

CALIFORNIA LOTTERY

Audit Report

SAM 20000 AUDIT: CONTRACTS CYCLE

January 1, 2006, through December 31, 2007



JOHN CHIANG
California State Controller

January 2007



JOHN CHIANG
California State Controller

January 31, 2007

Joan M. Borucki
Chief Deputy Director
California Lottery
600 North Tenth Street
Sacramento, CA 95814

Dear Ms. Borucki:

The State Controller's Office audited the Contracts Cycle as part of our process of studying and evaluating the accounting and administrative controls of the California Lottery for the biennial period ending December 31, 2007. The purpose of our audit was to determine and identify any accounting and administrative control strengths and weaknesses over the Contracts Cycle.

Our audit did not disclose any significant internal control problems or weaknesses that would be considered pervasive in their effects on the accounting and administrative controls over the Contracts Cycle.

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

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

JVB/vb

cc: John Mass, Chairman
California Lottery Commission
Rachel Montes, Commissioner
California Lottery Commission
Manuel Ortega, Commissioner
California Lottery Commission
Patt Eberhart, Director
Finance and Administration
California Lottery
Stacy Matsunami, Director
Special Projects
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Audit Report

Summary

The State Controller's Office (SCO) is in the process of studying and evaluating the internal accounting and administrative controls of the California State Lottery (Lottery) in accordance with *State Administrative Manual* Section 20060 (Internal Control Reporting) for the biennial period ending December 31, 2007. The SCO has concluded the audit for the Contracts Cycle. The last day of fieldwork was October 17, 2006.

The purpose of our audit was to determine and identify any accounting and administrative control strengths and weaknesses over the Contracts Cycle.

Our audit did not disclose any significant internal control problems or weaknesses that would be considered pervasive in their effects on the accounting and administrative controls over the Contracts Cycle.

Background

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

The Lottery Act created a special fund, known as the State Lottery Fund, within the State Treasury. The State Lottery Fund operates as an enterprise fund and is required to be entirely self-funded from Lottery sales. The Lottery Act further stipulates that 50% of lottery sales proceeds are to be allocated to prizes, and that no more than 16% are to be used for administrative costs. The remaining proceeds from lottery sales, a minimum of 34%, are to be directed to the benefit of public education.

California's *Public Contract Code* Section 100 states:

. . . it is the intent of the Legislature in enacting this code to achieve the following objectives: (a) To clarify the law with respect to competitive bidding requirements. (b) To ensure full compliance with competitive bidding statutes as a means of protecting the public from misuse of public funds. (c) To provide all qualified bidders with a fair opportunity to enter the bidding process, thereby stimulating competition in a manner conducive to sound fiscal practices. (d) To eliminate favoritism, fraud, and corruption in the awarding of public contracts. . . .

The State Contract Manual and Chapter 1200 of the *State Administrative Manual* provide additional information regarding California's contract rules and requirements.

The Contracts and Procurement Services Section within the Executive Division of the Lottery is the unit responsible for monitoring contracting activities. Contracts and Procurement Services oversee the overall

contracting process and procedures, while designated contract managers monitor the contract specifics, such as performance of services and reviewing contract invoices.

Authority

State Administrative Manual Section 20060 (Internal Control Reporting) states:

Pursuant to the FISMA [*Financial Integrity and State Manager's Accountability Act of 1983*], the head of each state entity shall prepare and submit a report on the adequacy of their entity's internal control on December 31 of each odd numbered fiscal year. . . . The report shall consist of a certification letter, the most recent audit report on internal accounting and administrative controls, and management's response to the audit report.

The Lottery delegated the duty of performing the biennial audit of internal controls to the SCO in a letter dated September 6, 2002.

Objectives, Scope, and Methodology

We studied and evaluated the accounting and administrative controls of the Lottery's Contracts Cycle in effect as of October 17, 2006. We conducted our study and evaluation in accordance with the *Standards for the Professional Practice of Internal Auditing*, issued by the Institute of Internal Auditors, and included testing that we considered necessary to determine whether accounting and administrative controls are in place and operative.

Lottery management is responsible for establishing and maintaining adequate internal controls. This responsibility, in accordance with *Government Code* Sections 13402 et seq., includes documenting internal control, communicating requirements to employees, and ensuring that internal control is functioning as prescribed. To fulfill its responsibility, Lottery management must assess the expected benefits and related costs of control procedures.

The objectives of accounting and administrative controls are to provide management with reasonable, but not absolute, assurance that:

- Assets are safeguarded against loss from unauthorized use or disposition;
- Transactions are executed in accordance with management's authorization and recorded properly, so as to permit the preparation of reliable financial statements; and
- Financial operations are conducted in accordance with policies and procedures established in the *State Administrative Manual* (SAM).

The specific objectives were to determine whether:

- Written policies and procedures for contracts are in place;
- Adequate separation of duties exists over the contracting function;

- Contracts are properly authorized and documented;
- Contracts are accompanied by the required supporting documentation and contain the required language;
- Competitive bidding requirements are followed;
- Contracts have not been split to circumvent expenditure limitations;
- Progress payments are made in accordance with contracts; and
- Contract administration is adequate to ensure contracting objectives.

The audit procedures performed included:

- Reviewing audit working papers for the prior SAM 20000 Contracts Cycle, dated October 31, 2005, to determine audit issues that may affect the audit;
- Interviewing Lottery Contract and Procurement Services personnel to determine whether the Contracts cycle controls reviewed in the report referenced above had changed; and
- Conducting tests in the areas we identified as requiring additional audit work.

Conclusion

Our study and evaluation did not reveal any significant internal control problems or weaknesses that would be considered pervasive in their effects on the accounting and administrative controls over the Contracts Cycle.

In our opinion, the Lottery's accounting and administrative controls over the Contracts Cycle in effect as of October 17, 2006, taken as a whole, were sufficient to meet the objectives stated above.

As a result of changing conditions and the degree of compliance with procedures, the effectiveness of controls changes over time. Specific limitations that may hinder the effectiveness of an otherwise adequate system of controls include, but are not limited to, resource constraints, faulty judgments, unintentional errors, circumvention by collusion, and management overrides. Establishing controls that would prevent all of these limitations would not be cost-effective; moreover, an audit may not always detect these limitations.

Views of Responsible Official

We conducted an exit conference on October 17, 2006, and discussed our audit results with Kathie Johnson, Audit Specialist, Internal Audits. Ms. Johnson agreed with the audit results. Our audit disclosed no findings; therefore, a draft report is not necessary and we will issue the report as final.

Restricted Use

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

Original signed by

JEFFREY V. BROWNFIELD
Chief, Division of Audits

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