

CALIFORNIA LOTTERY

Audit Report

KPMG LLP DRAW AUDITING AND REVIEW SERVICES CONTRACT

January 1, 2006, through April 30, 2008



JOHN CHIANG
California State Controller

December 2008



JOHN CHIANG
California State Controller

December 31, 2008

Joan M. Borucki, Director
California Lottery
600 North Tenth Street
Sacramento, CA 95811

Dear Ms. Borucki:

The State Controller's Office audited the California Lottery's (Lottery) monitoring of and compliance with the KPMG LLP draw auditing and review services contract, for the period of January 1, 2006, through April 30, 2008.

Our audit of the contract disclosed that the Lottery is not properly approving contract payments. We noted that the contract manager did not properly approve (sign and date) invoices sent to the Lottery's Accounting Operations and Tax Bureau to authorize release of the invoices for payment as stipulated in the California State Lottery Contract Manager's Handbook, dated June 2007.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/vb

cc: John Mass, Chairman
California Lottery Commission
Cynthia Flores, Commissioner
California Lottery Commission
Manuel Ortega, Commissioner
California Lottery Commission
Michael T. Ota, Deputy Director
Finance Division
California Lottery
Roberto Zavala, Chief
Internal Audits
California Lottery

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Audit Report

Summary

The State Controller's Office (SCO) audited the California Lottery's (Lottery) monitoring of and compliance with the KPMG LLP draw auditing and review services contract (Contract No. 8672), for the period of January 1, 2006, through April 30, 2008.

The purpose of our audit was to determine whether the Lottery is complying with sound financial and program management practices in the administration of the contract.

Our audit disclosed that the Lottery contract manager did not properly approved invoices to the Lottery's Accounting Operations and Tax Bureau for payment.

Background

By authority of the California Constitution, Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "... the Controller shall suggest plans for the improvement and management of revenues."

Proposition 37, the California State Lottery Act of 1984 (Lottery Act), amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the Commission broad powers to oversee the operation of a statewide lottery.

Pursuant to Government Code section 8880.67, the SCO may conduct other special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

Pursuant to Government Code section 8880.30, "... drawings shall be witnessed by an independent lottery contractor having qualifications established by the Commission. Any equipment used in the drawings shall be inspected by the independent lottery contractor and an employee of the Lottery both before and after the drawings. The drawings and the inspections shall be recorded on both videotape and audiotape."

The Lottery entered into a contract with KPMG to provide lottery draw auditing and review services in Sacramento and Los Angeles, California, for various draw activities.

Under this contract, KPMG is required to provide the following services:

- A lead professional at each draw activity and one or more trained audit staff to serve as auditor(s) for each game draw
- A minimum of four trained audit staff to provide for adequate staff rotation and to ensure draw coverage
- A detailed work plan documenting the responsibilities of the lead professional and audit staff
- An audit program and audit procedures for all draws
- Agreed-upon procedures reports for each draw indicating whether or not the Lottery has complied with the established draw procedures
- Meetings at the request of the Lottery Contract Manager to present findings, conclusions, and recommendations
- Any other services related to game draws requested by the Lottery Contract Manager

The original KPMG contract was for the period July 1, 2003, through June 30, 2006, and included contract funding of \$1.1 million. Under the original contract, the terms was extended once and amended twice. The following amendment was reviewed under this audit:

<u>Amended Date</u>	<u>Description</u>
March 15, 2006 (A02)	To extend contract to June 30, 2008, and add \$200,000 to the balance

Objectives, Scope, and Methodology

The purpose of our audit was to determine whether the California Lottery's fiscal controls over payments to the contract are adequate and monitoring procedures of the contract are adequate to ensure compliance with the terms and conditions of the contract.

We conducted this performance audit in accordance with generally accepted government auditing standards. We did not audit the Lottery's financial statements. 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.

The specific objectives of the audit were to determine if:

- The contract payments are legal and proper;
- The Lottery is abiding by state laws, rules, regulations, and policies with regard to the contract; and
- The Lottery's monitoring procedures of the contract are adequate to ensure compliance with terms and conditions of the contract.

The procedures performed during the audit included:

- Reviewing the contract and subcontracts, contract law, regulations, rules, Lottery policies, and related accounting records;
- Reviewing work performed by external audit organizations or by other Lottery units;
- Interviewing and observing individuals involved in the development, authorization, and monitoring of the contract;
- Performing tests of procedural compliance and tests of payments; and
- Obtaining an understanding of components of internal controls sufficient to conduct the audit.

Conclusion

Our audit disclosed that the Lottery did not follow the procedures stipulated in the California State Lottery Contract Manager's Handbook, dated June 2007. These procedures ensure that payments are proper and legal and reduce the risk of making excessive payments to the contractor. The Finding and Recommendation section of this report summarizes the control deficiency related to this area.

Views of Responsible Official

The SCO issued a draft report dated October 22, 2008. Joan Borucki responded by the attached letter dated November 14, 2008. Ms. Borucki agreed that the current written procedures require contract managers to sign and date invoices signifying approval of payment. In addition, Ms. Borucki's letter provided explanation as to how the e-procurement process provides a means of approving invoices electronically while maintaining sound controls.

