to Internal Audit allowed us to complete our work effectively and efficiently.

PROCESS OVERVIEW

After a retailer application is approved, GTECH provides the licensed retailer with a terminal at the retailer's premises to conduct lottery business. The terminal records transactions that are initiated at licensed retailer locations and provides information to retailers about their accounts. The licensed retailers' transactions are then transferred in near-real time from ProSys, GTECH's gaming system software, to the Internal Control System (ICS).

ICS is an automated audit tool developed by Elsym Consulting, GTECH's vendor, used to verify that lottery transactions have been properly processed. For each processing day, transactions by licensed retailers are totaled separately by ProSys and ICS. The transactions must be produced on ICS with the exact same results as those generated by the ProSys system. When the results balance, the Lottery has gained assurance that transactions have been properly transferred and recorded. If the results do not balance, the discrepancy is researched to determine the cause.¹ The transactions captured by ProSys are the basis for recording and maintaining retailer accounts, including collections or distributions through the weekly sweep and adjustments to retailer accounts.

The Texas Lottery Commission does not receive independent transactions directly from retailers. The Texas Lottery Commission is reliant upon GTECH to provide accurate information. Internal Audit's review did not include verifying the reliability and integrity of the data from ProSys used to determine the retailers' weekly sweep amounts. We relied upon other audit work as relevant and appropriate.²



¹ GTECH Proposal for Lottery Operations and Services, June 2001.

² Texas Lottery Commission Internal Audit of Sales Reporting, Project No. 06-010, December 2005 and GTECH Texas Report on Controls Placed in Operation and Tests of Operating Effectiveness, September 16, 2008.

DETAILED REVIEW RESULTS

The objective of our audit was to evaluate the adequacy and effectiveness of internal controls in place to ensure accurate and efficient retailer collections and adjustments. In completing our objective, Internal Audit performed a reconciliation of the retailer sweep to net sales reported for the week ending February 14, 2009, and reconciled retailer commissions to net sales reported. Internal Audit also reviewed adjustments to retailer accounts, the collections process of retailer accounts that were no longer in a sweepable status, and the processing of non-sufficient funds (NSFs.) In addition, we reviewed the use of the pooled bond fund and the retailer financial securities, two tools used to protect the State from monetary losses.

The results of our review are presented below.

1 Retailer Accounts Sweep Process

Transactions³ by licensed retailers are captured by the ProSys system. The transactions are totaled separately by ProSys and ICS and then reconciled to ensure accuracy. Weekly, ICS creates an Electronic Funds Transfer (EFT) file that is sent to the Comptroller of Public Accounts in order to deposit or withdraw funds from each active licensed retailer's account. This process is referred to as the weekly retailer sweep. The sweep process is entirely automated and overlaps divisions within the agency. The Lottery Operations division is responsible for the accounting of individual retailer accounts and relies on GTECH's ProSys system for individual retailer account information. The Office of the Controller is responsible for reporting the aggregate of the retailer accounts and relies on ICS for financial information that is populated into the agency's financial system, MIP. Both divisions rely solely on the automated process for accurate sweep amounts. However, each division relies on separate systems to accomplish their objectives. This highlights the need to ensure a complete understanding of both automated systems and business processes. Additionally, business rules that drive the retailer sweep have not been completely documented. This may leave the agency vulnerable as reliance is placed on institutional knowledge and established system coding.

How is the Weekly Retailer Sweep Calculated?

Retailer Net Sales

- Ticket Validations (Prizes Paid)
- Commissions
- + Fees or Penalties Assessed, if any
- +/- Prior Weeks Activity, if any

Net Weekly Retailer Sweep Amount

To evaluate the accuracy of the automated sweep process, Internal Audit, 1) reviewed the end of year reconciliation of accounts receivable performed by the Office of the Controller for Fiscal Year 2008, and 2) sought to reconcile the retailer sweep to the reported net sales for the week ending February 14, 2009. The result of the Office of the Controller's reconciliation of accounts

³ Transactions include lottery sales, validations, instant ticket returns, retailer commissions and adjustments.

receivable between the Weekly Retailer Settlement Report and the internal accounting system for Fiscal Year 2008 was within their acceptable range.⁴

Internal Audit reconciled the retailer sweep to reported net sales for the week ending February 14, 2009. In performing this reconciliation, Internal Audit had to rely upon institutional knowledge from the Information Resources department and from Elsym Consulting. Elsym provided ICS system documentation regarding the aggregate retailer account detail needed to reconcile the total sweep amount.

