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An Audit Report on Management Controls at the Texas Lottery Commission

August 1997

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Key Points of Report

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Overall Conclusion

The Commission did not exercise strict control and close supervision over the activities of its contractors, nor did it take prudent and necessary steps to ensure that business with the Lottery Operator and other contractors was conducted at "arm's length." However, due to scope limitations encountered during this audit, we are unable to provide complete assurance that all relevant information was obtained concerning some of the issues reviewed in this report.

Key Facts and Findings

- Our work identified that the Commission did not exercise strict control and close supervision over the activities of its contractors, nor did it take prudent and necessary steps to ensure that business with the Lottery Operator and other contractors was conducted at "arm's length."
- We believe the Lottery Operator did not live up to its obligations under the contract and its own ethics policies to serve the public trust, avoid embarrassment to the Lottery, and perform all business activities in a manner that is beyond reproach.
- Certain allegations of impropriety or questionable business activities have not been fully addressed due to a lack of timely cooperation by the Lottery Operator and certain individuals with first-hand knowledge of the events in question.
- A material weakness in the Commission's control environment contributed to these contractual control deficiencies. An organization's control environment consists of the operating procedures through which management relays its expectations about duty and integrity to employees, contractors, and the public. We documented control weaknesses in integrity and ethical values, commitment to competence, assignment of authority and responsibility, management's philosophy and operating style, and board of directors (Commissioners) or audit committee participation.
- We found no evidence that the integrity of the Lottery games has been compromised in any manner, despite weaknesses identified in the Commission's management of its contracts and in certain other management controls.

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This management control audit was conducted in accordance with Government Code, Sections 321.0132 and 321.0133.

Executive Summary

The Texas Lottery has generated \$11.6 billion in sales between its inception in fiscal year 1992 and the end of fiscal year 1996. Currently, it has the second highest sales among all state lotteries and the seventh highest sales of any lottery in the world. During this same period, the Lottery transferred \$3.9 billion into the State's General Revenue Fund. However, given the particularly sensitive nature of the Lottery's operations, success must also be judged on factors other than the amount of revenue generated.

In the State Lottery Act, the Texas Legislature mandated that the Lottery must be strictly controlled and closely supervised to ensure the integrity, security, honesty, and fairness of Lottery operations. The Texas Lottery Commission (Commission), its staff, and its contractors must adhere to the highest ethical standards and avoid even the appearance of impropriety or conflicts of interest. Measured by this yardstick, the operation of the Lottery cannot be viewed as an unqualified success.

The Commission did not exercise strict control and close supervision over the activities of its contractors, nor did it take prudent and necessary steps to ensure that business with the Lottery Operator and other contractors was conducted at arm's length. As a result, there is no assurance that the Commission was in a position to negotiate the best available bargain under certain contracts.

In several states, including Texas, agents of the Lottery Operator have engaged in questionable business practices which have created the appearance of impropriety and resulted in state and federal investigations. In addition, by entering into lucrative contracts with several individuals who had personal ties to the Commission's former Executive Director, we believe the Lottery Operator created at least the appearance of conflicts of

interest. With respect to these and other business practices, we believe the Lottery Operator did not live up to its obligations under the contract and its own ethics policies to serve the public trust, avoid embarrassment to the Lottery, and perform all business activities in a manner that is beyond reproach.

Due to scope limitations encountered during this audit, we are unable to provide complete assurance that all relevant information was obtained concerning some of the issues reviewed in this report. Certain allegations of impropriety or questionable business activities have not been fully addressed due to a lack of timely cooperation by the Lottery Operator. In addition, a number of former employees of the Commission and former employees and agents of Lottery contractors who have first-hand knowledge of the events in question were unwilling to agree to an interview. This lack of cooperation significantly hampered our efforts to fully review all areas of concern, and thus resulted in a limitation on the scope of this audit.

However, our work did identify a material weakness in the Commission's control environment that contributed to the contractual control deficiencies. An organization's control environment consists of the operating procedures through which management relays its expectations about duty and integrity to employees, contractors, and the public. We documented control weaknesses in the areas of integrity and ethical values, commitment to competence, assignment of authority and responsibility, management's philosophy and operating style, and board of directors (Commissioners) or audit committee participation.

It is important to note that, despite weaknesses identified in the Commission's management of its contracts and in certain other management

Executive Summary

controls, we found no evidence that the integrity of the Lottery games has been compromised in any manner.

Our work also identified areas in need of improvement such as policies and procedures relating to management of the Prize Reserve Fund. The appendices to this report include discussions of work performed regarding the reasonableness of the lottery operator contract extension and a financial comparison of the Texas Lottery with other state lotteries and those throughout the world.

In this report, we generally use the term "Commission" when discussing the duties and responsibilities of Lottery management. It is important to note that some of the conditions we discuss initially arose before management responsibility for the Texas Lottery was transferred to the Commission. However, since the conditions persisted after the Commission assumed management

responsibility, we consider it appropriate to refer to the Commission when discussing these issues.

Also, many findings in this report occurred during the tenure of the Commission's former Executive Director. At the current time, the Commission's management is making progress in addressing many of the control weaknesses identified by its internal review or by this report. Management is instituting new controls and procedures in the areas of ethics and contract monitoring in an effort to ensure that the Commission and its contractors maintain an appropriate arm's-length relationship and avoid even the appearance of impropriety or conflicts of interest. The Commission plans to establish and implement improved management controls to strengthen accountability over a number of its other functions.

Section 1:

The Commission Should Manage Relationships With Contractors More Effectively

The Commission and Executive Director have broad authority and shall exercise strict control and close supervision over all lottery games conducted in this state to promote and ensure integrity, security, honesty, and fairness in the operation and administration of the lottery.

Government Code Section 466.014 (a)

The success of the Texas Lottery depends upon a cooperative working relationship between the Commission and its contractors. However, the interests of the Commission and those of its contractors are not identical. The Commission's interests are to ensure that the State receives the best value and services under its contract for the lowest price. The contractors' interests are to maximize profits and to ensure that they retain profitable contracts.

To promote the integrity of the Lottery and maximize revenues for the State Treasury, the Commission must maintain independence from its contractors and take all steps necessary to preserve its bargaining power in contract negotiations. Such principles are sometimes discussed in terms of conducting transactions "at arm's length."

The Commission's contractors also have an obligation to assist the Commission in promoting integrity, security, honesty, and fairness in the operation and administration of the Lottery. To do this, they must respect the Commission's need for autonomy and independence, and refrain from conduct that could, in the minds of reasonable observers, create the impression that they might be seeking to unduly influence contracting decisions.

Section 1-A:

The Commission Should Maintain an Arm's-Length Relationship With Its Contractors

In our opinion, the Commission did not consistently maintain an "arm's-length" relationship with its contractors. As we use the term, an "arm's-length" relationship exists when transactions take place in an open market between unrelated parties, who are free of any potential undue influence and who possess all information needed to fully distinguish their own economic interests from those of the other party.

We believe that, in the past, the Commission allowed itself to become too closely intertwined with and too dependent upon its contractors, especially the Lottery Operator. We consider the following to be indicative of a less than arm's-length contracting relationship:

- The Lottery Operator and other contractors created the appearance of conflicts of interest through awarding lucrative contracts to close friends of the former Executive Director. This occurred despite the fact that the Commission had the contractual right to insist upon replacement of these contractors. (See page 5.)

- The Commission permitted the Lottery Operator and the instant ticket vendor to pay for meals and entertainment for Commission employees. In some cases, reimbursements were not made for months or years after the fact. (See page 8.)
- The Commission did not exercise due diligence in obtaining Lottery Operator financial data to which it is entitled under state law and the lottery operator contract, which placed the Commission at a disadvantage in negotiations with the Lottery Operator. (See page 9.)
- The Commission did not adequately enforce certain contract terms including the timely levying of liquidated damages against the Lottery Operator (See page 10.)

In all procurement decisions, the Executive Director shall take into account the particularly sensitive nature of the lottery and shall act to promote and ensure integrity, security, honesty, and fairness in the operation and administration of the lottery and the objective of producing revenues for the state treasury.

Government Code §466.101(b)

A less than arm's-length relationship with contractors can create the appearance that the Commission's independence and objectivity have been compromised. In such circumstances, it is difficult to dispel doubts about the integrity of contracting decisions, even though they may have been made strictly on their merits.

Two recent decisions to extend contracts without competitive bids were called into question by the

Commissioners after publicity arose concerning relationships between Commission staff and the Lottery's contractors and agents:

- In 1996, the Commission renewed its instant ticket contract without competitive bids. When the Commissioners elected to rebid these services in 1997, it achieved an estimated \$4 million per year in cost savings.
- In 1996, the Commission extended the Lottery Operator's contract for five years without competitive bids. Staff members were instructed by the Commissioners to negotiate a contract extension that included price concessions rather than accept the options as first presented.

At the Commission meeting to discuss whether to extend the lottery operator contract or seek new bids for these services, four options were initially presented by staff for the Commissioners' consideration. A review of the transcript of the meeting indicates that the Commission's staff members appeared inclined toward the option favored by the Lottery Operator, yet they had not gathered sufficient financial information to fully evaluate this option or the other options under consideration. The Commissioners, primarily the Chair, were reluctant to proceed to a decision without the information needed to protect the State's bargaining position in contract negotiations. At a subsequent meeting, the Commissioners voted to extend the lottery operator contract without a rebid, but not before they had obtained the price reduction and other concessions in exchange for what appears to be a relatively minimal reduction in the services outlined in the Lottery Operator's initial offer.

The decisions to renew rather than rebid may well have been appropriate under circumstances prevailing at the time. However, the less than arm's-length relationship between the Commission and its contractors raises unresolved questions concerning whether the Commission was in a position to receive the best value when negotiating renewals of the contracts.

The Commission and its contractors should avoid the appearance of conflicts of interest. The Commission has primary responsibility for monitoring and policing relationships with contractors. However, the Commission's contractors are also obligated to monitor and police their own conduct and that of their agents.

The Lottery Operator entered into lucrative consulting contracts with several individuals who have close ties to the former Executive Director. In one case the Lottery Operator acknowledges that the consultant received \$30,000 without performing any work of significance. In another case, a consultant initially performed some work, but was paid in excess of \$100,000 over a three-year period for which there is no evidence of work performed.

Principle of Independent Objective Judgment

Public servants should employ independent objective judgment in performing their duties, deciding all matters on the merits, free from conflicts of interest and both real and apparent improper influences.

1. Conflicts of Interest

Public Servants should safeguard their ability to make independent, fair, and impartial judgments by scrupulously avoiding financial, social, and political relationships which might compromise, or give the appearance of compromising, objectivity, independence, or honesty.

Principles of Public Service Ethics
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In addition, the instant ticket vendor and the instant ticket vending machine vendor both hired an individual with close ties to the former Executive Director to perform lobbying and consulting services. The instant ticket vendor acknowledged that the consultant's friendship with the former Executive Director was a key factor in the hiring decision.

The intermingling of contractual and social relationships can give the appearance of compromising the Commission's independence and objectivity. As noted earlier, the Commission had the right to insist upon replacement of these consultants and did not exercise this contractual right. In addition, we believe the Commission's contractors should have recognized that the relationships between the consultants and former Executive Director could create the appearance of conflicts of interest, and avoided such conduct on their own initiative. The contractors cannot abdicate responsibility for policing their conduct to the Commission.

In some cases, the Lottery Operator's consulting contracts were to remain in effect for as long as the Lottery Operator retained the Texas contract. This included any extensions of the existing contract, but did not include any new contract awarded to the Lottery Operator after competitive bids. Therefore, it was in the consultants' financial interest for the Lottery Operator to retain the Texas contract for as long as possible without a rebid.

Public Office as a Public Trust

Section 3(D) Organizational vs. Personal Loyalties.

Public Servants with supervisory authority should safeguard and protect the public interest, the reputation of government, and the integrity and efficiency of their department, even at the cost of injuring a superior, colleague or friend.

Principles of Public Service Ethics
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The former Executive Director headed the team that was responsible for developing options for the Commission concerning whether to renegotiate the lottery operator contract or to seek competitive bids. Because any option selected would have significant economic consequences for close friends, the former Executive Director was placed in an untenable position where personal loyalties were potentially in conflict with loyalties owed to the organization.

appearance of conflicts of interest. The resulting environment lacked the inherent safeguards that an arms-length relationship would provide.

We have found no evidence to date that any agent or employee of the Commission’s contractors attempted to exert undue influence on the Commission, nor have we found evidence that the former Executive Director’s presentation of options to the Commission was influenced by her relationships with these consultants. However, as noted in Section 2, the scope of our review was limited by a lack of cooperation from some of the individuals involved. As a result, we were precluded from conducting a complete review of these issues.

It is also important to keep in mind that undue influence is very difficult to either prove or disprove. It is for this reason that the Commission and its contractors must avoid any conduct creating an environment where the potential for undue influence exists.

Any (Lottery Operator) employee, agent, lobbyist, or representative affiliated with or working on this Contract who is reasonably determined by the Lottery, in good faith, to be unsatisfactory for successful completion of the work shall be replaced by (the Lottery Operator) with a person reasonably deemed satisfactory by the Lottery within five (5) working days of receipt of written notice from the Lottery

Lottery Operator Contract, Section V(9)

The Commission is empowered under the lottery operator contract to insist upon replacement of any of the Lottery Operator’s Texas consultants. In our view, the Commission should have exercised this right with respect to consultants who have close ties to staff with responsibilities concerning the lottery operator contract. While acknowledging the difficulty of making decisions adversely affecting friends or colleagues, we believe the higher ethical standards mandated for the Commission require this result.

We also found that the Commission’s ethics policies were not specific enough to detect and resolve actual or apparent conflicts of interest. For example, the Commission allowed its contractors to develop their own code of conduct under very general guidelines. As a result, there is no assurance that the Commission’s contractors are being held to uniform, specific, and enforceable ethics policies.

Recommendation:

The Commission should establish uniform ethics policies to govern relationships between the Commission and its contractors. The policies should also apply to any agents or subcontractors performing duties relating to the Texas Lottery. We recommend that these policies be made applicable as a condition of employment or contract award and include, at minimum:

- Examples of prohibited or questionable conduct, including actual and apparent conflicts of interest
- Requirements for disclosure, prior to employment, of detailed information relating to the proposed services and remuneration of lobbyists, consultants, or other agents who are to perform duties relating to the Texas Lottery
- A duty to report any violation of law, contract, or ethics policy to the Commission
- A duty to disclose any business, social, or personal situation or relationship that may create a conflict of interest or the appearance of a conflict of interest, with a procedure for independent review and resolution of any ethical questions presented
- The citation and text of relevant laws establishing ethical responsibilities
- The range of sanctions for violation of ethics policies

The Commission should actively monitor and enforce these policies in compliance with its statutory duty to ensure integrity in the operation and administration of the Lottery. The Commission should also consider establishing a mandatory ethics training program for its employees as well as the agents and key staff of its contractors.

The Commission's contractors should take the opportunity to reexamine their business practices, preferably with the aid of an independent authority on ethics and governmental relations, and discontinue any practices that are found to be inconsistent with the high standards of ethics mandated for the operation of the Texas Lottery.

Management's Response:

By the fall of 1996, steps were being taken to revise the Personnel Policy Handbook which included, in part, the agency's ethics guidelines. Ethics policies were revised and new guidelines were adopted by the Commission on January 7, 1997, and on February 14, 1997 which forbid agency staff from accepting anything of value from lottery vendors and prohibits socializing with vendors. Management issued a policy memorandum further defining and enhancing our ethics policies and those of our contractors. We view the enhancement of our ethics policies and those of Commission

contractors to be an ongoing process to ensure the integrity, security, honesty, and fairness in the operation and administration of the lottery.

While issues pointed out by the State Auditor's Office in this report are directed at specific situations that occurred with specific high level former employees, we have begun mandatory ethics training for all employees. This training will be in concert with the Texas Ethics Commission in an attempt to promptly address any old or new potential issues by enhancing the ethics policies. This training will continue on a periodic basis. Management has taken steps to make employees aware of a reporting process related to ethics issues. The reporting process ensures that an employee may make a report without fear of reprisal and thereby encourages the employee to make such a report. It is management's intent to appropriately investigate all reports by employees.