Restricted Use

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

December 31, 2008

Finding and Recommendation

**FINDING—
Noncompliance with
established procedures
for approving contract
payments**

The Lottery did not follow invoice processing procedures for the KPMG contract. We tested three of the 27 KPMG contract invoices (9%) and noted that two of the three invoices did not contain the Lottery contract manager's signature and date as required for approval. In addition, we noted that the Lottery's Accounting Operations and Tax Bureau (AOTB) processed the invoices for payment without receiving approved/hard copy invoices. The February and March 2008 invoices, marked with the approval sticker, wet signature, and date, were located in the contract manager's file.

Chapter 4, page 15 of the California State Lottery Contract Manager's Handbook, dated June 2007, states that the contract manager must approve the invoice by signing and dating it, retaining a copy of it for his/her records, and forward the approved invoice to the Lottery's AOTB for payment. An approved invoice contains a physical sticker that reads, "Please release this/these invoice(s) in E-Procurement" along with a wet signature and date.

Recommendation

We recommend that the Lottery follow the procedures for approving invoices as outlined in the California State Lottery Contract Manager's Handbook to ensure that payments are proper and legal and reduce the risk of making excessive payments to the contractor. We also recommend that AOTB not process payments until an approved/hardcopy invoice containing the signature and date by the contract manager is received.

Lottery's Response

The Lottery agrees with SCO that the Contract Manager's Handbook instructs contract managers to sign and date invoices signifying approval of payment. However, the key control for paying invoices at the Lottery is e-Procurement. The hardcopy signed invoice provides a hardcopy record, but is not considered a key control. The Contract Manager's Handbook will be updated to eliminate any confusion on approving invoices for payment.

SCO's Comments

The Contract Manager's Handbook instructs contract managers to sign and date invoices signifying approval of payment. Next, the contract managers enter a release record into the e-Procurement system. Then, the approved invoice is forwarded to AOTB for payment.

During the audit, the manager of the Lottery's AOTB informed the SCO auditors that a wet signature and date on invoices are required from the contract manager before payments can be scheduled; AOTB considers this to be a control. The finding remains unchanged.

**Attachment—
California Lottery’s
Response to Draft Report**



California State Lottery

Headquarters

600 North Tenth Street

Sacramento, CA 95814

November 14, 2008

Andrew Finlayson, Chief
State Agency Audits Bureau
State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, California 94250-5874

Re: State Controller's Office Audit of the KPMG LLP Draw Auditing and Review Services Contract - January 1, 2006 through April 30, 2008

Dear Mr. Finlayson:

The California State Lottery (Lottery) offers the following general comments and specific points regarding the recently concluded audit conducted by the State Controller's Office (SCO). The audit scope was limited to an audit of the Lottery's monitoring of the KPMG LLP Draw Auditing and Review Services Contract.

The Lottery takes its mission as a public agency very seriously. We also understand that it is an important part of this mission to perform its duties in a cost-effective and transparent manner to ensure that there has been no violation of the public trust. Further, as stated above, the focus of the audit was on the Lottery's monitoring of the KPMG LLP Draw Auditing and Review Services Contract and we are pleased to note that in this area, after a lengthy and thorough review by the SCO, there are no findings that would hinder the Lottery's performance of its mission.

The draft report listed one recommendation for the Lottery to consider enhancing its internal control structure by following its policies and procedures. The Lottery continually evaluates and implements methods to improve its business practices and refine its internal control structure, and the Lottery intends to adopt recommendations that cost effectively improve business functions.

Below is the Lottery's response to the specific recommendation provided in the draft audit report.

FINDING 1 – Noncompliance with established procedures for approving contract payments.

Andrew Finlayson
November 14, 2008
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RECOMMENDATION:

SCO recommends the Lottery follow the procedures for approving invoices as outlined in the California State Lottery Contract Manager's Handbook to ensure the payments are proper and legal and reduce the risk of making excessive payments to the contractor. SCO also recommends that AOTB not process payments until an approved/hardcopy invoice containing the signature and date by the Contract Manager is received.

RESPONSE:

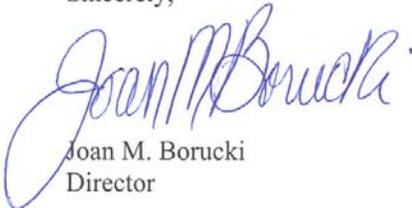
The Lottery agrees with SCO that the Contract Manger's Handbook instructs contract managers to sign and date invoices signifying approval for payment. However, the key control for paying invoices at the Lottery is e-Procurement. The hardcopy signed invoice provides a hardcopy record, but is not a key control. The Contract Manager's Handbook will be updated to eliminate any confusion on approving invoices for payment.

The Lottery recognizes the importance of effective and efficient internal controls. As such, with efficiency in mind, the Lottery introduced e-Procurement several years back to address the issue of hardcopy documents serving as key controls when approving invoices.

The e-Procurement system provides a means of approving invoices electronically while maintaining sound internal controls. Once the Contract Manager approves and enters the invoice into e-Procurement, a receipt number is issued. This receipt number is then matched with the Lottery's accounting system. If a match does not occur, the invoice cannot be released for payment by accounting, even though accounting receives a signed hardcopy invoice from the contract manager. Access controls to the Lottery's e-Procurement system prevents someone other than the Contract Manager from entering and approving invoices for payment. The Lottery has found this internal control to be effective and efficient and consistent with industry best practices. The Lottery believes its internal controls over contract payments are sound.

If you have any additional questions, please contact my Audit Chief, Roberto Zavala at (916) 323-7156.

Sincerely,



Joan M. Borucki
Director

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874**

<http://www.sco.ca.gov>