While information is readily available in ProSys for the weekly sweep amount for each individual retailer, the aggregate amount swept each week had to be ascertained through direct conversations with Elsym Consulting who reviewed system coding for the EFT file created by ICS. In some instances, Internal Audit could only rely upon the coding in the ICS automated system obtained from Elsym as the business process of record.

For example, in order to perform the reconciliation of the sweep amount, Internal Audit performed a reconciliation of the commissions paid to the reported net sales to ensure accurate commissions are being paid to retailers. Internal Audit was initially unable to reconcile the retailer commissions, 5% of reported net sales, because of differences resulting from Pick 3 and Daily 4 commissions and free/promotional ticket commissions.

In Internal Audit's initial meetings with responsible staff, there was not a consensus on the treatment of commissions for all types of promotions resulting in free tickets. With contradicting information provided and no TLC documentation on commission payments for free/promotional tickets, Internal Audit relied upon the coding in the ICS automated system as the business process of record. Additionally, while researching the treatment of commissions for coupon promotions, we found one case in which validation parameters in ProSys allowed for an expired coupon to be redeemed. While this particular incident does not pose a significant risk (\$336 in free tickets and \$16.80 in commissions paid from expired coupons) and would not likely have been discovered during the ordinary processing and management of the retailer sweep, both examples illustrate the need for improved coordination between the divisions to ensure that intended results are achieved.

To reconcile Pick 3 and Daily 4 commissions, Internal Audit received the total sales from Information Resources for all retailers with sales ending in fifty cents for the test week. This is because both the Pick 3 and Daily 4 games can have wagers of 50 cents. With commissions of 5%, this results in a rounding of commissions by half a cent (i.e., five percent of 50 cents is 2.5 cents, which is then rounded up to 3 cents in favor of the retailers). For our test week, this rounding resulted in the Lottery paying retailers an additional \$64. This half cent payment is by design and in accordance with current payment practice for retailer commissions.

As recommended in the *Internal Audit of Sales Reporting*, IA #06-010, issued December 2005, corrections have been made in the ICS programming to account for miscellaneous credits in the general ledger. However, as previously reported, policies that drive how the ProSys and ICS systems calculate and apply retailer commissions to retailer accounts have not yet been documented.

⁴ Texas Lottery Commission Procedure *OC-GL-019, Accounts Receivable Reconciliation*, Effective Date 6/3/09.

Recommendation:

Internal Audit recommends the agency:

1. Ensure documentation is created and maintained for all business rules related to the automated sweep process, the payment policies for commissions on free tickets, adjustments, and any other relevant areas. The documentation should clearly state the policy decisions that drive the process. For example, the policy to round up the commissions paid for fifty cent wagers for Pick 3 and Daily 4 should be documented in the software requirements specification. Process owners, both in the Office of the Controller and Lottery Operations, should be responsible for sign-off on system documentation and the creation of corresponding procedures. Process owners should further verify that changes to business processes are documented and the impact to the automated system, both financial and accounting, is detailed in the system change documentation.

Management Response:

Management agrees with the recommendation. The Information Resources Analyst responsible for coordinating system changes affecting the automated sweep process will ensure that the corresponding business rules have been clearly documented; reviewed and approved by the respective business owners (Office of the Controller/Lottery Operations). Such documentation will be maintained by the Information Resources Department including appropriate sign-offs. Information Resources will develop and implement procedures that detail the process for documenting changes to the automated sweep process to include any associated policy directives. This procedure will be in place September 1, 2009.

2 Retailer Adjustments

In order to receive credit for various reasons, including misprinted or damaged tickets or tickets disputed by lottery players, retailers submit a Texas Lottery Retailer Request for Adjustment form. These forms and related tickets are processed in the claim center and entered into the Automatic Claims Tracking System (ACTS). Retailer Services picks up the forms and tickets from the mail room, reviews the request and determines the appropriate amount of the adjustment based on the information submitted by the retailer. A separate individual enters the adjustment into ProSys and a person independent of the transaction entry verifies the adjustment. ProSys generates a daily Retailer Adjustment Report which shows the detail for all adjustments made for each retailer. Retailer Services management reviews this report for unusual transactions. In addition, Retailer Services management has created an exception report that notifies management of any adjustment amounts that exceed a pre-determined threshold.