The Commission should consider prohibiting contractors from paying expenses on behalf of its employees. In a number of cases, Commission employees did not reimburse contractors in a timely manner for costs incurred on their behalf for meals, entertainment, and other items. Even if a lack of timely reimbursement is due simply to carelessness, it can cause an ethical problem for the Commission and the contractor, because it may create the impression that there was never an expectation that reimbursement would occur. Since Commission employees are prohibited from accepting gifts, favors, or benefits from Lottery contractors, it is essential that the Commission and its contractors have controls in place to ensure compliance with this prohibition.

The Lottery Operator and the instant ticket vendor did not consistently bill Commission employees in a timely manner or contact the Commission about delinquent accounts when payments were not made. Given the control weakness creating these conditions, whether or not all expenses incurred on behalf of Commission employees have been properly billed and reimbursed could not be established.

When concerns were raised about this issue, the instant ticket vendor began making improvements to its procedures to monitor expenses and reimbursements in all states where it conducts lottery business.

Recommendation:

The Commission should consider establishing a policy that absolutely prohibits its contractors from incurring costs on behalf of Commission employees, along with a system to monitor and enforce the policy and impose sanctions for violations of the policy by its employees or by contractors. By implementing such a policy, the Commission and its contractors would avoid having to establish elaborate tracking procedures for reimbursements and would also avoid situations that are inherently susceptible to the appearance of conflicts of interest.

Management's Response:

The interim Executive Director, who now serves as General Counsel, immediately dissolved the practice of allowing Contractors to incur costs on behalf of Commission employees and this policy is being followed today. The issue of enforcement of this policy is addressed within the Texas Lottery Commission's Personnel Policy Handbook.

The Commission should exercise due diligence in obtaining Lottery Operator financial data. The Commission did not obtain Lottery Operator financial data needed to make informed decisions concerning the costs of operating the Texas Lottery. As a result, the Commission was placed at a disadvantage in negotiations with the Lottery Operator.

Although the Lottery Operator is required by contract to prepare an annual cost report, it only did so in 1993. In subsequent years, the Lottery Operator has only supplied the Commission with its audited financial statements. Neither the 1993 cost report nor the financial statements contain sufficient data to allow the Commission to make informed decisions concerning the actual cost of lottery operations. The Commission took no steps to seek more detailed and useful cost information, even though the State Lottery Act and the lottery operator contract provide the Commission with complete access to the Lottery Operator's financial records. The following examples illustrate that the Commission did not have cost data needed to make informed decisions:

- During the February 21, 1996, Commission meeting at which renewing the lottery operator contract was discussed, the former Executive Director was unable to answer the Commission Chair's question regarding the Lottery Operator's cost for installing a lottery terminal.
- During the March 4, 1997, Commission meeting, neither the Commission's staff nor the Lottery Operator were in a position to respond to basic questions from the Commissioners concerning costs and profits associated with operating the Texas Lottery.
- Prior to the contract renewal negotiations, the Commission's Systems Administrator was directed to prepare a cost estimate for operating the Texas Lottery. To ensure an independent estimate, the Systems Administrator was instructed that no financial data from the Lottery Operator should be used in preparing the estimate. However, after the estimate was completed, the Commission did not seek actual cost data from the Lottery Operator. Actual cost data could have been compared against the Commission's cost estimate to improve its bargaining position in the upcoming negotiations.

The absence of detailed Lottery Operator cost information has left the Commission unable to determine:

- Whether proposals received from the Lottery Operator offer fair and reasonable terms to the Texas Lottery
- Whether proposed amendments to the lottery operator contract or settlement offers on liquidated damages are justified from a cost standpoint
- Whether the Commission should have considered exercising its option to purchase the Lottery Operator's system as originally installed, which it could have done in 1996 at a one-time cost of \$79 million. Although additional operating costs would need to be taken into account, it would appear this option should have been carefully analyzed considering the Commission paid the Lottery Operator \$135 million in fees during fiscal year 1996.

In recent months, the Commission has started to receive limited cost information from the Lottery Operator. The Commission is currently in the process of securing audit services to verify the accuracy of this financial data. This should improve the Commission's bargaining position in future negotiations with the Lottery Operator and in the planned rebid of the lottery operator contract.

Recommendation:

The Commission should move forward with the proposed financial audit of the Lottery Operator. Supplemental audit work should be performed annually until the Commission determines and obtains the financial information it needs in the Lottery Operator's cost reports to allow the Commission to make informed management decisions. Future contracts should specify that the Lottery Operator is required to submit cost reports and other information concerning lottery operations within the time and in a format determined by the Commission.

Management's Response:

In March 1997, the Commission directed Lottery staff to issue an RFP to perform these audit services. That RFP was issued and we are in the process of awarding that contract. We will enhance language in the lottery operator RFP to obtain sufficient cost reports to meet the needs of the Commission.

The Commission should maintain adequate contract monitoring controls. We identified inadequate monitoring and a lack of monitoring procedures with respect to key contract provisions:

- As discussed above, the Commission did not monitor or enforce the requirement for submission of an annual cost report.

- The Commission tracked and collected liquidated damages in an inconsistent manner. From the inception of the Texas Lottery through October 1996, the Commission did make four timely assessments totaling approximately \$387,000. However, as illustrated in Table 1, the Commission allowed much larger amounts of liquidated damages to remain uncollected over a long period of time.

Table 1

Date Assessed	Period in Which Damages Occurred	Number of Days in Which Damages Occurred	Total Liquidated Damages
November 19, 1993	April 21, 1993, through November 17, 1993	211	\$1.6 million
June 3, 1994	May 30, 1992, through April 19, 1994	690	\$6.5 million
March 31, 1995	June 3, 1994, through March 3, 1995	274	\$0.3 million
August 14, 1996 ¹	April 7, 1995, through June 16, 1996	437	\$1.0 million

¹ Former management assessed damages on August 14, 1996 after the State Auditor's Office requested a report on liquidated damages on August 9, 1996.

- The Commission has not established procedures for monitoring unauthorized access to secured facilities managed by the Lottery Operator and for assessing liquidated damages as appropriate.
- The Commission could improve procedures for ensuring that the Lottery Operator visits each retailer twice per month. Currently, compliance is monitored three months after the fact relying on records created and maintained by the Lottery Operator.
- The Commission did not adequately monitor the hires of the Lottery Operator (See page 5.)
- The Commission does not routinely receive and review reports from the Lottery Operator concerning litigation initiated against the company. The Lottery Operator is contractually required to send a copy of such litigation to the Commission within 15 days of occurrence.

Effective monitoring and enforcement of key contract terms allow the Commission to independently determine the effectiveness and efficiency of the Lottery Operator's performance and ensures the maintenance of an arms-length relationship with the contractor.

Recommendation:

The Commission should complete its plans to create a contract compliance unit. The Commission should also review its contracts with the Lottery Operator and other contractors, identify key compliance areas, and ensure it has adequate procedures to monitor and enforce contract terms.

Management's Response:

Contract compliance monitoring was decentralized within this agency. For better contract compliance monitoring, the agency has centralized this function. Internal realignments were made to create a full-time position to monitor agency-wide contract compliance. Duties for this position include developing an effective monitoring database to ensure vendor compliance for all major contracts. Senior management within the agency had previously requested a contract management system that would include a contract compliance group. The agency has now acquired a contract management system that will be implemented by the contract compliance group.

Section 1-B:

The Lottery Operator Should Fulfill Its Contractual Obligation to Avoid the Appearance of Impropriety

The Texas Lottery is an extremely sensitive enterprise because of the nature of the business and because it is government operated. Therefore, it is essential that its operation, and the operation of the other enterprises which would be linked to it in the public mind, avoid not only impropriety but also the appearance of impropriety.

Lottery Operator Contract, Attachment A

Business practices should be consistent with high standards of ethics. The State Lottery Act includes provisions that express the clear intention of the Texas Legislature that the lottery will be operated with integrity and in a manner free from scandal. Under the terms of the Texas contract and its own ethics policies, the Lottery Operator is under the obligation to conduct its business activities according to the highest ethical standards by avoiding not only impropriety, but the appearance of impropriety. We believe the Lottery Operator has not met this obligation.

In several states, including Texas, agents and a former employee of the Lottery Operator have engaged in questionable business practices that have created the appearance of impropriety and resulted in state and federal investigations.

The unique nature of this RFP and the contract that will result from this procurement will result in a relationship between (the Lottery Operator) and the Lottery that must rely on mutual trust and respect if it is to succeed.

Request for Proposals for Lottery Operator, Section 1.6

The Lottery Operator's former national sales manager awarded a lucrative New Mexico consulting contract, with no apparent expectation of performance, to an individual with close personal ties to the Commission's former Executive Director. Although residing in Texas, the consultant used the New Mexico address of a relative of the former Executive Director to receive payments under the contract.

When this matter was discussed at a Commission meeting, the Lottery Operator acknowledged that this conduct was improper. However, the Lottery Operator tried to draw a distinction between ethics issues and commercial issues, and expressed concern that ethics issues should not be resolved by addressing the commercial side; that is, through a rebid of the lottery operator contract. The Lottery Operator also lauded its record in producing revenues for the State, and cautioned the Commission against taking action that might jeopardize the revenue stream.

Given the particularly sensitive nature of the Lottery, we believe that consideration of ethics issues cannot be divorced from commercial issues. Furthermore, while the Lottery Operator undoubtedly deserves credit for the financial achievement of the Lottery, this is not the sole criterion by which to judge the Lottery's success.

The Lottery Operator also attempted to distance itself from the conduct of the sales manager by maintaining that his actions were those of a single errant employee in a company of over 4,000 employees, and that the sales manager was operating without the company's knowledge and in contravention of company policy. However, even accepting that the Lottery Operator was unaware of the true nature of the New Mexico contract, we believe this does not relieve the company of responsibility for the sales manager's conduct. During the period in question, the sales manager was a member of senior management and had been delegated broad authority to negotiate contracts on behalf of the company. On the sales manager's recommendation, the New Mexico consulting contract was written by a company lawyer and approved by a senior vice president of the company.

Due to a lack of cooperation on the part of the consultant and the former sales manager, information which may be known only by these individuals was not available during this audit. In addition, the Lottery Operator asserted the attorney-client privilege and the attorney work product doctrine in refusing to provide certain information relating to the company's internal investigation of this matter. As a result, we have no assurance that all pertinent information relating to the New Mexico contract has been disclosed.

Recommendations:

The Lottery Operator should continue conducting an examination of its business practices and discontinue any practices that are found to be inconsistent with the high standards of the ethics mandated for the operation of the Texas Lottery.

Business practices should not result in unfavorable publicity and

embarrassment to the Lottery and the State of

Texas. Under its contract with the Texas Lottery, the Lottery Operator has pledged to serve the public trust, to avoid unfavorable publicity and embarrassment to the Commission, and to perform all business activities in a manner that is beyond reproach. We believe that the Lottery Operator and its agents have not fulfilled this obligation.

The (Lottery Operator) functions under the supervision of the Lottery and must operate in a manner that will not cause any embarrassment to the Lottery and the State of Texas.

Request for Proposals for Lottery Operator, Section 1.6

In many state and national periodicals, the Lottery Operator has been the subject of news articles and editorials that are highly critical of certain business practices of the company and its agents. A spokesman for the Lottery Operator is usually quoted as disagreeing with these reports. However, these reports appear to have some basis in fact, even if the Lottery Operator disagrees with the conclusions that have been drawn from those facts.

(The Lottery Operator) serves the public trust and, as a matter of Company policy conducts its business accordingly. The best defense against unfavorable publicity and embarrassment to both the Lottery and (the Lottery Operator) is to perform all business activities in a manner that is beyond reproach

Lottery Operator Code of Conduct, Section 4.13.2

It is important to recognize that the Lottery Operator itself has not been charged with wrongdoing in connection with any of the reported activities. Furthermore, some of the allegations of impropriety involving the company's agents may ultimately prove to be unfounded. However, the sheer volume of unfavorable publicity has created embarrassment for the Lottery Operator and, more importantly, for the Texas Lottery. Furthermore, if the media reports are accurate, the business practices which they describe cannot reasonably be characterized as "beyond reproach."

The unfavorable publicity focuses primarily in two areas. The first involves what is reported to be a common practice of awarding lucrative contracts to individuals with close ties to government decision makers, in some cases with no apparent expectation that significant work would be performed.

We asked the Lottery Operator to furnish specific information in order to ascertain whether these media reports were accurate. As of the close of the fieldwork phase of this audit, the Lottery Operator had not furnished the specific information requested, so we have been unable to complete our review of this issue.

A second focus of adverse publicity has been on the activities of the Lottery Operator's former national sales manager, who has since left the company. The sales manager entered into a number of agreements under which a portion of revenues received by Lottery Operator consultants were paid back to the sales manager. In some cases, it is reported that there is scant evidence of work performed by the sales manager.

In New Jersey, the sales manager and a Lottery Operator consultant were convicted on charges of money laundering and commercial bribery. It has been reported that the sales manager's contracting practices have been investigated or are under investigation in several other jurisdictions, including Kentucky, New York, and Texas.

In Texas, the matter that has received the greatest amount of unfavorable publicity involves a local lobbying and consulting firm that received over \$20 million under contracts with the Lottery Operator. This firm reportedly entered into an agreement with the former national sales manager under which one-third of the revenues received under the firm's primary contract with the Lottery Operator were to be paid to the former sales manager in exchange for consulting services. Over half of a million dollars was reportedly paid to the former sales manager before the agreement was terminated. We were prevented from obtaining more details concerning the agreement and any services provided under the agreement by a lack of cooperation by the former sales manager and the Texas lobbying and consulting firm.

Recently, the Lottery Operator and the Texas firm agreed to sever their relationship. In exchange for cancellation of the contracts, the Texas firm received a settlement package worth approximately \$23 million.

Considering the particularly sensitive nature of the Lottery, the Lottery Operator has an even greater duty to closely supervise and manage its own business activities and those of its agents to ensure that the company fulfills its pledge to serve the public trust. The Lottery Operator has taken some steps toward addressing these issues by strengthening some policies relating to governmental services consultants and creating and filling the positions of vice president of compliance and state compliance officer for Texas.

Recommendation:

To ensure future compliance with its contractual obligation to perform all business activities in a manner beyond reproach, the Lottery Operator should continue reviewing ethics policies for its officers, employees, and agents, especially with respect to avoiding the appearance of impropriety or conflicts of interest.

The Lottery Operator should continue to actively monitor compliance with its ethics policies. The Lottery Operator should immediately report any possible violations of its ethics policies to the Commission if they could affect the operation of the Texas

Lottery or might otherwise cause unfavorable publicity or embarrassment to the Commission.

Section 2:

Scope Limitations Hindered Our Ability to Investigate All Allegations Fully

Auditors report significant constraints imposed on the audit approach by data limitations or scope impairments. Due to scope limitations encountered during this audit, we are unable to provide complete assurance that all relevant information was obtained concerning some of the issues reviewed in this report.

We were unable to obtain the cooperation of a number of former employees of the Commission and former employees or agents of the Commission's contractors who have knowledge pertaining to the issues we reviewed. As a result, critical information that may be known only to these individuals has not been made available during the audit.

The State Lottery Act provides the State Auditor with authority to conduct a complete audit of all records of the Lottery Operator and to take statements under oath. However, as of the close of audit fieldwork, the Lottery Operator has not provided complete and timely responses to our requests for information. The Lottery Operator also denied us access to certain information we requested concerning its contracting practices, contending that such information is protected from disclosure by the attorney-client privilege or the attorney work product doctrine. As a result, we have been unable to complete an assessment or ask needed follow-up questions concerning the Lottery Operator's contracting practices.

We received full and prompt cooperation from the Commission's instant ticket vendor during our review.

Section 3:

The Commission Should Strengthen Its Control Environment

The questionable management of the contracting relationships discussed in Section 1 is partially the result of a material weakness in the Commission's control environment. An organization's control environment consists of the operating procedures through which management relays its expectations about duty and integrity to employees, contractors, and the public.

The control environment is often referred to as "the tone at the top." It sets the standards for and influences the actions of everyone in the organization from the board room to the mail room. A strong control environment demonstrates an organization's commitment to managing risk and safeguarding its resources.

