
RHODE ISLAND LOTTERY

MANAGEMENT COMMENTS

JUNE 30, 2003 AUDIT

Ernest A. Almonte, CPA, CFE
Auditor General

State of Rhode Island and Providence Plantations
General Assembly
Office of the Auditor General



ERNEST A. ALMONTE, CPA, CFE
AUDITOR GENERAL
EALMONTE@OAG.STATE.RI.US

STATE OF RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

- ◆ INTEGRITY
- ◆ RELIABILITY
- ◆ INDEPENDENCE
- ◆ ACCOUNTABILITY

December 19, 2003

Joint Committee on Legislative Services, General Assembly
State of Rhode Island and Providence Plantations:

Members of the Rhode Island Lottery Commission:

We audited the financial statements of the Rhode Island Lottery (the "Lottery") for the year ended June 30, 2003 and have issued our report thereon dated November 7, 2003. In accordance with *Government Auditing Standards*, we have also issued a report dated November 7, 2003 on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations and contracts.

Our report on the Lottery's compliance and internal control over financial reporting included a matter that we considered to be a reportable condition involving internal control. We did not report any material instances of noncompliance with laws, regulations and contracts. However, we did note certain additional matters involving compliance, internal controls, and other operational matters that are presented for your consideration. These comments and recommendations are intended to enhance compliance with laws, regulations and contracts, improve internal control, or result in other operational efficiencies.

This report is intended for the information of the Joint Committee on Legislative Services, the Rhode Island Lottery Commission and Lottery management, and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely,

Ernest A. Almonte, CPA, CFE
Auditor General

**RHODE ISLAND LOTTERY
MANAGEMENT LETTER
JUNE 30, 2003 AUDIT**

TABLE OF CONTENTS

	<u>PAGE</u>
<u>FINDINGS AND RECOMMENDATIONS</u>	1
INFORMATION SYSTEMS SECURITY	1
INFORMATION SYSTEMS SECURITY- CURRENT POLICY AND PROCEDURE CONCERNS	2
MONITORING	3
MANAGEMENT'S RESPONSIBILITY FOR CONTROLS OVER FINANCIAL REPORTING	5
CAPITAL ASSETS	6

FINDINGS AND RECOMMENDATIONS

INFORMATION SYSTEMS SECURITY

Our *Independent Auditor's Report on Compliance and on Internal Control over Financial Reporting* issued as a result of our audits of the Lottery's financial statements for fiscal years 2000 through 2003 has included a reportable condition relating to the Lottery's need for a comprehensive information systems security plan. During our fiscal 2003 audit, we found that the Lottery's implementation of a comprehensive information system security plan, while in process, has not been completed and tested. The complete implementation and testing of this plan is necessary to ensure that system access is appropriately restricted and any unauthorized access is detected by the Lottery on a timely basis with appropriate follow-up.

As previously recommended, the Lottery should complete the implementation of its comprehensive information system security plan in conjunction with its on-line and video lottery games contractor. This plan should, at a minimum, (1) identify and fully utilize all designed security features of the Lottery's gaming systems, (2) strengthen other system security aspects to ensure that adequate security measures are in place and operational, (3) delegate certain system security functions to the Lottery for appropriate segregation of duties and (4) implement procedures for continual monitoring of compliance with the overall information system security plan.

With respect to the Lottery's internal information systems network, we found that overall security and monitoring was significantly improved. Additionally, the Lottery has communicated formalized information systems security policies and procedures to their gaming system provider. The Lottery, however, now must evaluate the provider's overall compliance with these procedures.

The most critical aspects of Lottery operations are those conducted by the gaming system provider. The Lottery's comprehensive security plan will only safeguard these critical operations to the extent the gaming system provider has complied with these policies and procedures.

The Lottery has recently issued a request for proposal to contract with an independent firm to conduct an assessment of the gaming system provider's compliance with its comprehensive information system security plan. Once conducted, this assessment will represent the first step in continual monitoring of the gaming system provider's compliance with the Lottery's information system security plan.

RECOMMENDATION

1. Complete the implementation of a comprehensive system security plan by ensuring the gaming system provider's compliance with established policies and procedures.

Auditee Views:

The Lottery concurs with this recommendation.