Based on risk, Internal Audit focused its review efforts on the retailer adjustments that were not system generated⁵. Internal Audit reviewed the adjustments made for the week ending February

⁵ System-generated adjustments are those made automatically to retailer accounts resulting from NSF's or manual sales adjustments. These are interest and penalty charges resulting from NSF's, and adjustments to retailers' commissions resulting from manual sales adjustments.

14, 2009. For the period reviewed, there were 240 non-system generated retailer adjustment transactions on the Retailer Adjustment Reports. These transactions included adjustments for manual payments of NSFs, sales, instant ticket validations, and bank returns.

The majority of the reviewed adjustments were made to sales and for manual payments of NSFs. Sales adjustments made up the majority of the number of transactions, while manual payments of NSFs accounted for the majority of the dollar value of the total adjustments made for the period.

Internal Audit verified the data on the Retailer Adjustment Reports with the information located in the Retailer Services Document Library in the Document Repository. Internal Audit also compared the information from the Retailer Adjustment Reports to the Retailer Accounting Sub-System to verify that the transactions matched. All transactions were properly processed with minor exceptions. No exceptions were found among the manual payments tested.

Internal Audit also reviewed the length of time to process the retailer adjustments. We found manual payments were entered and posted within a day. Determining the length of time to process retailer sales adjustments was a little more difficult since the date the Texas Lottery Commission received the Retailer Request for Adjustment form was not available in every instance. To determine the processing time for retailer sales adjustments, Internal Audit compared the date the Retailer Request for Adjustment form was signed by the retailer to the date the adjustment was entered. Using these parameters, the average time to process retailer sales adjustments was 27 days⁶. Retailer Services is meeting its goal of processing adjustments within 4 – 6 weeks of receipt.

Overall, our testing revealed that adequate and effective controls are in place to ensure that non-system generated retailer adjustments are properly made, entered, reviewed and approved.

3

Processing of Non-Sufficient Funds (NSFs) and Collections Process

A “bank return” occurs if the total amount due is not available when the EFT system sweeps the retailer’s account. The retailer is informed that their account had insufficient funds to cover the sweep amount and is instructed to remit payment in order to avoid license suspension. If payment is not made within the required timeframe, the retailer’s license is suspended; and any lottery terminal linked to their retailer number is disabled. In addition, the retailer is subject to a penalty (5 percent of total amount due) and a \$25 fee.⁷

Information Resources provides Retailer Services with a report of all retailers with an NSF. Retailer Services reviews each retailer’s status in ProSys, highlights NSF amounts greater than \$10,000 for management to review, and highlights those retailers for which this is their fourth NSF within a year. Retailer Services telephones the retailers on the report that are not in cancelled or suspended status to inform them that they had an NSF and they must remit payment to a claim center by a specific date and time or their terminal will be turned off.

⁶ Our calculation excludes two outliers which had processing times of 245 days and 246 days, respectively.

⁷ Texas Lottery Commission Retailer Guide As of August 31, 2008, p. 32.

Internal Audit observed Retailer Services' review of the NSF report and retailer telephoning. In addition, Internal Audit performed a review of manual payments of NSFs during the adjustments testing described previously in this report. The process appears to be working as intended and Internal Audit did not note any discrepancies.

If payment for an NSF is not made within the required timeframe or the retailer has had four NSFs within a year, the retailer's license is suspended and any lottery terminal linked to their retailer number is disabled.⁸ The retailer is then tracked through a separate collections process and is no longer part of the automated sweep process.

In order to ensure outstanding amounts owed are collected, Retailer Services has various collection tools available. These include asset freezes, asset levies, liens and cash register seizures. In addition, a vendor hold is placed with the Texas Comptroller of Public Accounts, which prohibits the state from making payments to a retailer with an outstanding debt to the state.⁹

In order to track and actively collect outstanding retailer accounts, Retailer Services utilizes various automated tools. The Lottery Retailer Management System maintains retailer account information and generates reports each week that identify retailers that have been cancelled and are no longer included in the weekly automated sweep process. These reports show the collection status, the original and current balance owed, and the type of collection activity pursued. In addition, monitoring reports are available that show the status of the collection efforts and the results of the collection efforts by assigned staff in Retailer Services. According to Retailer Services, the agency's current practice is to actively pursue an outstanding retailer account for a minimum of 12 months before the debt is certified as bad debt and no longer actively pursued. For FY 2008 the percentage of bad debt to lottery sales was 0.01%.