An assessment of an organization's control environment depends on the effectiveness and reliability of controls in areas including:

- Integrity and Ethical Values
- Commitment to Competence
- Assignment of Authority and Responsibility
- Management's Philosophy and Operating Style
- Board of Directors or Audit Committee Participation

We identified weaknesses in each of these control areas, causing us to conclude that a material weakness exists in the Commission's control environment. Strong controls in these areas establish an environment in which there is an awareness of possible conflicts and an ability to institute effective policies and procedures to safeguard against any appearance of impropriety.

The Commission has already taken positive steps to address weaknesses in some of these control areas. It is now at a crossroad as a new Executive Director comes on board and it moves forward with the planned rebidding of its lottery operator contract.

Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioral standards to personnel through policy statements and codes of conduct and by example.

Statement on Accounting Standards 78,
Appendix ¶ 3a

Section 3-A:

Integrity and Ethical Values

Management should further strengthen its ethics policies. Gaps in the Commission's ethics policy contributed to questionable behavior by members of the Commission's staff and management. The Commission's ethics policies do not sufficiently prohibit third parties from paying expenses on behalf of Commission personnel, or restrict the establishment of personal relationships that may create an appearance of conflict of interest.

- Several members of staff and management accepted meals, entertainment or other benefits from the Lottery Operator which they were supposed to reimburse. Many of these reimbursements came only after adverse publicity regarding this practice. In some cases, reimbursement occurred over two years after the expense was incurred (See page 8.)
- The Commission's former Executive Director, former deputy Executive Director, and intergovernmental affairs supervisor took a weekend vacation trip with the instant ticket vendor's Texas lobbyist.

When the Lottery was reorganized from a division of the Comptroller of Public Accounts' (Comptroller) Office into a separate commission, the Commission adapted the Comptroller's personnel policy manual. In doing so, it did not adequately consider the ethics policy needs that were unique to the Texas Lottery. In some instances, Lottery employees were being held to ethics standards that were applicable solely to employees of the Comptroller's office, for example, encouraging and achieving the highest degree of voluntary compliance with the tax laws and regulations of the State of Texas. The Commission is working to improve its personnel policies, especially in the area of ethics. Management has developed updated policies, some of which are still in draft form. However, the new policies require further enhancement.

Recommendation:

The Commission should make the following enhancements to its policies, and finalize and formally adopt those in draft form:

- The Commission should adopt a policy that specifically bans Commission staff from accepting any benefit from vendors, or vendors' agents, including business meals. Commission employees should be required to pay such expenses at the time they are incurred or to pay in advance. The Commission should enforce this policy by imposing sanctions on contractors or employees who violate the prohibition.
- The Commission should adopt fraternization policies similar to those at the Teacher Retirement System of Texas and the Texas Rehabilitation Commission. These policies forbid nonprofessional socialization, such as dating, visiting each other's residence, vacationing together, and similar personal relationships, with vendors and other third parties.

The Commission should also expand the duties of its ethics coordinator. Duties associated with this position should include monitoring for compliance with ethics policies, periodically reviewing and updating the policies, and implementing timely policy corrections. Consideration should be given to having the ethics coordinator report directly to the Commissioners.

Management's Response:

The interim Executive Director, who now serves as General Counsel, immediately dissolved the practice of allowing Contractors to incur costs on behalf of Commission employees and this is being followed today. Ethics policies were revised and new guidelines were adopted by the Commission on January 7, 1997, and on February 14, 1997 which forbid agency staff from accepting anything of value from lottery vendors and prohibits socializing with vendors. Management issued a policy memorandum further defining and enhancing our ethics policies and those of our contractors. In

addition to the adoption of these ethics policies, House Bill 3370, 75th Regular Session, makes the statutory prohibition of accepting anything of value from a person with a significant financial interest in the lottery applicable to all Commission employees. Further, all contractors owed money by Commission employees state that they have been paid in full.

We have three functions within this agency that share the duty of the Ethics Officer; they are Human Resources, Legal and Internal Audit (who reports to the Commissioners).

Section 3-B:

Commitment to Competence

Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

Statement on Accounting Standards 78,
Appendix ¶ 3b

Management's adherence to hiring controls will help ensure personnel have necessary qualifications. Key Commission staff do not meet the required qualifications for their positions, in part because management overrode hiring controls. As a result, positions were filled with individuals who did not have qualifications which were identified as essential to perform those duties.

An examination of a sample of personnel files revealed that seven individuals did not have the necessary qualifications for their positions. These seven individuals included one member of executive management, three directors, and three supervisors. None had the required education for their position, one did not have the necessary job experience, and one did not have the required supervisory experience.

Additionally, we identified four employees who did not go through the standard hiring process. This included all three division directors hired since the Commission became a separate agency. Two of these directors did not have applications or resumes on file in the Human Resource Department. One of these directors was hired within weeks of being demoted in his previous workplace.

An internal survey of Commission staff in 1996 revealed that management's hiring practices were having an adverse effect on staff morale. The survey revealed approximately 40 percent of staff members were dissatisfied with the Commission's hiring and promotion practices. Roughly 35 percent of respondents also stated that they were not satisfied with their future career opportunities at the Commission. About 20 percent of staff members also stated their manager was not effective at his or her job.

Hiring staff members that have the necessary qualifications and skills is essential to ensure the Commission has competent staff in key positions. Using an effective

recruitment process increases the likelihood that the Commission will have qualified candidates from whom to choose. Only rare overrides of a recruitment process may be acceptable when an unusually qualified job candidate is available and such hiring decisions are fully documented.

Human resources controls must ensure employees will have sufficient qualifications to perform required duties. The Commission has failed to sufficiently link job performance to salary actions, define job performance for all positions, and maintain effective training records.

Management does not consistently document justification for raises and promotions. Inadequate documentation weakens management's ability to prove that it only promotes deserving staff who have demonstrated the necessary job skills and compromises management's ability to defend raises.

Commission policy requires each employee to receive an evaluation annually. In addition, employees receiving personnel actions are required to have a current evaluation. Reasons for the lack of timely evaluations include the fact that not all supervisors are held accountable for conducting timely performance appraisals and the Human Resource Department stopped tracking the completion of performance evaluations. The Department resumed tracking evaluations in September 1996.

The Commission does not have valid criteria to measure the performance of all Commission staff because management has not developed and documented current, accurate, sufficiently detailed job descriptions and job responsibilities for each staff position. Detailed job descriptions and well-defined criteria for performance evaluation would put the Commission in the best position to defend its employment decisions in the event they are challenged through grievances or litigation.

The Commission had \$11.2 million in salary expenses during fiscal year 1996. Managing this expenditure effectively is essential to efficient performance of its operations. Accurate definition of job duties and expectations is an essential part of the appraisal process because it builds some criteria against which to judge job performance.

Commission training records are not kept in a manner that allows management efficient access to critical training information such as the types of training provided and individual training records. As a result, management cannot readily determine whether persons performing important tasks such as preparing performance evaluations or hiring have received the proper training. Assembling individual training records is also problematic.

Recommendation:

The Commission should use its standard recruitment and selection process to fill positions, with very few exceptions. The Commission should examine the performance of persons filling positions for which they are not qualified to determine whether these individuals' background deficiencies adversely affect their job performance. In cases in which there is an adverse effect, management should take steps to correct the problem. In cases where there is no effect, management should reexamine the job description and determine whether the qualification is truly necessary.

All supervisors should be evaluated on the timeliness of formal performance feedback given to staff. The Commission should require certification that a current evaluation is on file before personnel actions are granted.

Valid criteria should be established to measure the performance of each employee. We recommend that management update job descriptions and job performance standards and expectations for all employees. This could be done as part of current employees' annual evaluation and prior to hiring new employees. We also recommend that management enhance the definitions of all performance ratings. Consideration should be given to adding performance examples for all ratings as part of the enhancement process. Persons administering evaluations should receive the necessary training on using evaluation criteria.

The Commission should maintain training data in a more effective manner. A user-friendly database could be developed that allows both management and staff easy access to records by class and by employee.

Management's Response:

Management will ensure that there is adequate documentation for performance evaluations and that they are being prepared timely for all Commission employees. Human Resources is working with the Information Systems Division to obtain a new computerized system to manage a variety of tasks including training records. In addition, hiring practices are being revised and written procedures are being finalized.

Management is currently reviewing all job descriptions and valid criteria to measure the performance of all agency staff. In addition, several of the individuals identified by the SAO are no longer employed by the Texas Lottery Commission, including one member of executive management. Two of the four persons who did not go through the standard hiring process are no longer employed, including the individual demoted in his previous workplace. Of the remaining employees identified by the SAO, they have received performance evaluations demonstrating their competency for their

positions. Where applicable, relevant job-related experience can substitute for a college degree, we will further review the skill set needed for that one position.

Section 3-C:

Assignment of Authority and Responsibility

This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, and recognize how and for what they will be held accountable.

Statement on Accounting Standards 78,
Appendix ¶ 3f

Appropriate business practices should ensure that the Commission is in compliance with those applicable laws, regulations, policies, plans, and procedures that could have a significant impact on operations.

Certain Lottery promotions and advertising did not comply with state law. The Commission entered into advertising and promotional contracts with two racetracks, a practice clearly forbidden by the Lottery Act. The Lottery Act prohibits the Commission from entering into contracts for services, such as advertising, with racetracks at which

wagering is authorized under the Texas Racing Act.¹

In addition, the Lottery Act has a similar prohibition against contracting with individuals operating in locations for which a person holds a liquor license. However, the Commission has held promotional events at sports arenas and other venues that serve alcoholic beverages. This practice appears to violate the Lottery Act. When this issue was brought to its attention through this audit, the Commission suggested that there may be a question concerning whether the Legislature intended this prohibition to apply to venues whose primary business is not serving alcoholic beverages.

The Commission entered into these contracts because it had not adequately considered steps needed to comply with all portions of the Lottery Act.

Recommendation:

Management should ensure its advertising and promotional contracts comply with the Lottery Act. Management should seek an Attorney General's opinion if it wants to continue advertising at venues that serve alcoholic beverages.

² Legislative changes effective September 1, 1997, enables racetracks at which wagering is authorized under the Texas Racing Act to be sales agents. This change now enables the Lottery Commission to contract with these racetracks for advertising and promotional contracts.

The Commission should create a compliance checklist for each type of contract it enters—including advertising. Vendors contracting with the Commission should be required to complete the checklist, which should be reviewed and verified by counsel to ensure all contracts are in compliance with the Lottery Act.

Management's Response:

As footnoted in the report, House Bill 1445, 75th Legislature, Regular Session, authorizes tickets to be sold at a racetrack. Texas Lottery Commission vendors that provide goods or services in connection with the operation of the lottery must be eligible for a sales agent's license in accordance with the State Lottery Act (Chapter 466, Texas Government Code). Contracts with such vendors contain a provision that requires the vendors to certify that they are eligible for a sales agent's license.

We will seek further clarification from appropriate regulatory sources regarding the proximity of lottery locations in connection with locations where alcoholic beverages are permitted.

The Commission should develop certain key policies and procedures. The lack of written policies and standardized procedures contributed to ineffective management of Commission affairs. Some written policies and procedures are nonexistent, exist only in draft form, or are out of date in certain key areas. This lack of current, effective written policies contributed to the following:

- Theft of instant tickets used in a sales promotion that resulted in a potential prize payout to the thief(s). Management did not strengthen policies which contributed to the loss until 1.5 years after the theft. These procedures need further strengthening,
- Accumulation of \$40.25 million in the Commission's Prize Reserve Fund. This issue is discussed in greater detail in Section 5.
- Failure to collect liquidated damages promptly. This issue is discussed in greater detail in on page 10.

Although management has strengthened procedures over promotional ticket giveaways, there are still insufficient controls to distinguish tickets which have been intentionally given away in promotions from stolen tickets. In addition, the Commission cannot determine the dollar loss due to theft of promotional tickets.

Several additional critical areas lacked adequate written policies and procedures. The Commission's key accounting procedures exist only in draft form and the written bank reconciliation procedures do not accurately reflect the actual procedures used to reconcile the Commission's bank accounts. Marketing procedures exist only in draft form. The Commission was in the process of drafting automation security policies.

Additionally, the Commission's policies for topics such as the Commission's hiring policy, demotion, standards of performance, and the Family Medical Leave Act were also in need of update.

Formalized policies and procedures document management's expectations of controls and processes used in daily operations. Documented policies and procedures are important because they:

- Communicate expectations of controls and processes to employees.
- Provide guidance to employees performing duties in the absence of others.
- Provide a mechanism to ensure continuity of operations in the event a key employee resigns or transfers to other job responsibilities.
- Reduce the risk that errors or irregularities could occur and not be detected.
- Reduce the likelihood of confusion and inconsistencies that could occur if employees are not fully aware of the procedures.
- Facilitate the efficiency of operations.
- Form a basis for evaluations.

Recommendation:

We recommend management develop a comprehensive set of policies and procedures that documents the important functions, policies, processes, and steps needed to complete tasks necessary to Commission operations. Procedures in draft form should be reviewed, updated as necessary, and finalized.

The Commission should adopt the following recommendations to enhance accountability of tickets given away at promotions:

- Establish the requirement that a copy of the promotional ticket receipt be maintained separately from the tickets themselves while tickets are transferred to an event official. Maintaining copies of such forms allows easy identification of tickets.
- Revise the promotional ticket form to establish procedures to document exactly which tickets have been transferred. The ticket transfer form should aid in specific identification of transferred tickets.
- Establish procedures for tracking when specific tickets are given away during multi-day events. Management should know which tickets are given away on a specific day.

Management's Response:

The Commission's policies related to in part, the hiring of employees and FMLA were adopted by the Commission on February 14, 1997. The Commission's policy related to demotion and standards of performance are in draft form and will be presented to the Commission for adoption.

The Commission can identify stolen tickets when they are reported. Procedures are in place to prevent paying stolen winning tickets. The Commission's Security Division routinely assists the law enforcement agencies to identify perpetrators for prosecution.

Procedures governing instant ticket promotions were not followed which resulted in this one incident in August 1995. Immediately afterwards, management revised instant ticket promotion procedures to further enhance compliance. Although these procedures, in draft form, were circulated to appropriate personnel, they were not formally approved by executive management until February 13, 1997. As a result of such procedures, no other incident has occurred. To further strengthen the existing procedures, revisions were made, effective June 26, 1997, to amend the ticket distribution form to address the SAO recommendations.

Section 3-D:

Management's Philosophy and Operating Style

Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks, management's attitudes and actions towards financial reporting ... , and management's attitudes toward information processing and accounting functions and personnel.

Statement on Accounting Standards 78,
Appendix ¶ 3d

Adherence to established policies and controls and interaction with staff are two important indicators of management's philosophy and operating style. Weaknesses in former management's philosophy and operating style were apparent through overrides of management controls and micromanagement of some aspects of Commission operations.

Overrides of management controls contributed to the weakness in the control environment. The Commission overrode

existing policies and procedures which fostered an operating style that contributed to the control environment weakness.

- Management overrode hiring controls causing key positions to be filled with staff members that do not meet the required qualifications for their positions. This issue is discussed in greater detail in Section 3-B.
- Management of various divisions overrode purchase controls by receiving and authorizing payment for services prior to proper approval of the proper purchase

documents. In one case, management had not signed a contract for the services prior to receipt of services.

- Executive management prohibited Commission investigators from performing routine surprise inspections on certain designated lottery sales agents, which hindered the Commission's efforts to enforce the Lottery Act. Investigators had to notify a designated member of the sales agent's organization prior to an inspection or an investigation. As a result, certain sales agents had the opportunity to correct potential deficiencies prior to inspections. Granting preferential treatment to certain retailers increases the risk that violations of the Lottery Act and the Commission's rules and regulations will not be detected.

The policy of prohibiting surprise inspections of certain sales agents ended upon appointment of the interim Executive Director and the new security director.

Overriding policies and procedures compromises the integrity of the controls those policies and procedures are designed to enforce. When management uses overrides that are not an unavoidable exception, these actions are an indication of management's attitude toward the importance of the policies and set the tone for the rest of the organization.

