

STATE OF NORTH CAROLINA

INVESTIGATIVE REPORT

NORTH CAROLINA EDUCATION LOTTERY

RALEIGH, NORTH CAROLINA

JUNE 2012

OFFICE OF THE STATE AUDITOR

BETH A. WOOD, CPA

STATE AUDITOR

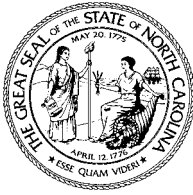
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AUDITOR'S TRANSMITTAL

The Honorable Beverly Perdue, Governor
Members of the North Carolina General Assembly
Alice Garland, Executive Director, North Carolina Education Lottery

Ladies and Gentlemen:

Pursuant to North Carolina General Statute §147-64.6(c)(16), we have completed an investigation of allegations pertaining to the North Carolina Education Lottery. The results of our investigation, along with recommendations for corrective action, are contained in this report.

Copies of this report have been provided to the Governor, the Attorney General and other appropriate officials in accordance with G.S. §147-64.6(c)(12). We appreciate the cooperation received from the management of the North Carolina Education Lottery during our investigation.

Respectfully submitted,

A handwritten signature in cursive script that reads "Beth A. Wood".

Beth A. Wood, CPA
State Auditor

June 20, 2012

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INTRODUCTION

During an audit of contract monitoring practices,¹ the Office of the State Auditor determined that the North Carolina Education Lottery (Lottery) was accepting goods and services from its primary gaming vendor, GTECH Corporation, as payment for liquidated damages.² The purpose of liquidated damages is to recoup potential sales losses from GTECH due to their failure to perform under certain aspects of their contract with the Lottery. We initiated an investigation of this practice because of concerns regarding its propriety. Our investigation included the following procedures:

- Review of applicable North Carolina General Statutes
- Review of applicable policies and procedures of the North Carolina Office of the State Controller
- Examination of relevant documents and records
- Interviews with employees of the Lottery, GTECH, and the Office of the State Controller

This report presents the results of our investigation. The investigation was conducted pursuant to North Carolina General Statute § 147-64.6(c)(16).

¹ Performance Audit Report titled *Service Contract Monitoring Practices* issued by the Office of the State Auditor in November 2010.

² According to *Black's Law Dictionary*: "An amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches."

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ORGANIZATION OVERVIEW

North Carolina Education Lottery

In August 2005, the North Carolina General Assembly authorized the creation of the North Carolina Education Lottery (Lottery) as a self-supporting enterprise to generate funds for education purposes.³ Chapter 18C of the North Carolina General Statutes established a nine-member Lottery Commission responsible for starting, supervising, and administering the Lottery. Five members are appointed by the Governor, four members are appointed by the General Assembly, and the chairperson is selected by the Governor. The Lottery maintains offices and claim centers in Raleigh, Charlotte, Greensboro, Greenville, and Asheville, with an additional claim center in Wilmington.

The General Statutes specify that, to the extent practicable, 50 percent of revenues should be paid out in prizes, 35 percent of revenues should be transferred to the Education Lottery Fund, 8 percent of revenues can be used for Lottery expenses, and 7 percent of revenues should be paid to the lottery game retailers as compensation.

Of the revenues transferred to the Education Lottery Fund, the General Statutes originally designated that 50 percent of net proceeds pay for teacher salaries in grades K-3 and the former *More at Four* program, 40 percent is distributed to counties for school construction projects, and 10 percent is used for college scholarships based on financial need. However, the General Assembly can adjust that allocation each year in the state budget.

GTECH Corporation

GTECH Corporation (GTECH) is a gaming technology and services company. The Lottery entered into two contracts with GTECH on January 30, 2006: one to provide lottery gaming systems and services and one to provide instant ticket lottery games systems. Section 20 of both contracts states that the Lottery will assess liquidated damages against GTECH for various incidents such as delayed or untimely performance and lottery system and ticket machine downtime.

³ The North Carolina State Lottery Act (House Bill 1023) and the 2005 Appropriations Act (Senate Bill 622).