Internal Audit reviewed the collection process and monitoring reports available, as well as the percentage of bad debt to lottery sales as reported in the agency's performance measures.

Based on our review, adequate controls are in place and appear to be working as intended to aid in the processing of non-sufficient funds and in the collections process.

4 Tools for Protecting the State

Per the State Lottery Act, the executive director has the same "administrative, enforcement, and collection powers"¹⁰ of the State Comptroller as provided by Chapter 111 of the Tax Code. As such, the Texas Lottery has several tools and processes in place to protect the State from monetary loss in the event of retailer non-payment.

⁸ Texas Lottery Commission Retailer Guide As of August 31, 2008, p. 32.

⁹ Texas Lottery Commission Procedures:

LO-RS-016, Asset Freezes, Effective Date 12/18/07

LO-RS-017, Levies and Releases, Effective Date 1/9/08

LO-RS-019, Filing and Releasing Liens, Effective Date 1/23/08

LO-RS-021, Limited Seizures (Cash Register and/or Cash Box), Effective Date 1/9/08

LO-RS-044, Vendor Holds, Effective Date 1/23/08

¹⁰ Texas Government Code §466.019

As part of our audit, Internal Audit sought to evaluate some of these tools.

The Texas Lottery Commission sweeps approximately \$1.5 billion per year from retailer accounts. For fiscal years 2005 through 2008, approximately \$2.1 million was written off as certified bad debt (CBD). This averaged to approximately \$500,000 per year. For fiscal years 2007 and 2008, the percentage of bad debt to lottery sales reported was 0.01%. This percentage is an indicator of the adequacy and effectiveness of the tools and systems in place to protect the State.

While this percentage is low, opportunities may exist to further manage and minimize the State's risk of loss.

a) Pooled Bond Fund

The Texas Lottery Act authorizes the Executive Director to establish a pooled bond fund "to protect the State from possible losses."¹¹ Each new licensee contributes \$25 as part of their license fee to the pooled bond fund.

Effective September 1999, the 76th Legislature reduced the pooled bond fund from the then-balance of \$20 million to a cap of \$5 million and required the agency to, "...transfer all pooled reserve fund revenues and balances that exceed \$5 million to the Foundation School Fund"¹² each year. Our review and discussions with the Office of the Controller management indicate that the pooled bond fund is not and has not been utilized by the agency to off-set losses from uncollectible retailer accounts since at least that time. Rather, those amounts are written off annually as CBD. Since the pooled bond fund is not utilized, the balance has remained at its cap and all incoming licensee fees have been accordingly transferred to the Foundation School Fund (FSF). For fiscal years 2005 through 2008, approximately \$297,000, or an average of over \$74,000 per year, was transferred to the FSF from new licenses.

The agency has not established policy or procedures regarding the use of the pooled bond fund. Further, the current practice does not facilitate an examination and analysis of the adequacy of amounts needed to protect the State from possible loss. In discussing the need for each retailer to post a financial security including a contribution to the pooled bond fund, the State Lottery Act states, "The amount of the security shall be determined by the executive director and must reflect the possible losses to the state from the operation of the sales agent."¹³ As stated earlier, an average of approximately \$500,000 is written off as CBD each year, while approximately \$74,000 is assessed for pooled bond fund contributions each year.

b) Financial Securities

Currently, the Texas Lottery Commission performs a credit review during the retailer licensing process. If a potential retailer does not meet certain credit and other criteria, they are required to furnish a financial security (i.e., Certificate of Deposit or other financial instrument) to protect the State in the event they do not have funds available at the time of a weekly sweep. The amount of the financial security is either \$5,000 or \$10,000 depending

¹¹ Texas Government Code §466.156

¹² House Bill No.1 Conference Committee Report (General Appropriations Act), 80th Legislature, 2007

¹³ Texas Government code §456.156(a)

on the applicant type, certain conditions and credit results.¹⁴ If the retailer does not have any non-sufficient funds instances (NSFs) for one consecutive year, the Texas Lottery Commission releases the financial security to the retailer. If the retailer has an NSF, the period is extended one year from the date of the NSF. Financial securities may ultimately be used to recover delinquent amounts.