Recommendation:

All policies and procedures should be fully and fairly enforced. Management should lead by example in placing the highest importance on adherence with policies and procedures to preserve the integrity of management controls. Management overrides of procedures should occur only in situations that are unavoidable and should be fully documented and justified.

The Commission should ensure all employees with approval responsibility are adequately trained in and fully understand the procedures for which they are responsible. Management should levy appropriate sanctions against persons not following Commission procedures.

Management's Response:

Current management has pledged its intention to carefully monitor hiring practices and purchasing controls to ensure these situations do not occur. The interim Executive Director, who now serves as General Counsel, authorized surprise inspections of retailers. As a result, such inspections began and continue to be performed.

Delegation of management responsibilities promotes staff development and operational efficiency. Former executive management performed tasks that should have been delegated to Commission staff or lower levels of management. A controlling style of micromanagement, which includes excessive involvement in routine operational activities, promotes an environment that is conducive to control overrides and reduced recognition of the need for effective policies and procedures.

- All vouchers in excess of \$5,000 had to be approved by the former Executive Director or the former Deputy Executive Director. At one point, these individuals approved every voucher, regardless of dollar amount.
- The former Executive Director approved routine advertising such as newspaper ads and radio scripts.
- The former Executive Director examined minute details of Commission correspondence. Besides reviewing this correspondence for content, the former Executive Director regularly reviewed it for errors such as typos.

Executive management should make decisions involving the strategic management of the Commission. Effective controls through policies and procedures provide management with the assurances that lower-risk decisions and activities will be handled properly, thereby promoting delegation of these activities. Additionally, effective assignment of authority and responsibility promotes development of management personnel and fosters increased operational efficiency.

Recommendation:

Executive management should delegate routine operational activities to mid- and low-level management while effectively monitoring these managers' activities.

Management's Response:

The interim Executive Director who now serves as General Counsel immediately delegated contract signing approval authority and other routine operational activities to division directors. Management continues this practice today.

Section 3-E:

Board of Directors or Audit Committee Participation

The Commission should finish implementing an operational internal audit function to help monitor its operations. The lack of a fully operational internal audit function has impaired the Commission's ability to detect some problems discussed in this report in a timely manner. The Commission's single internal audit

position was vacant 14 of the Commission's first 30 months as an agency, including a period of 13 consecutive months from March 1995 through April 1996.

An entity's control consciousness is influenced significantly by the entity's board of directors or audit committee. Attributes include the board or audit committee's independence from management. . . the degree to which difficult questions are raised and pursued with management, and its interactions with internal and external auditors.

Statement on Accounting Standards 78,
Appendix ¶ 3c

Additionally, the risk assessment used by the current Internal Auditor and her predecessors does not ensure that the highest-risk areas are identified and audited in a timely manner. The Commission had not approved the Internal Audit Charter when we reviewed the internal audit function.

The Commissioners and management are accountable for the adequacy and effectiveness of the Commission's system of internal control

and performance. The internal audit function is the specialized function designed to provide Commissioners with independent, objective information about management controls. Although the Commission has two required external audits, these audits are not designed to guarantee that the Commission's riskiest management control systems will be identified and audited in a timely manner.

Recommendation:

The Commission should ensure that it has allocated sufficient internal audit resources (time, coverage, and personnel) to carry out a program of internal auditing as required by the Texas Internal Auditing Act.

The Internal Auditor, with managements' participation, should improve the risk assessment methodology so that it accurately identifies all types of risk throughout the Commission. The risk assessment should identify auditable units and use risk factors relative to the Commission to assist in risk-ranking auditable areas. This improved risk assessment should be used to determine the amount of internal audit resources needed to provide a program of internal auditing.

Management's Response:

As SAO pointed out in their report, many of the weaknesses they identified resided with previous upper management's influence over controls. This was the basis of the risk assessment plan used in the Texas Lottery Commission's one person Internal Audit function. Further, the internal audit risk plan was modified from a generic audit risk plan developed by a member of the SAO. However, due to management changes and an associated change in risks, this risk plan will be revised to analyze risk within the various lottery operations. The Internal Audit Charter was reviewed by the Commissioners and will be formally presented to them in the next Commission meeting. To ensure a continuing Internal Audit Function, we are hiring another

auditor. As the risk plan is revised, the need for more audit resources will be reviewed. It is management's intent to dedicate additional resources as necessary.

Section 4:

The Commission Should Review Certain Privatization Issues

Section 4-A:

The Commission Should Reassess the "Texas Model"

The Executive Director may establish procedures for the purchase . . . of services The procedures must, as determined feasible and appropriate by the executive director, promote competition to the maximum amount possible

Government Code Section 466.101 (a)

To promote competition to the maximum extent possible, the Commission should procure services in a manner that does not unnecessarily restrict the number of viable competitors.

Since the inception of the Texas Lottery, there has been a strong emphasis on maximum privatization of lottery services. Privatization efforts are most successful when the bidding for services is truly

competitive. The pressures of competition force companies to perform more efficiently, thus they are able to provide services at lower costs. Competition also increases the Commission's options and bargaining power in contract negotiations, which can help achieve the statutory objective of producing revenues for the State Treasury.

The Texas Lottery has followed a procurement method that is designed to obtain the bulk of lottery services through a single private vendor. In the lottery industry, this method of procurement has come to be known as the "Texas Model." In 1992, the Lottery used this method to obtain the following services from the Lottery Operator:

- Operation of the Lottery's instant gaming system
- Operation of the Lottery's on-line gaming system
- Instant ticket warehousing and distribution
- Sales and Marketing

In the short term, the Texas Model can result in lower overall costs to the Commission and greater administrative efficiency. However, it also can restrict competition by effectively precluding all but the largest and most experienced vendors from submitting offers to deliver services. This is illustrated by the fact that in 1992, when the Lottery first used the Texas Model to procure lottery services, it received only two offers.

Because the Texas Model appears to restrict competition, long-term effects could be overdependence upon a single vendor, fewer viable options for service delivery, erosion of the Commission's bargaining power, and higher costs for lottery services.

As of the date of this report, the Commission plans to seek new bids for lottery services and is also examining a number of service delivery options.

Recommendation:

The Commission should continue to explore alternatives to the Texas Model that will foster competition and decrease the Lottery's reliance upon a single vendor. The Commission should consider "unbundling" the services provided under the current contract, which would allow smaller vendors the opportunity to compete for services. Vendors should be permitted to bid on any or all service components, but should be required to submit a separate bid for each. The Commission should weigh any immediate savings that may be presented by the continued use of a single vendor against the potential long-term impact of a less competitive market in the lottery industry.

Management's Response:

With regard to SAO's interpretation of the Texas Model, the original RFP for lottery operator services included the concept of the use of a consortium of suppliers as well as a single supplier.

On March 4, 1997, the Commissioners requested the preparation of requests for proposals (RFPs) for the purpose of gathering information on the ability and willingness of outside vendors to provide services to the Lottery. Their motion was not intended as a motion to terminate the lottery operator contract with the Lottery Operator nor does it preclude the Lottery Operator from bidding in the event the RFPs are authorized to be issued.

On March 18, 1997, the Commissioners voted unanimously to direct staff to prepare and issue an RFP by no later than June 30, 1997, or earlier as best efforts allow.

On June 9, 1997, a new Executive Director and Deputy Executive Director were hired.

On June 30, 1997, the Commissioners agreed to extend the date for issuance of an RFP until the end of July to allow the new Executive Director to provide input and to make certain that the RFP is accurate, fair and complete.

Section 4-B:

The Commission Should Be Prepared to Perform Lottery Services In-House

Although Texas has placed an emphasis on privatizing governmental services, the Commission should never be placed in a position where, due to the lack of a

competitive market, it must accept terms offered by a private vendor that do not represent the best value for the State. To ensure this does not occur, the Commission should be prepared, if necessary, to perform some or all lottery services in-house.

The Commission's appropriation for the upcoming biennium provides it with the flexibility to perform services in-house if necessary to ensure greater accountability or improved services. The Commission may exercise this option with the approval of the Governor's Office and the Legislative Budget Board.

If the Commission has a viable contingency plan for delivering services in-house, this should provide vendors with additional incentive to submit offers with terms favorable to the State and should also improve the Commission's bargaining power in contract negotiations.

Recommendation:

The Commission should develop and periodically update a contingency plan that would allow the Commission to quickly and efficiently convert to in-sourcing lottery services, in the event it is in the State's best interest to do so. Current cost, performance, and staffing data should be obtained from vendors and used in preparing the plan. The Commission should also ensure that its staff maintains an in-depth understanding of vendor operations and should draw on this knowledge in developing the contingency plan.

The Commission should ensure that it begins the service procurement process early enough so that it will have adequate lead time for approval and start-up if it chooses to in-source lottery services.

Management's Response:

On February 14, 1997, the Commissioners decided to review the feasibility or non-feasibility, the pros and cons, of the state operating the lottery.

As a result of the 75th Legislative Session, Rider 3 was added to the Texas Lottery Commission's bill pattern in the Appropriation Act, House Bill 1. Accordingly, to obtain additional financial and full-time employee resources, the Commission must submit a detailed plan to SAO for review and comment if activities previously provided by a private contractor should be operated by the Commission. In addition, the Commission must receive approval from the Governor and the Legislative Budget Board for additional full-time employees, transfer restrictions and capital budget restrictions.

The Commission will continue to enhance contract language and/or contract monitoring to ensure costs, performance and staffing data is maintained on significant

lottery contractors. Based on information received through these processes, it is management's intent to develop a contingency plan.

Section 4-C:

The Commission Should Ensure That Lottery Services Provided by Private Companies Are Subject to Public Scrutiny

Although the Successful Proposer is from the private sector, its operations will be subject to the same scrutiny and oversight that would exist if all operations were performed by Lottery employees.

Request for Proposals for Lottery Operator, Section 1.6

One consequence of privatization is that information concerning the operation of government-funded programs such as the Texas Lottery may become less accessible to the public. For example, the Lottery Operator, through its legal counsel, has vigorously opposed public disclosure of information reviewed during this audit, contending that such information is proprietary. The Lottery Operator also insisted upon the execution of a detailed confidentiality agreement

prohibiting public disclosure before permitting our auditors to review any of the requested information.

In addition, the Lottery Operator has cited the attorney-client privilege and the attorney work product doctrine in refusing to provide certain information requested during this audit. The Lottery Operator has also opposed public disclosure of information relating to its Texas consulting contracts and its settlement agreement with a Texas lobbying and consulting firm. The Attorney General has determined that information relating to the contracts and settlement agreement is available to the public.

The Lottery Operator's opposition to public disclosure appears to contravene the spirit, if not the letter, of the terms under which its Texas contract was awarded. The opposition to disclosure also makes it problematic for the Commission and auditors to publicly report on activities affecting the operation of the Texas Lottery.

If the public is unable to obtain information concerning Texas Lottery functions that are performed by private vendors, it becomes more difficult to hold the vendors accountable for their performance. In addition, public scrutiny can deter vendors from conducting business in a manner that may raise ethical questions or cause embarrassment.

Achieving the proper balance between a private company's interest in withholding proprietary information and the public's right to be informed about the affairs of government is a complex undertaking. This issue is likely to frequently arise as the Commission and other state agencies continue privatization efforts.

Recommendation:

The Commission should continue to encourage vendors to conduct all activities relating to the Texas Lottery in an open and forthright manner. The Commission should develop guidelines for vendors specifying the types of information that will be subject to disclosure and should incorporate the guidelines into its contracts, along with sanctions for noncompliance.

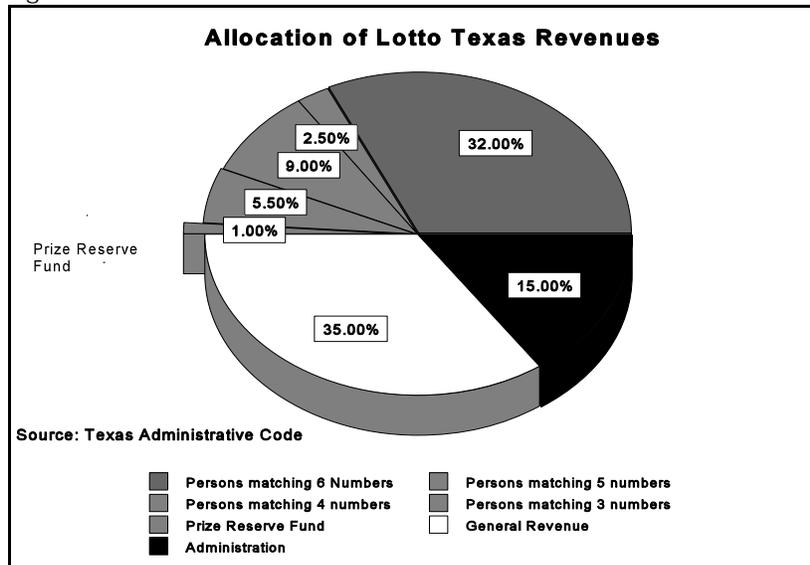
Management's Response:

For contracts with vendors who have a significant financial interest in the lottery, provisions addressing these issues are currently being included. The Texas Lottery Commission understands our role as a public entity that manages privatized services. In our contracts with our vendors, integrity, candor, and accountability must be the cornerstones of these agreements. To be diligent in serving the public's trust, we have and will continue to enhance and enforce disclosure requirements.

Section 5:

The Commission Should Improve Management of the Prize Reserve Fund

Figure 1



The Commission has managed the Prize Reserve Fund (Fund) inconsistently by:

- Allowing management relatively unchecked discretion over the Fund's operational use. (Section 5-A)
- Accounting for the Fund in an incorrect manner that made it difficult for decision makers to monitor fund activity. (Section 5-B)

The Lottery Commission established the Prize Reserve Fund in November 1992 when

Lotto Texas sales began. Lotto Texas receipts are currently divided as shown in Figure 1. One percent of gross Lotto sales is contributed to the Prize Reserve Fund. The general purpose of the fund is to augment the jackpot for Lotto winners when the

"estimated" jackpot, as advertised, is significantly different from the actual jackpot available.

Section 5-A:

Policies for Use of the Prize Reserve Fund Should Limit Management Discretion

The Lotto jackpot payout amount is 32 percent of Lotto sales, multiplied by the most recent interest factor. If this amount is less than the estimated jackpot by more than five percent or \$500,000, whichever is greater. . . . The Executive Director or his/her designee may decide to add to the jackpot prize pool, using money from the Prize Reserve fund, to promote the good of the game and the State of Texas.

The Prize Reserve fund may also be used for other Lotto-related prizes, such as second-chance drawings, at the discretion of the Executive Director or his/her designee.

Source: Texas Lottery Commission Policy EX-PO-009, Use of the Lotto Texas Prize Reserve Fund, August 9, 1996, revision

Management of the Prize Reserve Fund has been inconsistent largely because policies governing the management of the Fund do not contain sufficient checks and balances over discretion granted to the Executive Director. Aspects of fund management which have not adequately been governed by policy include:

- Projection of the Fund's needed balance
- Use of Fund proceeds and amounts accumulated in excess of the needed balance
- Amount of payout supplemented from the Fund

Projection of Fund Needs

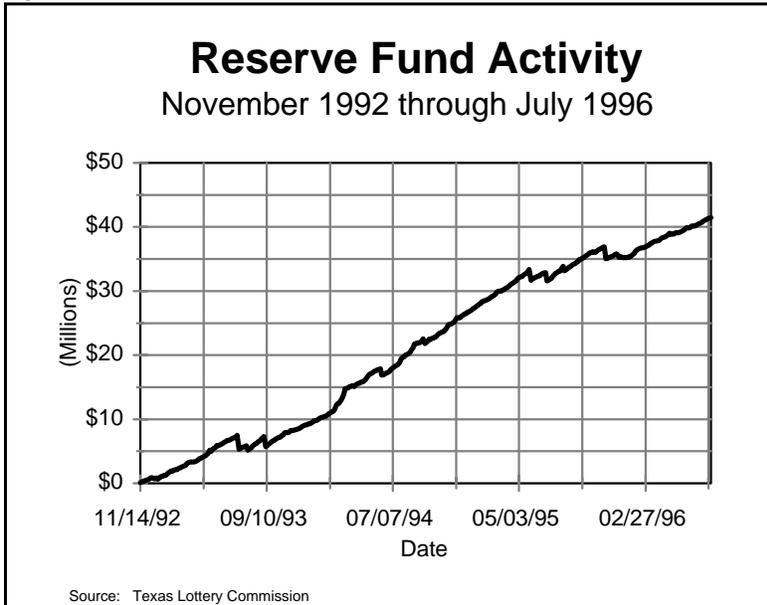
Commission policies and procedures over the Prize Reserve Fund do not specify an acceptable range of balances for the Prize Reserve Fund. Additionally, no projection is calculated for the Prize Reserve Fund balance necessary to sustain its intended use. As a result, the Fund could be allowed to grow above a prudent ceiling or to dip below an essential floor. Establishing policies and procedures to guide the management of the Fund will help ensure its availability and effective and efficient use.

