

California State Lottery Commission

2015 SLAA REPORT

December 31, 2015

Michael Cohen, Director
California Department of Finance
915 L Street
Sacramento, CA 95814

Dear Mr. Cohen,

In accordance with the State Leadership Accountability Act (SLAA), the California State Lottery Commission submits this report on the review of our systems of internal control and monitoring processes for the biennial period ended December 31, 2015.

Should you have any questions please contact Nicholas Buchen, Deputy Director, Finance Division, at (916) 822-8300, nbuchen@calottery.com.

BACKGROUND

In 1984, Proposition 37 amended the California Constitution to authorize the establishment of a statewide lottery. As an initiative statute, the California State Lottery Act of 1984 (Lottery Act) created the California State Lottery Commission and gave it broad powers to oversee the operations of a statewide lottery. The purpose of the Lottery Act was to provide supplemental monies to benefit public education without the imposition of additional or increased taxes. The California State Lottery (Lottery) is administered by a five-person Commission appointed by the Governor and confirmed by the State Senate.

The Lottery Act initially required that 50 percent of total annual revenues be returned to the public in the form of prizes and at least 34 percent of total revenues be allocated to the benefit of public education. No more than 16 percent of total revenues were to be used for administrative costs.

In 2010, the Lottery Act was changed to allow the Lottery flexibility to pay out more money in prizes and reduce the administrative cost limit to 13 percent of total revenues. The new law required the Lottery to return at least 87 percent of total revenues to the public in the form of prizes and net revenues to benefit public education. Revenues to education are placed in a special fund, known as the California State Lottery Education Fund, which holds revenues until they are allocated on a per capita basis, using prior year certified Average Daily Attendance data, to the following categories: K-12 education, Community Colleges, the California State University, the University of California, and other educational entities.

The Lottery has experienced significant growth in both sales and contributions to public education since the Lottery Act was amended in 2010. To achieve continued growth in sales and profits and become one of the largest lotteries in the nation, a foundation for the Lottery's most recent Strategic Plan was formed based on six objectives. All of the Lottery's current major initiatives tie back to one or more of these six objectives:

- Increasing the Lottery's profits by improving draw game sales.
- Reducing perceived barriers to buying Lottery tickets through efforts aimed at both players and non-players.
- Increasing efficiency and customization of marketing efforts directed at existing players and reallocating funding to attract new players.
- Strengthening the relationship with Lottery retailers and providing support through more customized approaches in selling, training, communications, and incentives.
- Commemorating the Lottery's 30th Anniversary by thanking players, retailers, employees, stakeholders, and Californians in general.
- Making improvements in the Lottery's infrastructure to increase efficiencies and effectiveness and further grow profits.

The Lottery sells its products (tickets for both instant and draw games) through a network of more than 22,000 retailers throughout California. The Lottery has approximately 800 employees operating out of various facilities across the state: headquarters located in Sacramento; nine district offices located in Sacramento, San Francisco, Hayward, Fresno, Van Nuys, Santa Fe Springs, Santa Ana, San Bernardino, and San Diego; and two distribution centers located in West Sacramento and Rancho Cucamonga. The Lottery is organized into eight divisions that report to the Director: Executive (which includes Legal Services and Contracts Development, Internal Audits, Information Security and Privacy, Legislative and External Affairs, Business Planning, and Equal Employment Opportunity), Finance, Human Resources, Operations, Corporate Communications, Security and Law Enforcement, Information Technology Services, and Sales and Marketing.

Maintaining public trust is vital for a lottery to remain successful. Lottery staff demonstrates integrity, honesty, and fairness in the operation and administration of the organization. This is crucial in reassuring players that games are operated fairly and that winning tickets will be honored. Accordingly, the Lottery maintains a comprehensive audit program. The Lottery not only employs internal auditing staff, but also contracts with the State Controller's Office (SCO) and independent firms to further ensure the integrity of all operations and transactions.

Annually, an independent audit firm performs financial audits of the Lottery's financial statements. Since the inception of the Lottery, the annual financial statements have cited unqualified opinions. Further, in recognition of the Lottery's commitment to prepare financial statements reflecting transparency and full disclosure, the Government Finance Officers Association of the United States and Canada has awarded a Certificate of Achievement for Excellence in Financial Reporting to the Lottery for the past 12 consecutive fiscal years. Additionally, the SCO conducts quarterly and annual post-audits of all accounts and transactions of the Lottery including quarterly transfers to education, vendor claim schedules, and all prize payments.