The total amount of financial securities cashed during fiscal years 2005 through 2008 was \$313,964.10, representing 102 retailers. Certified bad debt for this timeframe was \$2,152,935.49. Of those retailers listed as CBD during this timeframe, 57 had a financial security on file at some point during their history. Of those, a total of 16 retailers had their financial securities cashed by the Texas Lottery Commission to satisfy part of their debt.

i. Financial Security Amounts

In assessing the adequacy of the amount of financial security required, Internal Audit examined the historical redemption of securities in comparison to the debt owed by those retailers. To capture transactions that have completed the collections process, we narrowed our sample period and examined financial securities cashed in fiscal years 2005 and 2006. During this time period, the agency cashed financial securities from 38 retailers, totaling \$121,536.30. An additional \$114,016.37 was collected from these retailers, and the total amount written off as uncollectible from these same retailers was \$61,901.70. Thus the percentage of debt covered by a financial security for those retailers who defaulted was 40.86 percent.

Internal Audit also examined the individual amounts written off as CBD. During the period fiscal years 2005 through 2008, individual CBD amounts ranged from \$1 to \$151,304.48. Sixty-four percent of the amounts written off as CBD were \$5,000 or less. An additional 21 percent ranged from \$5,001 to \$10,000. The remaining 15 percent of the individual amounts written off as CBD were over \$10,000.

ii. Financial Security Selection Criteria

Of the 347 retailers on the CBD reports for fiscal years 2005 – 2008, 57 had a financial security on file at some point during their history as a retailer. An additional 92 retailers had financial securities cashed during this period, but did not ultimately appear on the CBD report. Thus, the ratio of retailers from whom a financial security is required to those who default is 34 percent (149/439).

iii. Financial Security Release Policies

As stated earlier, the agency releases financial securities if the retailer does not have any NSFs for one consecutive year. Internal Audit reviewed the length of time after a financial security was released that a retailer defaulted. In fiscal years 2005 – 2008, 41 retailers appeared on the CBD listing that had financial securities released by the Texas Lottery Commission. An average of 2.02 years elapsed after their financial security was released until the retailer was cancelled and 3.46 years until the retailer appeared on the CBD report.

¹⁴ Procedure LO-RS-006, *Application Pre-Edit and Processing*, Appendix B – CD Determination Reference Chart, Effective Date January 9, 2008.

iv. Controls over Financial Securities

If a retailer is required to obtain a financial security, the retailer and their bank complete the Assignment of Security form and submit the approved form and documentation of the financial security to Retailer Services. Prior to acceptance, Retailer Services verifies the conformance of the completed Assignment of Security form and the financial security documentation against agency specifications. The financial security documents are maintained in a fireproof filing cabinet in a room with restricted access and constant monitoring.

Retailer Services tracks and manages the current financial securities. Internal Audit reviewed Retailer Services' report of current financial securities as of 05/12/2009. The report detailed 243 financial securities totaling \$1,230,000. Internal Audit performed selected testing of the securities and inventoried all security documents maintained in the cabinet.

Our testing revealed that financial securities conformed to agency specifications tested without exception. Financial security documents were available as reported, properly authorized, adequately documented, and maintained in the reported amounts. However, while documentation of the financial security is not a bearer instrument, consideration should be given to determine whether the Office of the Controller might more appropriately maintain custody and control of such documents.

Recommendation:

While opportunities exist to further manage and minimize the State's risk of loss, it is important the agency weigh these considerations against the possible impact to attracting and retaining retailers.

Internal Audit recommends the following:

1. The agency should establish written policy and procedures regarding the use of the pooled bond fund. Consideration should be given as to whether such policy should be adopted in rule.
2. The agency should perform additional analysis to determine the adequacy, effectiveness, and compliance of its financial security requirements. Consideration should be given to determining whether certified bad debt is within tolerable levels for the agency. Financial security elements to be considered include examining the criteria of whom securities are required, assessing the adequacy and effectiveness of the required security amounts, and evaluating criteria for release of financial securities.
3. The Office of the Controller should review the maintenance of the financial security documents in Retailer Services, and give consideration as to whether the Office of the Controller might more appropriately maintain custody and control of such documents. If the agency decides to continue to maintain the documents in Retailer Services, Internal Audit recommends the Office of the Controller periodically review the controls and records for accuracy, completeness, and safekeeping, and document its review.