Since the inception of the Fund in 1992, the balance increased steadily to over \$41 million by February 1996. This growth occurred largely because utilization of the Fund was infrequent during the first years of operation (see Figure 2).

The Commission's policies offer insufficient guidance on how Prize Reserve Fund monies should be spent. In addition, the policies do not prescribe how the Commission would increase fund contributions to meet a shortfall. The only guidance for fund use, other than supplementing payouts, is that the fund can be used for other Lotto-related prizes. The Commission has used the Fund in this manner twice:

- In August 1996 the Lottery distributed \$2,000,000 from the Fund as part of the "2nd Chance" campaign.

Figure 2

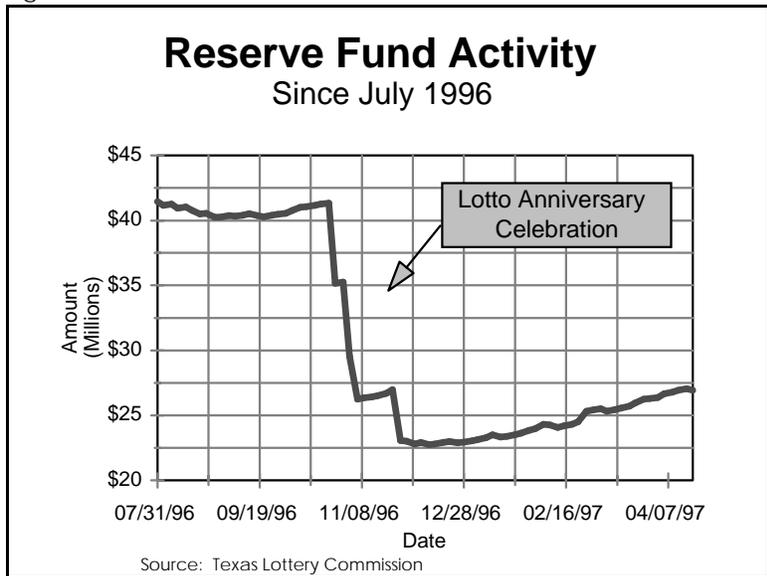


- In October and November of 1996, the Lottery distributed \$20 million as part of a birthday promotional campaign. This promotion caused an immediate stimulus in sales, followed by a rapid decline.

Figure 3 shows the increased distributions from the Prize Reserve Fund for these purposes.

Amount of Payout Supplemented From the Prize Reserve Fund - Policies over the Fund allowed the Executive Director to inconsistently supplement Lotto Texas payouts. Prior to recent changes in Lotto Texas game payouts, how much to augment jackpots or even not to augment the jackpot payouts from the Prize Reserve Fund was totally at management's discretion. This problem was resolved by the change from paying 32 percent of gross sales as the Lotto payout to paying the projected advertised jackpot.

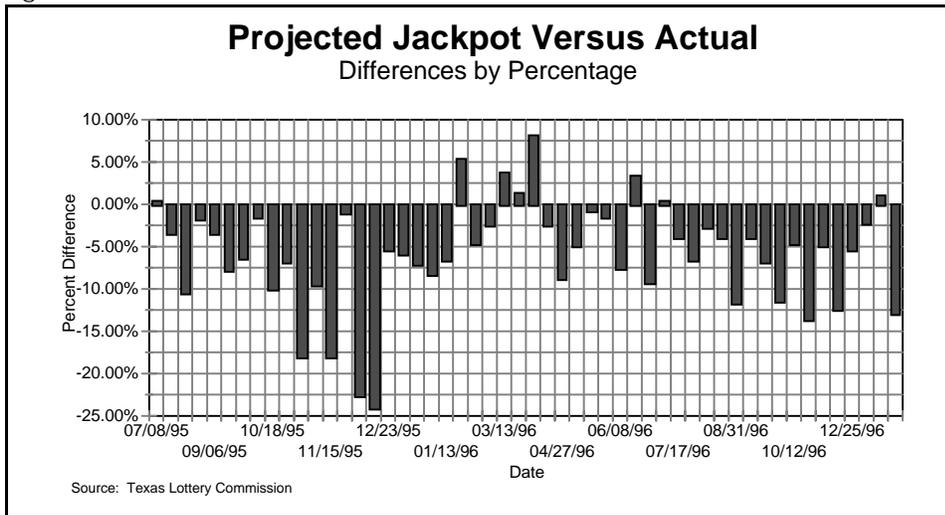
Figure 3



The introduction of the Cash 5 game caused Lotto Texas sales to drop. Falling Lotto sales decreased the money available for Lotto jackpots. As a result, the Commission consistently overestimated the amount of the Lotto Texas jackpot. As seen in Figure 4, management

overestimated 44 of 52 jackpots for Lotto Texas between July 8, 1995, and February 5, 1997, by an average of -5.8 percent (\$607,011). Management's overestimations were due to use of a jackpot projection method that relied too much on subjective judgments rather than objective methodology.

Figure 4



Rather than decrease the advertised jackpots, management maintained the advertised levels and focused on increasing sales to address the shortfall. Management also began to supplement payouts from the Prize Reserve Fund. In June 1996, the Commission enacted a Prize Reserve policy to govern the

transfers from the Fund that allowed the Executive Director complete discretion on how much, if any, to supplement the payout. This high level of management discretion contributed to the Commission inconsistently supplementing payouts. Ultimately, management corrected this system by paying the advertised jackpot regardless of sales.

Recommendation:

The Commission should adopt specific rules governing when and how the Prize Reserve Fund can be used. These rules should reduce the Executive Director’s discretion. These changes should include:

- Reserve Fund policies should require that management project the balance necessary to meet the Fund’s designated purpose. This change should include an acceptable range of fund balances that ensure adequate funding and efficient, effective use of Fund monies.
- The Commission should make rule changes that designate the disposition of money exceeding the fund ceiling. The Commission should also consider specifying dollar limits for Lotto promotional events and transferring excess monies to the State’s General Revenue Fund. The Commission should also specify means for increasing the Fund’s balance should the Fund fall below an acceptable range.
- If the Commission should ever choose to return to paying the Lotto grand prize based on sales, it should improve its policy to ensure an equitable payout enhancement.

In addition, the Commission should implement a standardized jackpot projection methodology to ensure that jackpots are objectively projected as accurately as possible. The State Auditor's Office has developed a regression model for projecting Lotto jackpots that we believe could enhance the accuracy of jackpot estimations significantly thereby lowering the reliance on the Prize Reserve Fund. We recommend that the Commission use this methodology in the development of a model that addresses its unique needs.

Management's Response:

It is important to note that management has consistently averaged a 98.2% payout of the advertised jackpot since Lotto inception. Under the new prize payout option, effective February 12, 1997, we pay what is advertised. This is the full estimated jackpot amount when the 25 year payment option is chosen or the net present value of the estimated jackpot amount when the lump sum or cash option is chosen.

Further, SAO's comments about overestimating 44 of 52 jackpots are primarily directed at the \$4 million jackpots. Many of the larger percentage variances noted in Figure 4 are at the \$4 million level and thus represent a lower dollar difference but wider percentage of variance. Texas Lottery Commission is attempting to prudently maintain the player base at the \$4 million level in order to generate more revenue for the State.

Currently, the jackpot estimation decision is based on information gathered by Financial Administration and Marketing personnel. These two divisions decide the jackpot estimated amounts. Further, the old procedure quoted by SAO (it has since been revised) allowed the Executive Director to supplement the jackpot "within ranges" specified in the procedure. This preserved the jackpot estimate within 98.2% of actual since the inception of Lotto. While the Commission could add the SAO jackpot estimation model to our sources used in estimating jackpots, the SAO model is based on knowing total sales through the time of the drawing. This information is not available when management is preparing the estimated jackpot amount. The Commission will continue to examine ways to improve the process while continuing to estimate the jackpot accurately.

Section 5-B:

Management's Accounting Treatment of the Prize Reserve Fund Should Be Changed

The Commission's accounting treatment of the Prize Reserve Fund appears to be at odds with generally accepted accounting procedures and tends to prevent the activity and balances in the Fund from being fully disclosed.

Despite the fact the Commission exercises considerable discretion as to the uses of the Fund, it recognizes the Fund as a liability on its financial statements. Additionally, the Fund is reported as Future Lotto Prizes in the notes to the financial statements. This accounting treatment is incorrect because liabilities are specific sums owed to specific creditors, not monies that can be expended at the debtor's discretion.

The Commission's reason for this treatment is that some day the monies in the fund will be eventually paid out to winners. The practical effect of recognizing the reserve fund as a liability is:

- The Commission's balance sheet equity is materially understated.
- It is difficult for external users of financial data to track the use of the Fund. For instance, the Commission would currently show the monies expended for the 1996 promotions as a reduction of a liability rather than an expense.

It is our position that since the Executive Director appears to exercise substantial control as to when, if, and how reserve monies are utilized to pay prizes, the Fund should be reflected as equity on the financial statements. An opinion from the Government Accounting Standards Board (GASB) with respect to the proper accounting treatment for the Fund was requested. On April 9, 1997, the GASB responded (in part): "Rather than report as a liability . . . we believe that this amount should be presented as restricted fund equity."

Recommendation:

The Commission should account for the Prize Reserve Fund as restricted fund equity.

Management's Response:

Based on preliminary research, it is not Lottery industry practice to account for the Prize Reserve Fund as recommended by SAO. We have contacted our independent external worldwide certified public accounting firm and several other worldwide accounting firms to corroborate that we are properly accounting for this fund. Based on our research to date, at least three of the six largest worldwide accounting firms who opine on other State Lotteries apply the same accounting treatment to the Prize Reserve Funds as that of our Commission. Further, our external accounting firm contacted the Government Accounting Standard Board (GASB) in May 1997, to bring additional information to their attention for further consideration of this issue. Therefore, it is not a clear material misstatement issue. The Texas Lottery Commission will continue to seek clarification with the GASB on this issue because there is no government accounting standard that specifically addresses the lottery industry nor SAO's recommended accounting treatment. If GASB does not reconsider this matter, we will make necessary adjustments as warranted.

Lottery Operator's Response and Auditor's Follow-Up Comments

Introduction

This section includes the Lottery Operator's responses to the findings in this report and detailed Auditor Follow-Up comments addressing the Lottery Operator responses in the areas of factual error, error in interpretation, and comments to provide general clarification.

Given the particularly sensitive nature of the Texas Lottery, the Commission and its contractors must conduct business in a manner that is above reproach. The focus of our report is not upon any specific decision made by the Commission, but rather upon the Commission's overall control environment. The State Lottery Act and the terms of the lottery operator contract make it clear that the Commission and the Lottery Operator have an obligation that goes beyond avoiding actual conflicts of interest. They must also avoid any situation where the potential exists for conflicts of interest or undue influence. Our findings regarding the lack of an "arm's-length" relationship between the Commission and its contractors are thus a matter of concern even assuming that all contracting decisions were made strictly on their merits.

The Texas Lottery Commission has generally agreed with our report and recommendations. The Commission found no errors of fact. The Commission is taking positive actions to improve the weaknesses identified and to implement the recommendations included in this report.

In contrast, the Lottery Operator has chosen to address report issues by raising immaterial, peripheral issues. The Lottery Operator has attempted to direct attention away from the weaknesses identified by suggesting that this report includes innuendo and implications where none exist.

The Lottery Operator complains that the report does not contain sufficient background information, yet omits the fact that our efforts to obtain such information were impaired by its lack of full and timely cooperation. We also disagree with the Lottery Operator's characterization of the information it furnished in response to our requests. Records were provided months after the specified due date, in many cases contained multiple copies of the same documents and often provided little tangible evidence of work performed by consultants. Certain information that was essential to our review was not provided at all.

The Lottery Operator makes a repeated contention that Generally Accepted Government Auditing Standards (GAGAS) have not been followed. This contention is unfounded. Throughout the processes of planning, fieldwork, and reporting, this audit meets all applicable standards. Each step of our audit process is subjected to a thorough quality control review to ensure strict adherence to auditing standards.

Contrary to the Lottery Operator's repeated assertion, our report does not imply that a rebidding of the lottery operator contract is necessary. Our point is that the Commission did not appear to have sufficient information about the costs and profits of operating the Texas Lottery to protect the State's bargaining power in contract negotiations. The absence of this key information made it difficult for the Commission to independently determine whether any of the contract extension options under consideration were in the State's best interest.

The Lottery Operator asserts that the auditor relies on the point that its review was not complete to suggest there might have been undue influence with regard to the renegotiation of the Lottery Operator contract. Reporting a limitation on the scope of our audit makes no such suggestion. Rather, it fulfills the requirement that auditors are to report scope limitations whenever significant constraints are imposed on their ability to obtain the information necessary to complete an audit. The declaration of a scope limitation is intended to assist the reader in determining the assurances that can be placed on information provided in the report. No other inferences can or should be drawn from a scope limitation.

Lottery Operator's Response

LOTTERY OPERATOR'S RESPONSE TO SECTIONS I-A AND I-A-1

The Report implies that rebidding the Lottery Operator contract is necessary, by suggesting that past Texas Lottery Commission (TLC) decisions relating to the contract were flawed. The Report's limited analysis (see page 4) of the TLC's 1996 consideration of the various options regarding the Lottery Operator contract omits many important facts, and makes the erroneous implication that the TLC's 1996 decision to extend the contract was affected by potential conflicts of interest.

The Report's fundamental error about the TLC's 1996 decision is the assertion that seeking new bids was an available option. In fact, the only competitor in a position to compete with GTECH at that time advised the TLC in a public meeting that it would not submit a proposal if the TLC rebid the contract in 1996. The TLC Chair was directly involved with the entire TLC process of evaluating options as to the Lottery Operator contract. This process included review of whether to rebid and, once rebidding was precluded by the competing operator's decision, extensive negotiation regarding options for extension of GTECH's contract.

As to the extension negotiations, the Report says the extension was approved, "but not before they had obtained the price reduction and other concessions in exchange for what appears to be a relatively minimal reduction in the services outlined in the Lottery Operator's initial offer." This characterization of the approved extension is incomplete and falsely suggests the Lottery Operator's original price proposal was unreasonable. In fact, price reductions were offered by GTECH in lieu of some of the items in the original proposal. The option chosen by the TLC eliminated a significant

number of on-line terminals, play stations and lighted signs (with a value well over \$20 million), from the proposal in order to allow for the rate reduction, at the expense of additional sales and revenue for the State.

The Report (see page 4) implies that GTECH preferred only the first option presented by the executive director and her staff, and not the agreement finally reached and approved. This is untrue. GTECH favored the rate reduction package as much as the original package or we would not have agreed to it. The fact is GTECH offered the TLC five, three, and one year proposals. It was the TLC staff which determined the five-year extension was best and presented that recommendation to the commission.

The Auditor "found no evidence" that personal relationships were involved in the TLC's 1996 evaluation of whether to renegotiate or rebid the Lottery Operator contract (although the Report includes 5 pages of text implying the process was not conducted at "arms length"). There has been no finding, nor is there any allegation in the Report, that any legal requirements regarding conflicts of interest were violated. Nevertheless, the Auditor relies on the point that its review was not complete to suggest there might have been undue influence.