INFORMATION SYSTEM SECURITY – CURRENT POLICY AND PROCEDURE CONCERNS

While progress has been made in moving towards a comprehensive systems security plan, certain security policies and procedures still require implementation. Although none of these issues individually represents a significant weakness, collectively they could negatively impact the overall information system security of the Lottery's information systems. Policies and procedures that have not been implemented include the following:

- Monitoring procedures must be instituted to ensure the gaming system provider's compliance with established password access controls.
- Computers acting as hosts for authorized remote users should be equipped with a secure electronic methodology for validating and authenticating the claimed identity of the remote user before that individual is allowed access to the system.
- Inspections of all hardware components connected to networks associated with Lottery operations must be performed on a scheduled basis to ensure that, as required, the most current software versions have been installed. Older software versions could contain security weaknesses that could be exploited to compromise the network.
- A formal electronic log documenting configuration changes made to network equipment (i.e. firewalls, routers, network printers, etc.) utilized in Lottery operations is not currently maintained. This procedure is necessary to ensure that all network devices are coordinated and configured properly once integrated into the Lottery's network.
- A formal electronic log of destroyed hard copy documents and computer media must be maintained. This control is necessary to monitor the destruction of sensitive information.
- All workstations within the networks associated with Lottery operations must be periodically inspected for undocumented internal/external modems. Control over these devices is necessary to prevent unauthorized access to the Lottery's information systems.

The Lottery needs to decide the best way to ensure compliance with these policies and procedures based on their available resources. In some instances, the Lottery may be able to design a suitable process to ensure compliance with established security policy. In other instances, hiring an independent contractor may be the most effective solution.

RECOMMENDATION

2. Develop a timetable to implement additional policies and procedures as part of the Lottery's information system security plan.

Auditee Views:

The Lottery concurs with this recommendation.

MONITORING

Due to the significant reliance on outside vendors to operate the Lottery's gaming operations, the Lottery must monitor operations using key financial data to ensure the accuracy of reported gaming operations. Adequate monitoring requires the analysis of critical gaming data, identifying inconsistencies, and investigating, on a timely basis, these issues to a satisfactory conclusion.

We noted an inconsistency related to the reporting of video lottery prize obligations. For example, recorded video prize awards paid (as included in the Lottery's draft financial statements) during fiscal year 2003 exceeded prize awards won during the year reported by the video lottery system. Although timing differences between the generation of a winning ticket and its subsequent validation for cash can cause this result over shorter time periods, the likelihood of this occurrence over the course of a year is unlikely.

While the dollar amount involved was immaterial, we believe the Lottery should have more fully investigated this issue to determine its cause. Consequently, we expanded our audit tests to further analyze video prize awards to determine the effect, if any, on the Lottery's financial statements. Our expanded audit tests noted the following:

- Changes in procedures implemented at the video facilities resulted in the understatement of \$99,769 in reported video prizes won. Failure to record these prize awards resulted in the overstatement of net terminal income reported by video terminals, and ultimately resulted in the overpayment of \$46,673 in video lottery commissions. The Lottery adjusted its financial statements for this issue and agreed to recover the commission overpayments.
- Certain video terminals generated duplicate validation tickets during the fiscal year. The Lottery was informed of this situation by the vendor in March 2003 and was told that the problem had been corrected. Further analysis by our office and inquiry of the vendor revealed that the problem was still occurring. The vendor quantified a resulting overpayment caused by this terminal malfunction of \$6,402 through June 30, 2003. Although we concluded that this issue, when fully resolved, would not likely result in a material misstatement of the financial statements, further independent analysis and quantification of this issue should be conducted by the Lottery. The Lottery adjusted its

financial statements for the known overpayment and will continue their independent resolution of this issue.

- Duplicate accounting entries resulting in the understatement of the video lottery prize obligation account by \$32,524 were also noted.

RECOMMENDATIONS

3. Develop a procedure to reconcile the video prize obligations reported in the financial statements with outstanding prizes redeemable reported by the video gaming system.
4. Adopt procedures to independently verify the effect of terminal malfunctions identified within video lottery operations.
5. Recoup remaining amounts due from the vendor related to video terminal malfunctions.

Auditee Views:

The Lottery is working with its gaming systems vendor to resolve these issues.

The Lottery reconciles amounts reported by the video lottery system with actual cash received by the video facilities on a weekly basis. This reconciliation often requires the Lottery to adjust the amounts reported by the video lottery system when certain terminals have not reported daily activity. As previously stated, video prize awards were understated due to a change in the operating procedures at the video lottery facilities. We noted the understatement by reviewing video adjustments made during the year. We found that several adjustments increased video proceeds played for specific terminals without recording the corresponding increase for related prize awards.