Management Response:

- 1. Management agrees with the recommendation. The Office of the Controller will develop written policy and procedures regarding the use of the pooled bond fund. The written policy and procedures will be implemented by February 1, 2010.*
- 2. Management agrees with the recommendation. Retailer Services Department staff will analyze the current financial security requirements. The analysis will focus on the appropriateness of the general criteria, the adequacy of the amounts required and the release of the securities back to retailers. This analysis will be completed and, if the need for any procedural changes is identified, such changes will be implemented by February 1, 2010.*
- 3. Management agrees with the recommendation. The Office of the Controller believes it is appropriate for Retailer Services to continue managing the maintenance and custody of the financial security documents. Beginning in May 2010, and on at least an annual basis thereafter, a review of the financial security documents for accuracy, completeness and safekeeping will be performed and documented by the Office of the Controller.*

This page intentionally left blank.

ADDITIONAL ITEMS

In conducting our review, additional items came to our attention that we believe warrant management's attention. The following is presented for management's consideration.

1. Agency Bad Debt Collections Policy and Rule

Texas Government Code Chapter 2107 Collection of Delinquent Obligations to State provides, "...a state agency shall refer an uncollected and delinquent obligation that meets the referral guidelines established by the attorney general to the attorney general for further collection efforts. The state agency must refer the obligation on or before the 90th day after the date the obligation becomes past due or delinquent."¹⁵

Texas Administrative Code §59.2 Collections Process: Uniform Guidelines and Referral of Delinquent Accounts states, "Agencies shall adopt reasonable tolerances, subject to review by the attorney general, below which an obligation shall not be referred." The Lottery Commission's procedure for certifications (i.e., referred to the attorney general for legal action) establishes less than \$10,000 as a reasonable tolerance for the agency. The procedure states, "Accounts with Lottery liability less than \$10,000 are not sent to the Attorney General's office for collection." The procedure for certifying bad debt is done annually at the conclusion of each fiscal year¹⁶.

Government Code Chapter 2107 further states:

A state agency that collects delinquent obligations owed to the agency shall establish procedures by rule for collecting a delinquent obligation and a responsible period for collection. The rules must conform to the guidelines established by the attorney general.

While TLC has procedures regarding the collection of delinquent accounts, these procedures have not been established by rule as required by Government Code Chapter 2107. Additionally, because the agency refers accounts once a year it is possible the agency is not in compliance with the requirement to report the uncollected and delinquent obligation to the attorney general not later than the 90th day after the date the obligation becomes delinquent. The agency may need to define when an account is "past due or delinquent" for purposes of compliance with Government Code Chapter 2107.

Management Response:

Management will develop a rule related to collections on delinquent accounts. A definition of past due or delinquent accounts will be developed in conjunction with the rule. Division procedures related to collections and reporting of delinquent accounts will be provided to the OAG for their input related to compliance with that agency's guidelines on this subject. Development of any rule and/or procedures related to this recommendation will be completed by April 1, 2010.

¹⁵ Texas Government Code §2107.004(a)

¹⁶ Texas Lottery Commission Procedure LO-RS-039, Certifications, Effective August 11, 2005

2. Agency Bad Debt Write Off Policy

Retailer Services runs a report on the first day of each fiscal year to reflect the status of collection accounts on the last day of the previous fiscal year. This list is used to identify accounts to be certified as bad debt and referred to the Office of the Controller for appropriate accounting treatment.

The Texas Comptroller of Public Accounts Fiscal Policies and Procedures for accounting for uncollectible accounts (APS 027) states the following:

The agency or institution must follow the OAG's collection procedures in an attempt to collect any past due accounts owed the agency... Only after the agency and the OAG have followed these procedures without success may a debt be classified as uncollectible and be written off on the agency's financial accounting records. ... The Comptroller's office requires that the reasons for writing off an account and compliance with the agency's write-off policy must be adequately documented and must be readily available for audit.