The referenced portions of the Auditor's Report contravene and violate Generally Accepted Government Auditing Standards (GAGAS), §§ 7.54, 7.55 and 7.57, which require that material reported shall be accurate, credible and reliable, and that findings and conclusions be supported by competent and relevant evidence and be presented in an unbiased manner. In addition, the Report violates GAGAS § 7.18, which requires reporting of appropriate background information to give the proper perspective necessary to understand findings, § 6.53 which requires sufficient evidence to support the findings and § 7.20, which directs auditors to specify their conclusions, rather than leaving them to be inferred by readers.

LOTTERY OPERATOR'S RESPONSE TO SECTION 1-A-2

The Report noted control weaknesses regarding reimbursement of expenses of TLC employees which were initially paid by GTECH and the State's instant ticket vendor. The Report acknowledges the instant ticket vendor's procedural improvements in this area, but the Auditor chose to leave out the fact that GTECH formalized the practice of preparing an invoice and sending it to the TLC in 1994. This practice created a public record that reimbursement was required and clearly established that a gift was not extended. This section of the Report violates GAGAS §§ 7.43, 7.52 and 7.57 by omitting any reference to improvements made to procedures already in place, and §§ 7.18 and 7.28 which require reporting of appropriate background information necessary to understand findings in the proper perspective.

LOTTERY OPERATOR'S RESPONSE TO SECTION I-A-3 AND THE FIRST POINT IN SECTION I-A-4

These sections of the Report also imply that rebidding the Lottery Operator contract is necessary, this time by suggesting that past TLC decisions relating to the contract were flawed due to the absence of detailed cost information for TLC consideration. The Report implies that the TLC's 1996 decision to extend the contract was affected by the amount of detailed cost information available to TLC (see also Section 4-B, which suggests that the TLC has been forced to accept terms that do not represent the best value for the State). The Report further suggests that TLC would have taken certain other actions but for the absence of detailed cost information.

These sections of the Report omit many important facts about these issues, and the presentation of the Auditor's conclusions violates at least the following sections of GAGAS: § 7.51, which requires that reports contain all information needed to promote an adequate and correct understanding of the matters reported; § 7.54 which requires that reports be accurate, and present truthful evidence and findings which are correctly portrayed; § 7.55 which requires that reports include only information, findings and conclusions supported by competent and relevant evidence; § 7.57 which requires that reports be objective and present evidence in a balanced and unbiased manner; § 7.18 which requires that reports provide perspective by including background information necessary for adequate understanding; and § 7.20 which requires that reports state specific conclusions, and that conclusions should not be left to be inferred by readers.

A. *The Report Erroneously Implies that GTECH's Financial Data Submissions are Inadequate*

The Report at page 10 recommends that the TLC proceed with additional work "until the Commission determines and obtains the financial information it needs in the Lottery Operator's cost reports to allow the Commission to make informed management decisions." This clearly implies that the financial data which is needed has not been submitted to date. GTECH has submitted all of the annual cost summaries required under the contract in a format that was prescribed by the TLC. Nevertheless, the Report inaccurately states that GTECH "only did so in 1993." We have never been advised by TLC that the information in these summaries is incomplete, inaccurate or deficient in any way. As stated in GAGAS § 7.54, "the need for accuracy is based on the need to assure readers that what is reported is credible and reliable. One inaccuracy in a report can cast doubt on the validity of an entire report...."

B. *The Report Erroneously Describes GTECH's Submission of Required Cost Summaries to TLC*

GTECH has submitted all annual cost summaries which are required by the contract to the TLC, and the Report is clearly erroneous when it says only one such summary

has been prepared. In addition, the Report is misleading when it says GTECH was not "in a position to respond to basic questions from the Commission, concerning costs and profits associated with operating the Texas Lottery" at the March 4, 1997 TLC meeting, and it is misleading when it says this example illustrates that the TLC did not have the cost data needed to make informed decisions. GTECH provided a detailed response to this request within ten days. GTECH's financial records have always been available to Texas officials. It is irresponsible (and inconsistent with GAGAS § 7.54, which requires that findings be "correctly portrayed") to imply that GTECH is not "in a position" to provide cost information because GTECH prudently provided a precise answer to an important financial question, rather than an off-the-cuff response during a TLC meeting.

C. The Report Misstates the Contract Provision on Uses of Operational Cost Information

The Report, at pages 9 -10, says that the absence of detailed Lottery cost information has "left the TLC unable" to make various determinations, including (1) the fairness of terms offered to TLC by GTECH, and (2) whether the TLC should have considered purchasing the GTECH system. However, the contract provision that requires an annual summary of operational costs (see Section 7.5 of the Request for Proposal, RFP, incorporated into the contract) has very specific limitations on the use of the cost summary. The uses listed by the Auditor at page 10 of the Report are not the types of uses authorized by the contract. Section 7.5 of the RFP requires:

"The purpose of this review shall be to determine which areas of the Successful Proposer's operations are functioning efficiently and which areas have experienced costs greater than anticipated.

It is anticipated that, over the life of this contract, certain functions performed by the successful proposer may not be performed to the satisfaction of the Lottery. It may be the desire of the Lottery to assume control over these functions. In addition, functions not originally contemplated in the contract may be required. The Lottery may require the Successful Proposer to perform those functions.

As part of the Annual Cost Review, any significant changes in the functions originally contemplated that lead to contract amendments may have an impact on the total compensation percentage originally agreed to. By mutual agreement, the percentage may be revised as a result of the Annual Cost Review.

*It is **not** the intent of this review procedure to eliminate those contract functions that are perceived to be highly profitable for the Successful Proposer.* (emphasis added)

The Auditor's statement that the cost summaries were to be used by the TLC in negotiations of contract provisions is erroneous. Furthermore, the contract flatly prohibits the use of the cost review procedure for issues such as the purchase option mentioned by the Auditor at page 10 of the Report. The limited uses of the cost review

procedure under the current contract are underscored by the dramatic expansion of these uses that would be allowed under Section 3.30 of the RFP issued by the TLC on August 12, 1997. If the current Section 7.5 means what the Auditor claims it does, there would obviously be no need for the dramatic change of this provision in the new RFP. The Auditor's egregious mischaracterization of this point in its Report is disingenuous at best, contrary to GAGAS §§ 7.51 (completeness) and 7.54 (accuracy), and evidences a bias prohibited by § 7.57 (objectivity).

D. The Report Erroneously Implies that the Lottery Operator Contract is a "Cost Plus" Contract

The Report's repeated references to operating costs creates the impression that the contract is a "cost-plus" contract. The Report allows this misleading impression to be created even though the amount of money paid to GTECH by the TLC under the Lottery Operator contract is based on a percentage of lottery revenue and is not based on GTECH's costs in operating the lottery. This vital piece of background information is necessary to place the Report's frequent references to "detailed cost information" in perspective, and failure to include it clearly violates GAGAS § 7.18.

LOTTERY OPERATOR'S RESPONSE TO SECTION I-A-4

This section of the Report does not present a complete, accurate and objective view of the liquidated damages issue. It is important to note that GTECH notifies the Lottery, in writing, within 24 hours of an incident that requires liquidated damages. While the TLC may have from time to time delayed assessing liquidated damages, it is critical to mention that GTECH's notification has always been timely and has never wavered. Note also that GTECH requested in a May 5, 1994 letter to the TLC that the contract be amended to require payment of liquidated damages within a certain time frame, so they would not accumulate. The TLC chose not to pursue this change to the contract.

The table in the Report is misleading and incomplete. The table in the Report lists \$6.5 million as the amount of liquidated damages assessed on June 1, 1994, even though the actual amount paid was \$1.6 million. Listed below is complete and accurate information on the damages paid by GTECH to date:

Date of Payment	Amount Paid	Purpose
August 3, 1992	\$ 100,000	Instant System
March 31, 1993	\$ 43,052	Instant System
November 6, 1993	\$1,564,000	Various on-line and instant system down time as well as various incidents of terminal down time.
June 1, 1994	\$1,604,200	Various on-line and instant system down time as well as various incidents of terminal down time.

Date of Payment	Amount Paid	Purpose
June 7, 1994	\$ 57,000	Instant System
March 31, 1995	\$ 357,595	Various on-line and instant system down time as well as various incidents of terminal down time.
July 7, 1995	\$ 217,000	Instant System and Tape Delivery.
August 14, 1996	\$1,052,053	Various on-line and instant system down time as well as various incidents of terminal down time.
April 23, 1997	\$ 356,908	Various on-line and instant system down time as well as various incidents of terminal down time.
May 21, 1997	\$ 171,762	Various on-line and instant system down time as well as various incidents of terminal down time.
June 18, 1997	\$ 1,000	Instant System downtime.

LOTTERY OPERATOR'S RESPONSE TO SECTION 1-B (INCLUSIVE OF 1-B-1 and 1-B-2)

A. GTECH's High Standards for Ethics and Business Practices

The Auditor's Report acknowledges efforts by the TLC and the State's instant ticket vendor to improve internal control procedures (see pages 2 and 8), but it does not do justice to GTECH's high standards for ethics and business practices, and its substantial efforts to improve these areas. In fact, GTECH has aggressively taken proactive actions to improve the internal management controls which apply to its employees, agents and contractors. GTECH has been implementing the very recommendations which the Auditor now makes. Information provided to the Auditor months ago describes our actions (see the February 28, 1997 letter from GTECH's executive vice president to the TLC Chair, which was provided to the Auditor on March 24, 1997, along with a transcript of the TLC's February 14, 1997 meeting in which GTECH management described many of the company's actions in these areas. These documents are omitted from the Report).

GTECH continues its proactive examination and improvement of its ethics and business practices including, but not limited to, several actions taken over the past four years to improve internal controls that apply directly to subcontractors and consultants. These policies were provided to the Auditor, and would prevent recurrence of the particular situations discussed in the Report. In addition, GTECH has retained an independent expert to further strengthen its compliance program. Again, these changes by GTECH have been omitted from the Report.

GTECH has also worked directly with the TLC to improve its internal controls. In November of 1995, GTECH initiated a process through which the TLC staff and

GTECH worked together to identify and resolve any areas of the contract "which have not been adequately addressed and/or achieved." All of the items raised by the TLC were addressed to their satisfaction, yet the Report fails to address these factual matters and the results which were achieved.

Section 7.51 of GAGAS requires that an audit report be complete, i.e., "that the report contain all information needed to satisfy the audit objectives, promote an adequate and correct understanding of the matters reported," and include "appropriate background information." Section 7.43 of GAGAS requires a report to include noteworthy accomplishments. The Report's omission of GTECH's efforts described above clearly fails to meet these standards. These sections of the Report also violate § 7.18, which requires sufficient information and appropriate background to put the findings in proper perspective.

B. Numerous Errors Regarding "Appearance of Impropriety"

The Auditor's analysis of these issues forces one to question the Auditor's overall objectivity. Although the Report speaks of the appearance of impropriety, the Report itself notes that "no evidence [of undue influence] has been found," and that "the Lottery Operator itself has not been charged with wrongdoing in connection with any of the reported activities." As discussed previously, GTECH has already implemented improved policies to control areas where questions arose in the past. Even though the Auditor has not pointed out (and cannot point out) a single instance of impropriety, and even though the Auditor cannot point to a single specific internal control measure that has not already been implemented, the Report still recommends that GTECH implement additional, unspecified measures. These recommendations erroneously imply that GTECH has ongoing problems in this area, which is clearly inaccurate.

The Auditor's lack of objectivity regarding the "appearance of impropriety" is best exemplified by the discussion at page 5 of a consultant which GTECH allegedly hired because of close ties to the former executive director. The Report says the consultant "was paid in excess of \$100,000 over a three year period during which there is no evidence of work performed," implying that this sum is greater than the amount paid during the "initial" period in which there was "some" work done. However, the facts are that this consultant was hired before the former executive director became executive director, and that the consultant was extremely active during the lengthy period in which the Lottery was being established (as shown by approximately \$300,000 of detailed billings over a period in excess of two years). In addition, GTECH's payments to the consultant over the three-year period were pursuant to a contract. The key legal point the Report omits is that GTECH's association with the consultant fully complied with all contractual and statutory requirements regarding potential conflicts of interest. In essence, the Report attacks GTECH for what the Auditor would like the conflict of interest requirements to be, rather than judging GTECH by the standards that are in place. This type of biased analysis is especially unfair to GTECH when one considers the apparent impropriety involving the current

executive director of the TLC (a former employee of a major gaming business which is certain to appear before the TLC).

A proper auditing analysis of these issues would present as its principal finding that a material weakness in the system of internal controls was found (media concern suggesting impropriety), that investigation has been conducted and no actual impropriety or loss of integrity of the Lottery System has occurred, and that the TLC and GTECH have satisfactorily addressed the material weakness, so that the appearance of impropriety will not occur in the future. Instead, the Report violates numerous requirements of GAGAS, including §§ 7.18, 7.20, 7.43, 7.51, 7.52, 7.55 and 7.57 by failing to include the improved procedures already in place, and de-emphasizing the significant points that no evidence has been found of impropriety or any adverse effect on the integrity of the Lottery System.

C. The Report Erroneously Implies that Conflicts of Interest Affected the TLC's 1996 Decision to Extend the Lottery Operator Contract

The Auditor "found no evidence" that personal relationships were involved in the TLC's 1996 evaluation of whether to renegotiate or rebid the Lottery Operator contract. There has been no finding, nor is there any allegation in the Report, that any legal requirements regarding conflicts of interest were violated. Nevertheless, the Auditor relies on the point that its review was not complete to suggest there might have been undue influence. These portions of the Auditor's Report contravene and violate GAGAS, §§ 7.54, 7.55 and 7.57, which require that material reported shall be accurate, credible and reliable, and that findings and conclusions be supported by competent and relevant evidence and be presented in an unbiased manner. These sections of the Report also violate GAGAS § 7.18, which requires reporting of appropriate background information to give the proper perspective necessary to understand findings, and § 7.20, which directs auditors to specify their conclusions, rather than leaving them to be inferred by readers.

D. Erroneous Statements About Work Done by GTECH Consultants

The Report's assertions regarding work by GTECH consultants at page 5 is inconsistent with thousands of pages of records GTECH provided to the Auditor. In all cases except one GTECH provided a massive amount of information that showed its consultants performed significant work. For example, the Texas lobbying and consulting firm discussed in Section 1-B put in a significant number of hours for GTECH. The firm's efforts included government relations services and business advice with respect to the adoption and implementation of lottery legislation, and startup of the lottery and electronic benefits transfer operations in Texas. They were in daily contact with GTECH management, and thousands of documents reflecting their significant work were provided to the Auditor. Similarly, a second consultant with close ties to the former executive director and the consultant discussed in Part B of this response played key roles in establishing and implementing the lottery in Texas (although the consultant discussed in Part B is no longer performing consulting

services to GTECH, and GTECH has concluded the relationship). Their efforts are reflected in hundreds of pages of documents which were provided to the Auditor. In only one case was GTECH unable to provide details regarding a significant amount of work, and in that case GTECH did not have access to the former consultant or the GTECH employee who supervised his work. Note that the Auditor was similarly unable to obtain access to those individuals (although the Auditor has the authority to subpoena them, unlike GTECH). These sections of the Report also violate GAGAS § 7.18, which requires reporting of appropriate background information to give the proper perspective necessary to understand findings.

Auditor Follow-Up Comments

We believe that the Lottery Operator's response does not accurately characterize our findings and includes many erroneous statements and inferences. Rather than respond to each point of disagreement, we will provide follow-up comments with respect to errors of fact, errors in interpretation, and general clarifications.

Errors of Fact

- The Lottery Operator's response states that a certain consultant was hired before the former Executive Director assumed that title. The consultant's contract was signed over a month after the former Executive Director was named Lottery Director.
- The response claims that the Lottery Operator was not given credit for improvements in its procedures for ensuring reimbursement by Commission employees. Although the Lottery Operator claims that invoicing system improvements were made in 1994, our review shows that this control system was ineffective for billings in 1994 and later. For example:
 - Out of 392 instances reviewed where bills appeared to be required, the Lottery Operator issued bills only approximately 38 percent of the time.
 - When the Lottery Operator did bill, the billing was timely (within 30 days of the event) only approximately 25 percent of the time.
 - As a result of this failure to bill effectively, the Lottery Operator received timely collections in only approximately 35 percent of the instances.
- As of May 1997, the Lottery Operator has submitted all required annual cost summaries to the Commission. However, for the five contract years from 1993 through 1997, the Lottery Operator has only submitted reports twice, once in 1993 and again in 1997. The 1997 submission included cost summaries retroactive for all contract years (1993-1997) and clearly was so late as to impair

the usefulness of the information. Additionally, on both occasions, these reports were submitted only after the Commission formally requested them.