In addition, an independent audit firm witnesses and reviews every lottery draw (at least four draws occur each day of the year) to ensure accurate completion of the draw procedures, including the verification of technology systems, draw machinery, and draw items such as lotto balls.

Although the Lottery Act requires the review of the Lottery's adopted security measures on a biennial basis, the Lottery has opted for more frequent reviews. Specifically, World Lottery Association/International Organization for Standardization auditors conduct a review of Lottery security annually, and perform a comprehensive audit every three years. The audit includes a comprehensive study and evaluation of all aspects of security in the operation of the Lottery.

RISK ASSESSMENT PROCESS

The Lottery practices risk assessment throughout its planning and operations, and has several on-going processes that assess risk on a periodic basis, including:

- **Information Security Review Process.** The Lottery is a World Lottery Association/International Organization for Standardization-certified organization. As such, the Lottery is required to undergo periodic external review of its information security environment in addition to a continuous internal review of information security controls. The Lottery Act also requires the review of the Lottery's adopted security measures on a biennial basis; this review process is managed by the Lottery's Information Security and Privacy Office.
- **Portfolio Governance Committee/Project Management.** The Lottery has implemented a robust process of evaluating and monitoring Lottery projects. The Lottery's Enterprise Project Management Office manages the Lottery's project portfolio and acts as an independent review outside of the project manager/project sponsor to monitor each project's scope, schedule, and resources. Additionally, the Lottery's Portfolio Governance Committee, comprised of the Director and certain senior management, meets monthly to assess the status of the various projects in the Lottery's portfolio and make decisions as needed on projects that are experiencing scope, schedule, or resource issues.

- **Strategic Planning Process.** The Lottery develops once every three years a Strategic Direction that provides a general vision and outlines the major goals and key objectives for the ensuing three-year period. In developing this plan, the Lottery conducts a SWOT analysis of the internal and external operating environment, and examines industry and demographic trends. In addition, the Lottery develops an Annual Business Plan that provides specific details and tactics on how the Lottery will achieve the goals and objectives identified in the Strategic Direction. All levels of management are involved in both the Three-Year Strategic Direction and the Annual Business Plan, and both documents require Commission approval.
- **Senior Staff Meetings.** The Lottery's senior management team meets biweekly to bring forward and discuss Lottery-related issues (programmatic, policy, etc.). Additionally, Deputy Directors meet individually with the Director and Chief Deputy Director to discuss and/or get direction on issues. If enterprise-wide issues are brought forth, then they are vetted at the biweekly senior staff meetings. Additionally, the Designated Agency Monitor has standing one-on-one meetings with key senior staff members, and these meetings include discussions surrounding operational risks and compliance.
- **State Controller's Office.** The Lottery relies on SCO audit work to provide assurances to the public that the Lottery is safeguarding assets and is fiscally responsible with its resources. Further, the Lottery has implemented past audit recommendations. The SCO provides guidance to the Lottery in establishing effective fiscal controls and identifying areas of risk during the SCO Risk Assessment process. This process occurs periodically and the Lottery uses this information to complement its own efforts in assessing its risk.
- **Enterprise Risk Management.** The Lottery is in the early stages of reestablishing an enterprise-wide risk management program to proactively identify and manage risk. Under this program, the Lottery will holistically address risks and their impacts across the entire organization.

In the past, the Lottery's Internal Audits Office (IA) was responsible for conducting a risk assessment and reporting under the Financial Integrity and State Manager's Accountability Act. With the recent transition to the State Leadership Accountability Act, the Lottery's Deputy Director of Finance assumed the role of Designated Agency Monitor (Monitor) for the Lottery to facilitate the risk assessment process. The Monitor reviewed recent audits performed by both IA and the SCO and asked the Lottery's Senior Management team (which represents each functional area within the Lottery) to perform a self-assessment of risks to the Lottery. This self-assessment by Lottery Senior Management did not focus on one specific area but considered any risk that could severely impact the Lottery's mission. Identified risks were then reviewed, categorized, and consolidated by the Monitor, Chief of IA, and the Lottery's Chief Deputy Director and Director, and associated controls were developed.

EVALUATION OF RISKS AND CONTROLS

Operations- Internal- Staff—Key Person Dependence, Succession Planning

The Lottery tends to rely more heavily on specific individuals with significant expertise and knowledge in key areas, which makes the department vulnerable should those individuals leave or retire.

Each division maintains a workforce succession plan that is updated biannually.

Operations- Internal- Oversight, Monitoring, Internal Control Systems

Malicious or accidental exploitation of certain operational internal controls could lead to financial loss, corrupt or missing data, and threaten the Lottery's integrity.