Internal Audit was not able to ascertain if the agency has a write off policy as required by APS 027.

Management Response:

Management will enhance current procedures related to write-offs consistent with the OAG's collection procedures. Reasons for writing off an account will be documented to ensure clarity and transparency of the write-off process. This work will be performed in conjunction with that listed under item #1 above and will be completed by April 1, 2010.

3. Reporting of Financial Securities

As discussed earlier in this report, at the time of our review, documentation of \$1,230,000 in financial securities was on file in Retailer Services. These securities are typically in the form of a Certificate of Deposit, maintained at a bank, but which have been assigned to the Texas Lottery. Internal Audit discussed with the agency's independent financial auditors the need to record these securities in the agency's general ledger and report the amounts on the agency's financial statements. Based on our conversation, it appears it is possible these amounts may need to be reflected as an asset and liability in an Agency Fund. In addition, as discussed with the agency's independent financial auditors, ensuring all transactions related to these securities are recorded in the agency's general ledger improves control and oversight of these funds.

Management Response:

The Office of the Controller will continue to research the financial reporting requirements related to the agency's financial securities held in Retailer Services. All required research will be completed prior to submission of the agency's FY 2009 Comprehensive Annual Financial Report in December 2009.

AUDIT PURPOSE, SCOPE AND METHODOLOGY

Purpose:

Internal Audit completed a review of Retailer Accounts, as specified in the approved Fiscal Year 2009 Internal Audit Activity Plan. The objective of our audit was to evaluate the adequacy and effectiveness of internal controls for ensuring accurate and efficient retailer collections and adjustments. In addition, we sought to evaluate tools in place to protect the State from monetary loss in the event of retailer non-payment.

Scope:

Internal Audit performed a reconciliation of the retailer sweep to net sales reported for the week ending February 14, 2009, and reconciled retailer commissions to net sales reported. Internal Audit also reviewed adjustments to retailer accounts, the collections process of retailer accounts that were no longer in a sweepable status, and the processing of non-sufficient funds (NSFs). In addition, we reviewed the use of the pooled bond fund and the retailer financial securities, two tools used to protect the State from monetary losses.

Methodology:

In accomplishing our objective, Internal Audit reconciled the retailer sweep to the reported net sales for the week ending February 14, 2009.

In addition, Internal Audit selected a judgmental sample of retailer adjustments for the week ending February 14, 2009 for testing. Internal Audit reviewed the Retailer Adjustment Report and compared information on this report to documents located in the Retailer Services Document Repository. Internal Audit also compared this information to information located in the Retailer Accounting Sub-System. In addition, Internal Audit analyzed the number of days needed to process retailer adjustments to determine if adjustments are made in a timely manner.

Internal Audit reviewed the use of the pooled bond fund, and retailer financial securities and performed observations of the NSF process to ensure appropriate procedures were followed. Internal Audit interviewed responsible management and staff, examined and reviewed supporting documentation and electronic files, and performed selected test work as deemed necessary. Internal Audit's review did not include verifying the reliability and integrity of data from PROSYS. 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 this performance audit in accordance with the International Standards for the Professional Practice of Internal Auditing as promulgated by the Institute of Internal Auditors (IIA) in conjunction with generally accepted government auditing standards (GAGAS) as promulgated by the U.S. Government Accountability Office (GAO). Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Team

The following members of the Internal Audit Division performed this audit:

- Dale Hernandez, CIA, CGAP, CCSA, CFE (Project Manager)
- Susan Oballe, CIA, CGAP

STATE OF TEXAS
TEXAS LOTTERY COMMISSION

INTERNAL AUDIT DIVISION

An Internal Audit of
RETAILER ACCOUNTS

IA #09-020

October 2009

This report has been provided to the following:

Ms. Mary Ann Williamson, Chair
Mr. David J. Schenck, Commissioner
Mr. J. Winston Krause, Commissioner

Mr. Gary Grief, Deputy Executive Director
Mr. Philip D. Sanderson, Charitable Bingo Operations Director

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

Ms. Mary Katherine Stout, Director, Governor's Office of Budget, Planning and Policy
Mr. John O'Brien, Director, Legislative Budget Board
Mr. Joey Longley, Director, Sunset Advisory Commission
Mr. John Keel, CPA, State Auditor