Errors in Interpretation

- The report does not imply that any Lottery Commission decision was affected by potential conflicts of interest. The report identifies that these potential conflicts cause questions to be raised regarding the independence of these decisions.
- The report does not suggest that the Commission has been forced to accept Lottery Operator terms that do not represent the best value for the State. The report points out that the Commission did not have sufficient cost information to make these determinations.
- The report does not suggest that the Lottery Operator's price proposal was unreasonable. The report points out that due to the Commissioner's intervention, the Commission was able to secure a contract extension with terms the Commissioners viewed as more favorable to the Commission.
- The report does not imply that the Lottery Operator did not prefer the agreement finally reached and approved. The report states that the Lottery Operator favored one of the four options presented to the Commissioners. Since the final agreement was not an option proposed at that time, no inference could be made regarding the final agreement. We would assume that the terms of the final contract extension reached were agreeable to the Lottery Operator, otherwise, they would not have entered into it.
- We disagree with the Lottery Operator's expansive interpretation of one sentence in the original Request For Proposals (RFP) relating to the permissible uses of cost information. Although it is true that the recently issued RFP includes a more explicit description of the possible uses of cost information, the original RFP, when read in its entirety, affords the Commission broad discretion to use cost data to make informed management decisions concerning the delivery of lottery services. For example, the stated purpose of the annual cost report is to determine that operations are functioning efficiently and which areas have experienced costs greater than anticipated. This purpose clearly includes an analysis of costs which is more expansive than the interpretation advocated by the Lottery Operator.

Clarifications

- The fact that the Lottery Operator provided detailed responses to the basic request by the Commissioners for cost and profit information only supports the report's findings that the Commission should exercise due diligence in obtaining Lottery Operator financial data. If the Commission had routinely obtained the necessary

financial data, there would not be a need for the Lottery Operator to provide such a response. In discussions regarding the report findings, the Lottery Operator stated that when questioned in the meeting, they chose not to provide an "off-the-cuff ballpark" response and chose instead to provide a precise answer in a response within ten days of the request.

- The Lottery Operator's statement that only \$1.6 million in liquidated damages were paid on June 1, 1994, is misleading. The Lottery Operator gave the Commission 3,000 on-line terminals and 1,000 electronic display units in consideration for the abatement of all outstanding liquidated damages as of that date. At that time, the Lottery Operator had reported to the Commission \$6.5 million in outstanding liquidated damages, which included the \$1.6 million. This \$1.6 million in liquidated damages had been assessed by the Commission and was specifically mentioned in the contract amendment that waived the damages. However, the contract amendment also waived the remaining \$4.9 million in damages which were outstanding but had not yet been assessed against the Lottery Operator.
- The Lottery Operator chooses to elaborate on the extensive work effort and product produced by a certain consultant/lobbyist. The report references two specific situations where it is undisputed that payments to consultants continued over a significant period during which no work was performed, neither of which is in reference to the Texas lobbying and consulting firm referred to in the Lottery Operator's response.

Objective, Scope, and Methodology

The original objective of this audit was to evaluate the effectiveness of management processes and control systems within the Texas Commission. The original scope of the audit included consideration of the Commission's:

- Strategic planning
- Organizational structure
- Management information systems
- Human resource management
- Financial control systems
- Performance measures

The Commission's Bingo Division was excluded from this review.

Toward the end of fieldwork, we became aware of certain allegations of impropriety regarding Commission management and staff and Lottery Operator and vendor management, staff, and agents. We expanded the scope of our audit to investigate potential illegal acts and abuse which could have an effect on our audit results.

Agency financial data was analyzed, and relevant reports and documentation were reviewed. Conventional audit procedures were applied to collect information, including interviews with management and staff of the Commission. Audit testing and analysis included control review, trend analysis of expenditures and performance statistics, review of project and personnel files, and review of performance measures.

Fieldwork was conducted during the time period from April 1996 to June 1997. The audit was conducted in accordance with Generally Accepted Government Auditing Standards.

Analysis of the Texas Lottery Operator Contract Did Not Yield Conclusive Results

We performed an analysis of the overall reasonableness of the Lottery Operator's contract with the Texas Lottery Commission to provide operator services. Our analysis was based on both financial and non-financial factors because the Lottery Operator's costs were not well defined.

One analysis attempted to draw a correlation between the volume of sales, the amount of services provided, and the amount the Commission paid to the Lottery Operator. Although we were able to isolate and observe certain trends, we were unable to create a sufficiently compelling analytical model that would enable us to draw supportable conclusions regarding the contract's reasonableness. Our results indicated that although the Commission pays a higher commission rate than most states, this rate is, at least, partially explained by the large number of services provided to the Commission by the Lottery Operator.

Factors That Complicated Our Analysis Efforts

Other factors were identified which could also contribute to determining the contract's reasonableness:

- Each state's lottery has different missions, goals, objectives, strategies, administrative characteristics, and contract relationships.
- The competitive environment varies drastically. The degree of competition during contract negotiations directly impacts the operator commission rate.
- No standard performance measures exist in the lottery industry for the direct comparative assessment of contracts.
- Geographic concentration and demographics of a state's population impact sales and costs.
- Age and sophistication of technology often impact contract rates. However, technology sophistication was not always an overriding factor.

No Substitute for Financial Data

Although analysis is a useful tool, accurate financial information for comparison purposes is desirable. Only when sufficient Lottery Operator financial data is obtained

can Lottery management negotiate its operator contracts from a position of knowing the actual cost of service delivery in Texas (see pages 9-10).

Financial Comparison of the Texas Lottery in Relation to Other Lotteries

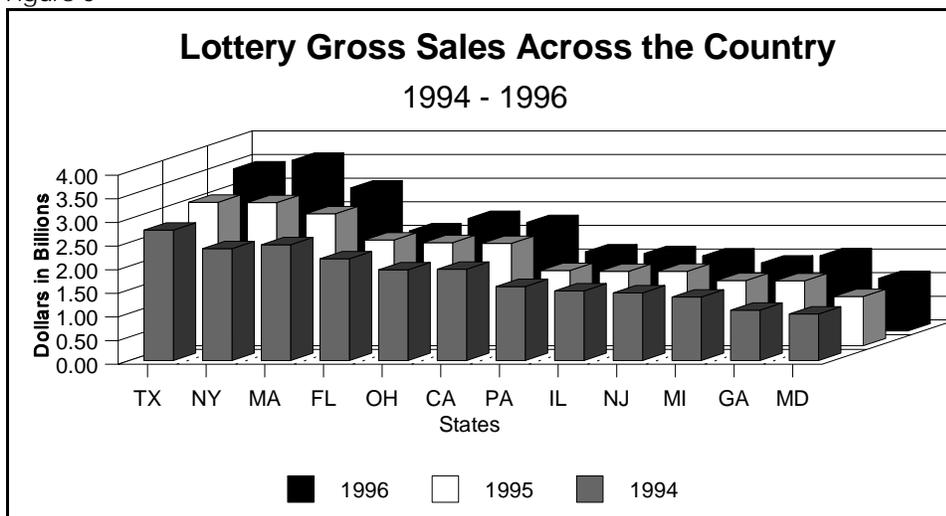
The Texas Lottery has had the first or second highest United States (US) lottery sales as well as the second or third highest US net profit in the past two to three years. However, sales and net profit are not the only indicators of performance. When compared to other US lotteries with over \$1 billion in annual sales, the Texas Lottery ranked in the middle when using other financial trends that indicate overall effectiveness. Some states that performed better in these other areas than Texas had

similar game mixes.

The rankings that follow put Texas' success in perspective with the performance of other states using factors in addition to gross sales and net profit.

The Texas Lottery had the highest lottery gross sales in the US in 1994 (\$2.8 billion) and 1995 (\$3.0 billion) and the second highest gross sales in 1996² (\$3.4 billion).

Figure 5



Lottery Gross Sales Across the Country 1994 - 1996 In Billions of Dollars												
Year	TX	NY	MA	FL	OH	CA	PA	IL	NJ	MI	GA	MD
1996	3.430	3.611	3.028	2.117	2.380	2.296	1.674	1.637	1.588	1.438	1.592	1.113
1995	3.037	3.029	2.793	2.238	2.182	2.166	1.592	1.574	1.576	1.381	1.375	1.042
1994	2.760	2.369	2.450	2.153	1.920	1.931	1.566	1.473	1.431	1.343	1.066	0.984

TX: Texas
NY: New York

MA: Massachusetts
FL: Florida

OH: Ohio
CA: California

PA: Pennsylvania
IL: Illinois

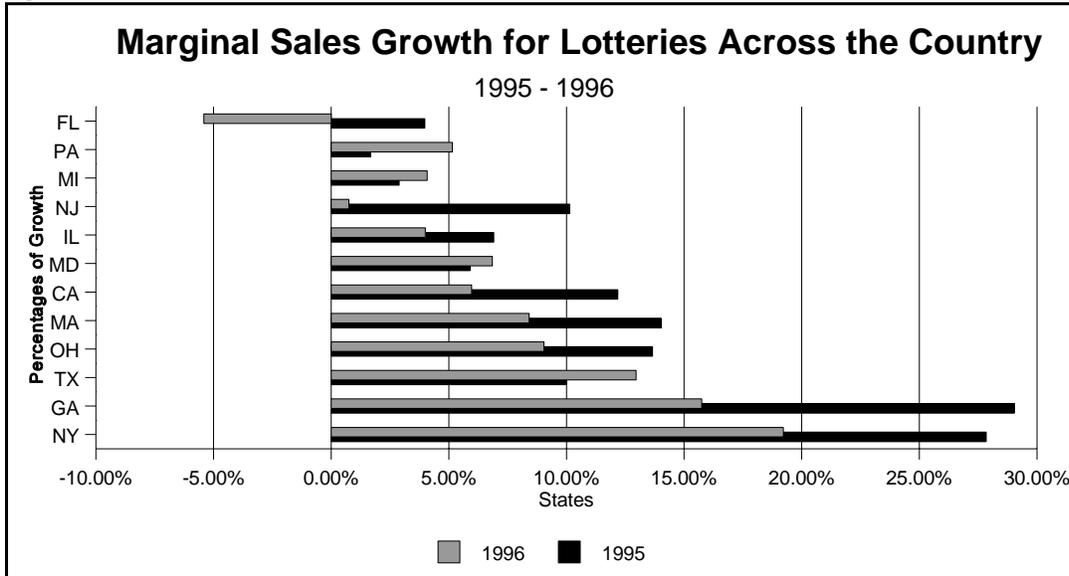
NJ: New Jersey
MI: Michigan

GA: Georgia
MD: Maryland

³ All 1996 financial information from states other than Texas is unaudited.

The Texas Lottery finished near the top of other lotteries of similar size in the area of sales growth. The Texas Lottery had the third average marginal sales increase (11.49 percent) on a national level for 1996. Marginal sales is the percentage increase of current year sales over the prior year and is an indicator of the rate that sales are growing from year to year.

Figure 6

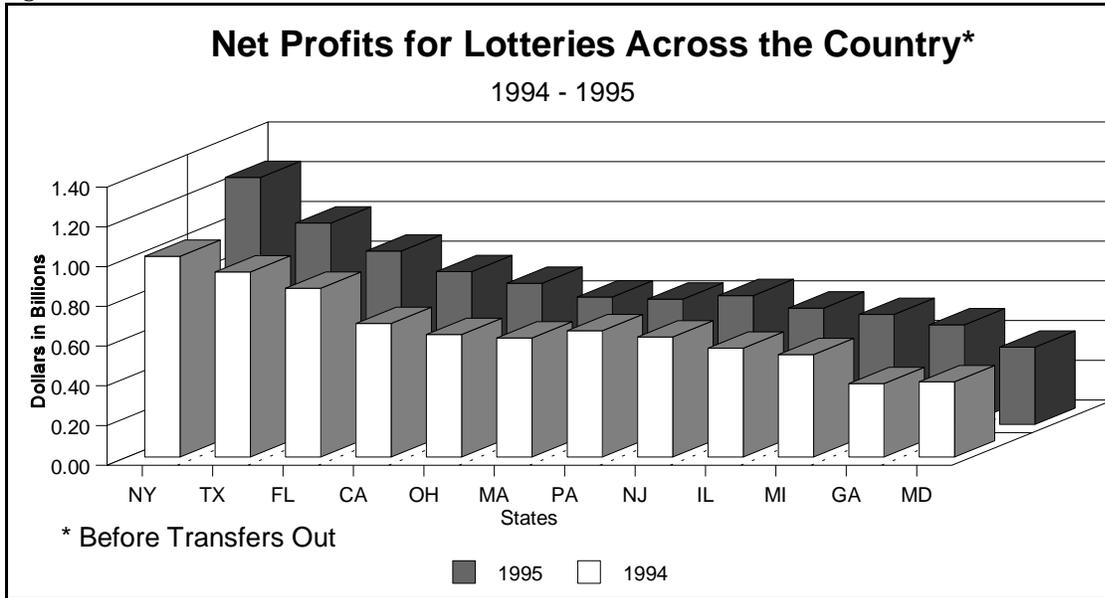


Year	NY	GA	TX	OH	MA	CA	MD	IL	NJ	MI	PA	FL
1995	27.84%	29.04%	10.01%	13.66%	14.02%	12.18%	5.90%	6.91%	10.13%	2.89%	1.67%	3.98%
1996	19.22%	15.75%	12.96%	9.04%	8.41%	5.97%	6.85%	4.00%	0.75%	4.08%	5.15%	-5.41%

TX: Texas MA: Massachusetts OH: Ohio PA: Pennsylvania NJ: New Jersey GA: Georgia
 NY: New York FL: Florida CA: California IL: Illinois MI: Michigan MD: Maryland

The Texas Lottery has successfully translated these sales to profits. The Texas Lottery had the second highest US lottery net profit on a national level during 1994 - 1995. Texas' net profit improved to \$1.1 billion in 1996.³

Figure 7



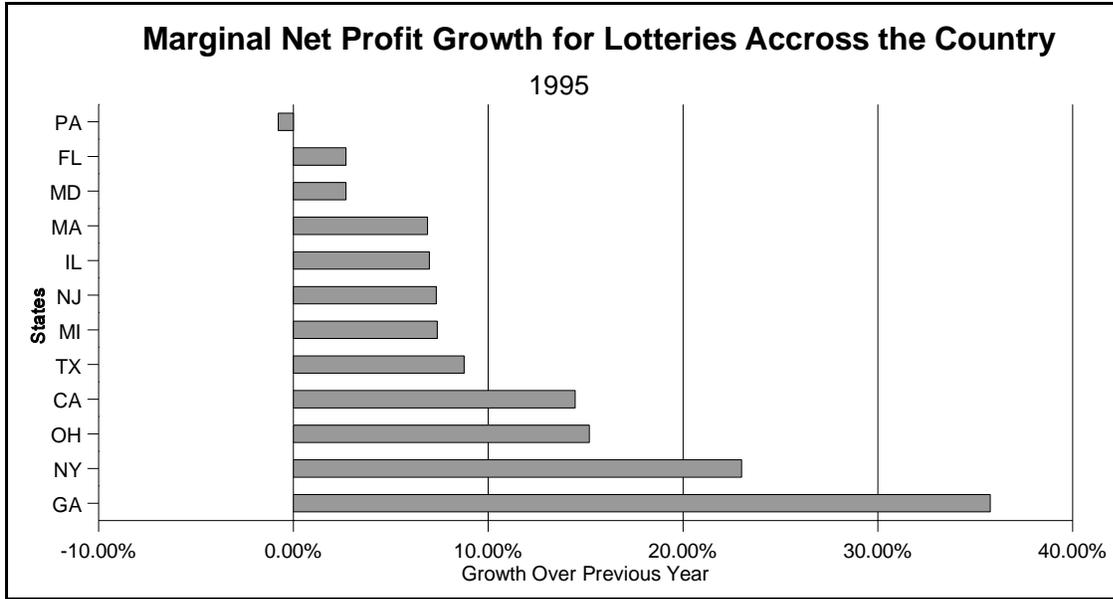
Net Profit for Lotteries Across the Country (Before Transfers Out)												
1994 - 1995												
In Billions of Dollars												
Year	NY	TX	FL	CA	OH	MA	PA	NJ	IL	MI	GA	MD
1995	1.244	1.014	0.873	0.770	0.711	0.642	0.631	0.649	0.586	0.554	0.502	0.389
1994	1.011	0.932	0.850	0.673	0.617	0.600	0.636	0.605	0.548	0.516	0.370	0.379

TX: Texas
 NY: New York
 MA: Massachusetts
 FL: Florida
 OH: Ohio
 CA: California
 PA: Pennsylvania
 IL: Illinois
 NJ: New Jersey
 MI: Michigan
 GA: Georgia
 MD: Maryland

⁴ Profit information was not available for states other than Texas for 1996.