Frequent review of internal controls to ensure they continue to be robust and meet the Lottery's evolving operational needs.

Operations- Internal- Resource Management

The Lottery may not be investing limited resources into the most effective promotions, campaigns, or projects due to lack of proper tools to enable timely return on investment analysis.

Implement some form of cost accounting and build time into the schedules of promotions, campaigns, and projects to allow adequate analysis to be conducted and ensure that profits are maximized.

Operations- External- Technology—Data Security

Cyber security breach of the Lottery's various systems and databases could lead to financial loss and threaten the Lottery's integrity.

Ensure that proper system controls, security protocols, and data redundancies are maintained. Continue ongoing and open communication between the Lottery's Chief Information Officer, Information Security Officer, employees, and vendors.

Operations- External- Economic Volatility

Being stagnant or not evolving quickly enough to remain innovative and relevant to consumers to maximize supplemental funding to public education.

Continue to strike appropriate balance of being innovative while operating within the confines of state government.

Operations- External- Economic Volatility

Over-reliance on specialized gaming vendors that are compensated based on top-line sales may lead to the Lottery undertaking projects that do not maximize funding to public education.

Allow for adequate and independent analysis to be conducted to ensure that profits are maximized.

ONGOING MONITORING

Through our ongoing monitoring processes, the California State Lottery Commission reviews, evaluates, and improves our systems of internal controls and monitoring processes. The California State Lottery Commission is in the process of formalizing and documenting our ongoing monitoring and as such, we have determined we partially comply with California Government Code sections 13400-13407.

Roles and Responsibilities

As the head of California State Lottery Commission, Hugo Lopez, Director, is responsible for the overall establishment and maintenance of the internal control system. We have identified Nicholas Buchen, Deputy Director, Finance Division, as our designated agency monitor(s).

Frequency of Monitoring Activities

As indicated previously, the Lottery has several processes that frequently involve assessing and monitoring risk. Going forward, we envision that the Lottery's Enterprise Risk Management (ERM) program will perform objective, ongoing monitoring of the Lottery's internal controls as required by the State Leadership Accountability Act. The Lottery previously had an ERM program, as referenced in our 2013 Financial Integrity and State Manager's Accountability Act report. Due to turnover of key staff, the previous program disbanded. The Lottery's new ERM program is currently in its infancy; although specific members and roles have not yet been defined, the Lottery's Designated Agency Monitor will be part of this program. It is envisioned that meetings will occur at least monthly and that meeting topics will include discussion of potential internal control issues that need to be addressed or revisited. Although the Lottery complies with the broad requirements of Government Code sections 13400-13407, the development of this report has reinforced that this agency still requires further maturation of its internal control and monitoring processes. The reestablishment of the ERM program will assist with this.

Reporting and Documenting Monitoring Activities

Although risk management in the Lottery currently is performed mostly at the divisional or functional level, the Lottery is in the early stages of developing an ERM program to assess and monitor risk as an integrated enterprise-wide program. It is envisioned that the Lottery's ERM program will assume the role of documenting the Lottery's ongoing monitoring activities and will establish a process for communicating monitoring results to the Lottery's management team.

Procedure for Addressing Identified Internal Control Deficiencies

Previously when internal control deficiencies were identified, there was no single, uniform process the Lottery followed to address the deficiency. For example, to the extent an employee within a division identified a deficiency that had only tangential impact on Lottery operations, that division's management may have resolved it by updating procedures. More typically, internal control deficiencies were identified by the Lottery's Internal Audits Office or an external auditor. In these cases, the Lottery's Internal Audits Chief and relevant staff met with management and subject matter experts of the impacted division(s) to discuss the deficiencies and a path for resolution. Once the Lottery's ERM program is fully implemented, the Lottery may consider employing more standardized procedures for addressing deficiencies identified through the ongoing monitoring process. Also, the Lottery Director position has recently been filled after a two-year period of being vacant. At this time, it is unclear if the Lottery's process for identifying and addressing internal control deficiencies will deviate from past practice. However, with new leadership comes new direction, and this is certainly an area that will be reviewed.

CONCLUSION

The California State Lottery Commission strives to reduce the risks inherent in our work through ongoing monitoring. The California State Lottery Commission accepts the responsibility to continuously improve by addressing newly recognized risks and revising risk mitigation strategies. I certify our systems of internal control and monitoring processes are adequate to identify and address material inadequacies or material weaknesses facing the organization.

Hugo Lopez, Director

cc: Department of Finance
Legislature
State Auditor
State Library
State Controller
Secretary of Government Operations