Supervisory review of video lottery adjustments is important to ensure that all activity is properly recorded by the Lottery. The review of these adjustments is also important because terminal adjustments can often be the first indication of a terminal malfunction. It is important that the lottery identify these trends in order to mandate appropriate resolution with the related vendors.

RECOMMENDATIONS

6. Improve overall monitoring of lottery operations by using key financial data to ensure the accuracy of reported information and security over gaming operations.
7. Ensure that a supervisor, with no responsibility for proposing video lottery adjustments, conducts a thorough analysis of weekly adjustments made to the gaming system.

8. Require video terminal vendors to resolve malfunctions in a timely manner.

Auditee Views:

The Lottery concurs with these recommendations. The Finance Administrator will conduct a thorough analysis of weekly adjustments made to the gaming system.

MANAGEMENT'S RESPONSIBILITY FOR CONTROLS OVER FINANCIAL REPORTING

Communication of operational matters

We noted instances where various operating issues had not been communicated to individuals within the Lottery who have responsibility for financial reporting. As a result, these issues were also not communicated to our auditors. This affected the financial reporting staff's ability to recognize and resolve unexplained variances in certain account balances on a timely basis. Ultimately, the fiscal 2003 financial statements were delayed because additional time was required to resolve these issues.

Specifically, we were not made aware of a change in Lottery operations that may have impacted our audit planning and test work. Additionally, management did not disclose a situation involving the malfunction of a vendor's video terminals until an inquiry was made by the audit staff regarding video prize obligations. As a result, this situation resulted in additional audit work being preformed to ensure a satisfactory resolution with the responsible vendor.

Timely communication of operational matters to the financial reporting staff and others with responsibility for financial control procedures is important to (1) facilitate and enhance financial monitoring procedures and (2) ensure the Lottery's financial statements accurately reflect and disclose all known facts. Additionally, such information should be made available to the auditors on a timely basis to allow effective planning of the audit.

RECOMMENDATION

9. Ensure that all information affecting the Lottery's financial statements is adequately recorded and disclosed. Communicate to the auditors all information that could potentially have an impact on the audit of the Lottery's financial statements.

Auditee Views:

The Lottery will ensure that all information affecting the Lottery's financial statements is adequately recorded and disclosed.

Financial Reporting

The Lottery is responsible for the presentation of their financial statements in accordance with generally accepted accounting principles. Draft financial statements (including note disclosures and Management's Discussion and Analysis) prepared by the Lottery did not fully reflect the effect of certain significant transactions. Additionally, comments from the Government Finance Officers Association (GFOA) relating to the Lottery's 2002 financial statement submission were not fully corrected in the 2003 draft financial statements. The GFOA requires previous year comments to be addressed as part of its Certificate of Achievement program.

The Lottery needs to enhance its overall ability to generate financial statements in accordance with generally accepted accounting principles by acquiring appropriate reference materials and providing opportunities for continual training to its financial reporting staff.

RECOMMENDATIONS

10. Ensure appropriate reference materials (e.g., GASB Codifications) are available to prepare financial statements in accordance with current financial accounting and reporting standards.
11. Provide accounting staff with opportunities for continual training in governmental financial reporting.

Auditee Views:

The Lottery concurs with these recommendations.

CAPITAL ASSETS

We noted the following areas where the Lottery can improve its reporting for capital assets:

- Approximately \$134,000 of recorded expenses qualified as capital improvements but were not capitalized during fiscal 2003.
- The Lottery's accounting for capital assets involving trade-ins should be revised to account for the transaction in accordance with generally accepted accounting principles.
- The Lottery currently has a capitalization threshold of \$500. This amount causes the Lottery to capitalize amounts clearly immaterial to their financial statements and complicates their tracking of capital assets by reporting a large number of small dollar assets. The Lottery should consider following the State Controller's capitalization threshold of \$5,000 to simplify their overall capital asset accounting.

RECOMMENDATIONS

12. Capitalize all assets in accordance with the Lottery's established policies.
13. Ensure that all capital assets transactions are recorded in accordance with generally accepted accounting principles.
14. Adopt the State's capitalization threshold of \$5,000.

Auditee Views:

The Lottery concurs with these recommendations.