Profit dollars have been growing. The Texas Lottery had the fifth highest average net profit increase on a national level for 1995:

Figure 8

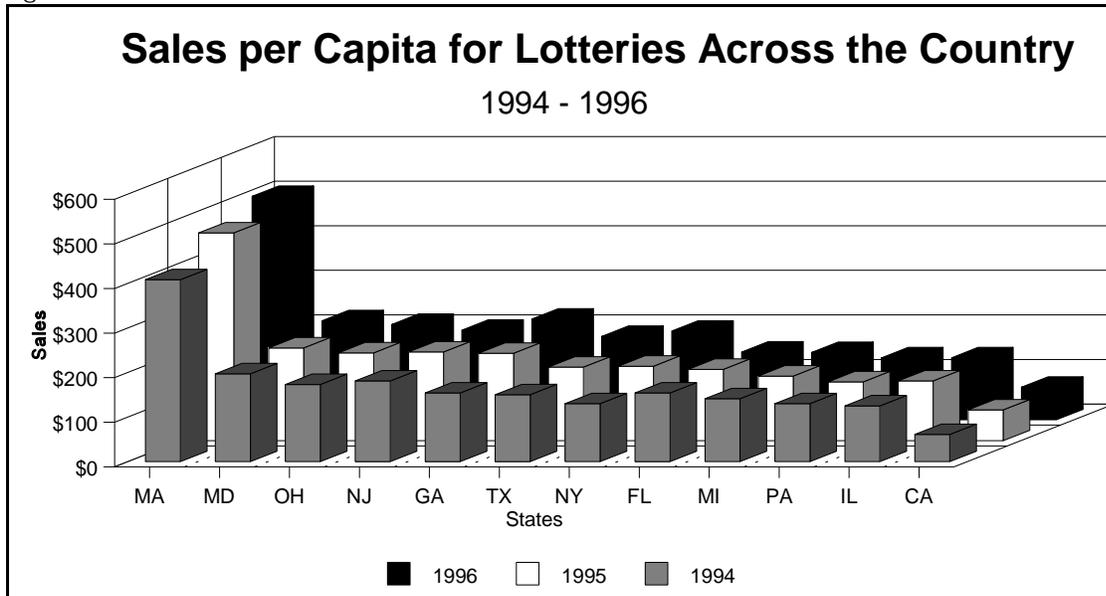


Marginal Net Profit Growth for Lotteries Across the Country 1995											
GA	NY	OH	CA	TX	MI	NJ	IL	MA	MD	FL	PA
35.77%	23.01%	15.19%	14.46%	8.76%	7.38%	7.33%	6.98%	6.88%	2.70%	2.70%	-0.78%

TX: Texas
 NY: New York
 MA: Massachusetts
 FL: Florida
 OH: Ohio
 CA: California
 PA: Pennsylvania
 IL: Illinois
 NJ: New Jersey
 MI: Michigan
 GA: Georgia
 MD: Maryland

The Texas Lottery consistently finished in the middle of billion-dollar lotteries in sales per capita from 1994 to 1996. Four of the lotteries which finished higher (Maryland, New York, Georgia and Massachusetts) have Keno games, which the Texas Lottery does not currently offer. With the exception of 1994, the Texas Lottery finished between the two other southern states with billion-dollar lotteries, Georgia and Florida, in sales per capita.

Figure 9

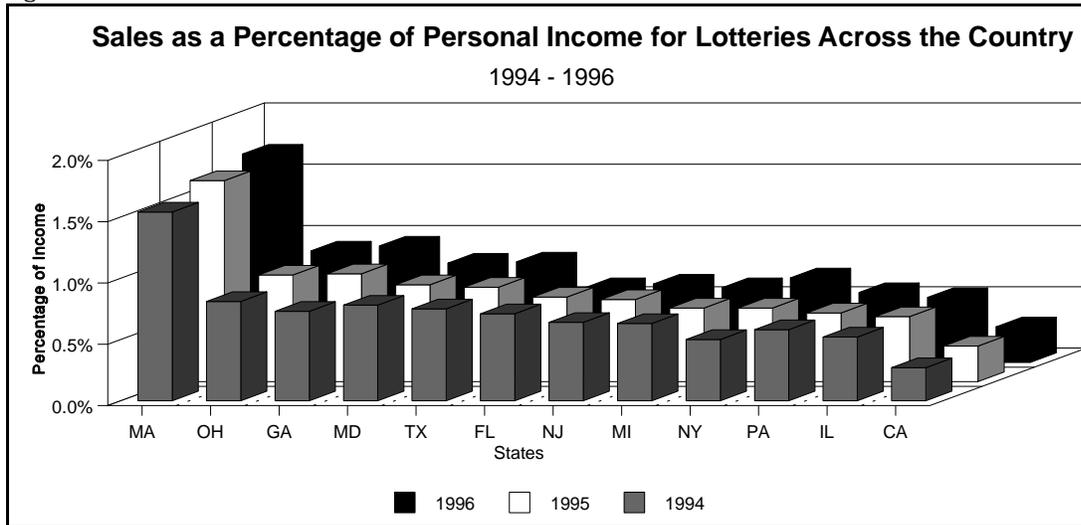


Year	MA	MD	OH	NJ	GA	TX	NY	FL	MI	PA	IL	CA
1996	\$501	\$222	\$214	\$201	\$226	\$187	\$199	\$152	\$151	\$139	\$139	\$73
1995	\$466	\$208	\$197	\$199	\$196	\$165	\$167	\$160	\$145	\$132	\$134	\$69
1994	\$408	\$197	\$173	\$181	\$154	\$150	\$130	\$154	\$141	\$130	\$125	\$61

TX: Texas
 NY: New York
 MA: Massachusetts
 FL: Florida
 OH: Ohio
 CA: California
 PA: Pennsylvania
 IL: Illinois
 NJ: New Jersey
 MI: Michigan
 GA: Georgia
 MD: Maryland

Texas finished slightly higher when compared against other lotteries based on sales as a percentage of personal income, garnering approximately four-fifths of one percent (0.82 percent) of Texans' personal income in 1996. The states that ranked higher than the Texas Lottery in this category also ranked higher in sales per capita.⁴

Figure 10



Year	MA	OH	GA	MD	TX	FL	NJ	MI	NY	PA	IL	CA
1996	1.70%	0.91%	0.95%	0.81%	0.82%	0.61%	0.64%	0.61%	0.69%	0.57%	0.53%	0.29%
1995	1.64%	0.87%	0.88%	0.79%	0.77%	0.69%	0.67%	0.60%	0.60%	0.56%	0.53%	0.29%
1994	1.54%	0.81%	0.73%	0.78%	0.75%	0.71%	0.64%	0.63%	0.50%	0.58%	0.52%	0.27%

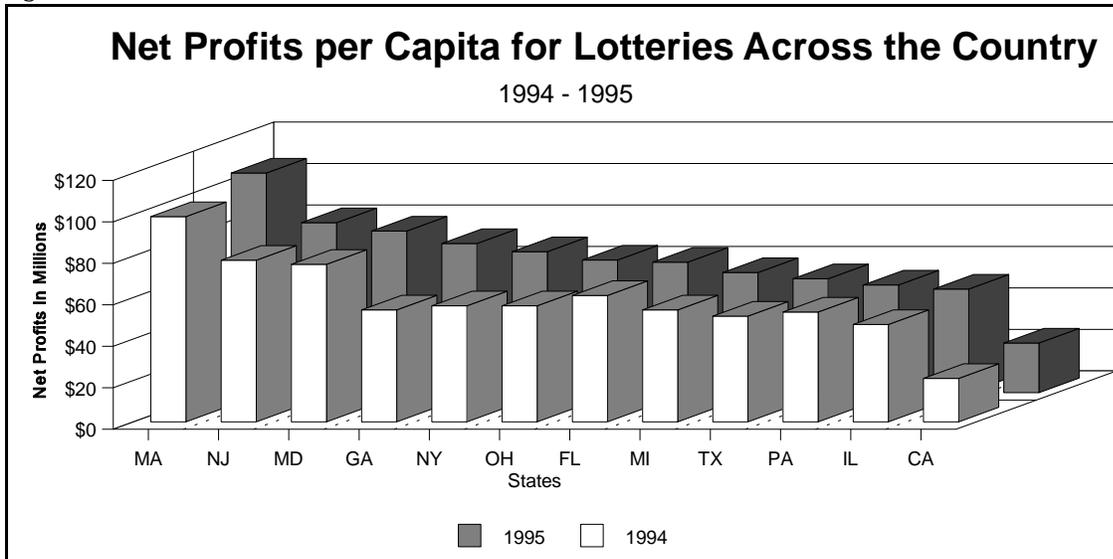
TX: Texas MA: Massachusetts OH: Ohio PA: Pennsylvania NJ: New Jersey GA: Georgia
 NY: New York FL: Florida CA: California IL: Illinois MI: Michigan MD: Maryland

⁵ The 1996 personal income for the fourth quarter was not available. Therefore, we used the average personal income for the first three quarters for 1996.

The Texas Lottery's net profit per capita moved from tenth to ninth of the billion-dollar lotteries. Texas's net profit per capita jumped to \$78 in 1996.

Texas has a similar game mix to Ohio. Ohio has higher profit per capita and earns a larger percentage of its residents' personal incomes. The Commission should study the Ohio Lottery to determine whether there are changes it can make to improve its trends, and thus its earnings, even further.

Figure 11

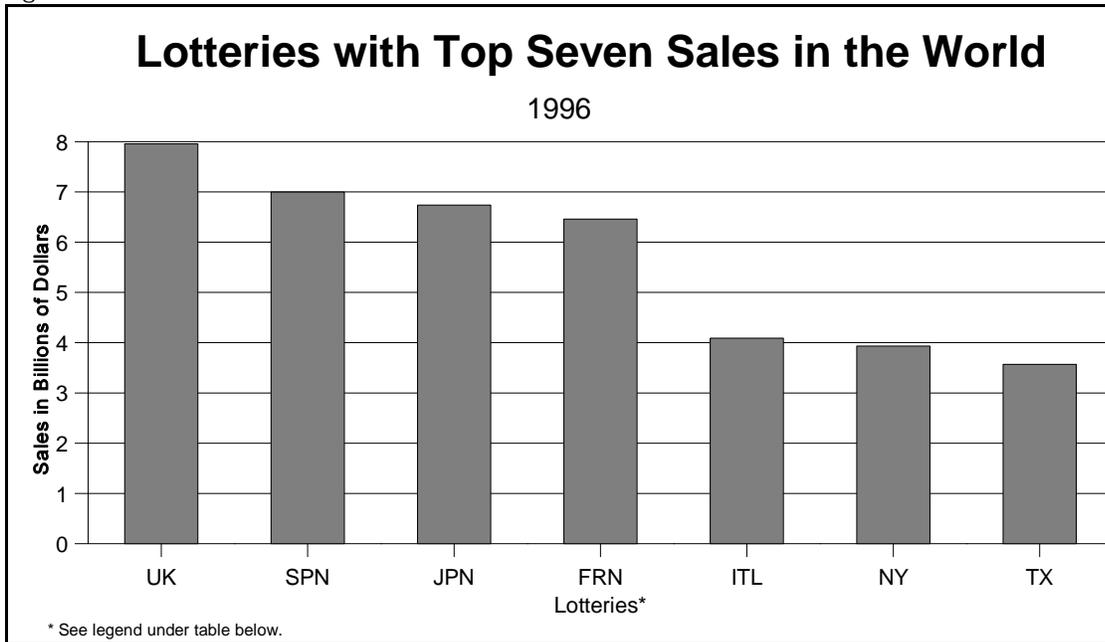


Year	MA	NJ	MD	GA	NY	OH	FL	MI	TX	PA	IL	CA
1995	\$106	\$82	\$78	\$72	\$68	\$64	\$63	\$58	\$55	\$52	\$50	\$24
1994	\$99	\$78	\$76	\$54	\$56	\$56	\$61	\$54	\$51	\$53	\$47	\$21

TX: Texas MA: Massachusetts OH: Ohio PA: Pennsylvania NJ: New Jersey GA: Georgia
 NY: New York FL: Florida CA: California IL: Illinois MI: Michigan MD: Maryland

Part of the Texas Lottery Commission's mission is to maximize revenue for the State Treasury. It has done this well. The Texas Lottery had the seventh-highest lottery sales in the world in 1996. Out of all the lotteries in the world, the New York Lottery was the only lottery that had higher lottery sales and higher sales per capita than Texas. Every other lottery with higher sales than the Texas Lottery had a customer population at least twice the size of Texas.

Figure 12



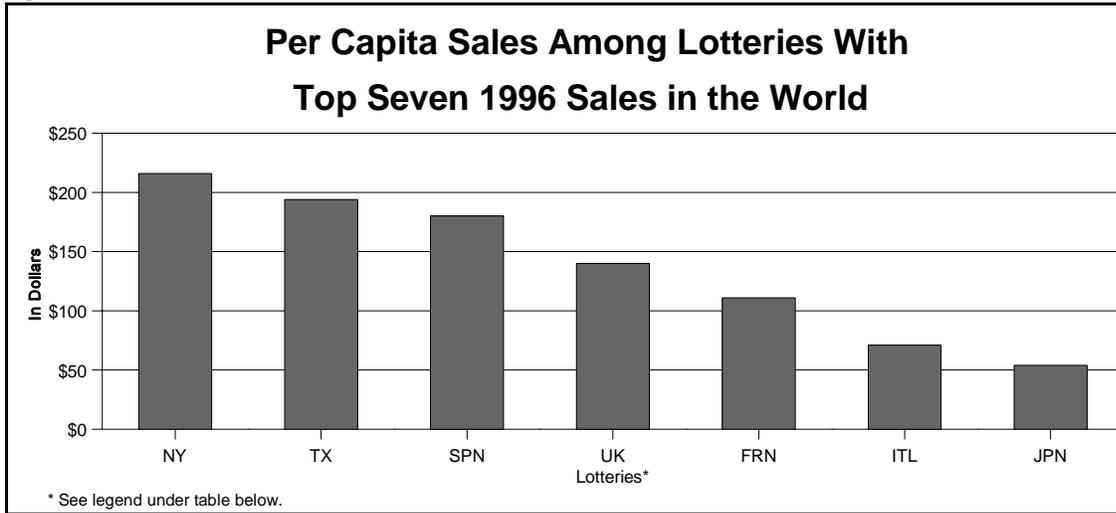
Lotteries With Top Seven Sales in the World 1996 In Billions						
UK	SPN	JPN	FRN	ITL	NY	TX
7.956	6.978	6.738	6.461	4.089	3.932	3.569

UK: UK National Lottery
SPN: ONLAE (Spain)

JPN: Dai-Ichi Kangyo (Japan)
FRN: La Francaise des Jeux (France)
ITL: Lottomatica (Italy)

NY: New York Lottery
TX: Texas Lottery

Figure 13



NY	TX	SPN	UK	FRN	ITL	JPN
\$216	\$194	\$180	\$140	\$111	\$71	\$54

UK: UK National Lottery
 SPN: ONLAE (Spain)

JPN: Dai-Ichi Kangyo (Japan)
 FRN: La Francaise des Jeux (France)

ITL: Lottomatica (Italy)
 NY: New York Lottery

TX: Texas Lottery