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FINDINGS AND RECOMMENDATIONS

1. THE NORTH CAROLINA EDUCATION LOTTERY FAILED TO COLLECT LIQUIDATED DAMAGES FROM GTECH IN VIOLATION OF STATE LAW.

From the inception of the Lottery in 2006, the North Carolina Education Lottery (Lottery) did not collect liquidated damages⁴ from its primary gaming vendor, GTECH Corporation (GTECH). Instead, the Lottery allowed GTECH to accumulate and carry an outstanding balance of liquidated damages for several years. This practice violated the State's Cash Management Policy regarding the collection and deposit of funds owed to the State.

From May 3, 2006 through June 30, 2011, the Lottery assessed liquidated damages totaling \$460,804. As of June 30, 2011, \$278,432 (60%) of the assessed liquidated damages had been collected in the form of goods and services. GTECH provided items such as televisions and DVD players for regional claim centers, additional Instant Ticket Vending Machines, GTECH retailer training meetings, equipment for the lottery system test lab, and signature cards in exchange for a reduction of \$278,432 in liquidated damages. The leasing of additional vending machines in October 2009 amounted to \$195,300 (70% of the value of the items provided by GTECH). The balance of \$182,372 remained uncollected as of June 30, 2011.

Until our notification in December 2011, officials with the North Carolina Office of the State Controller (State Controller) were unaware that the Lottery had allowed liquidated damages to accrue as receivables. Officials with the State Controller said the Lottery had not been reporting these receivables as required by the Statewide Accounts Receivable Program.⁵ Moreover, officials with the State Controller said the Lottery violated the State's Cash Management Policy as outlined in North Carolina General Statute § 147-86.11.

On December 9, 2011, the Office of the State Controller sent a letter to the Lottery notifying them that the failure to collect assessed liquidated damages from GTECH was a violation of General Statute § 147-86.11(e)3, which requires that all "moneys due to a state agency by... private persons be promptly billed, collected, and deposited." The letter instructed the Lottery to comply with the State's Cash Management Policy and to reduce the weekly scheduled payment⁶ to GTECH by the amount due for assessed liquidated damages immediately.

⁴ See supra note 2.

⁵ The Statewide Accounts Receivable Program per General Statute § 147-86.26 states that a state agency shall provide the State Controller a complete report of the agency's accounts receivable at least quarterly or more frequently as required by the State Controller. It also states that the report shall include the type of accounts receivable and an aging of those receivables.

⁶ The gaming systems contract between the Lottery and GTECH states that GTECH shall be paid an amount equal to 1.5999% of gross online ticket sales revenue less cancelled transactions.

FINDINGS AND RECOMMENDATIONS (CONCLUDED)

RECOMMENDATION

The Lottery should comply with the State's Cash Management Policy as directed by the Office of the State Controller. As such, the Lottery should discontinue the accumulation of liquidated damages as receivables and collect and deposit all monies owed to the State by GTECH.

2. THE NORTH CAROLINA EDUCATION LOTTERY FAILED TO VERIFY AND DOCUMENT THE VALUE OF CERTAIN ITEMS RECEIVED IN PAYMENT FOR ASSESSED LIQUIDATED DAMAGES.

As noted in Finding 1, the North Carolina Education Lottery (Lottery) allowed GTECH Corporation (GTECH) to pay \$278,432 of assessed liquidated damages with goods and services instead of cash. However, the Lottery was unable to provide adequate documentation to support the value of 12 Instant Ticket Vending Machines that offset \$195,300 of the assessed liquidated damages.

The only documentation available to support the value of the vending machines was a Letter of Understanding from the Lottery to GTECH. The Lottery's Deputy Executive Director of Finance admitted that the Lottery did not know the value of the vending machines. Instead, the Lottery relied upon and accepted the values provided by GTECH without verification. Therefore, it is uncertain whether the Lottery actually received goods and services worth \$278,432 from GTECH to offset the liquidated damages.

RECOMMENDATION

The Lottery should ensure that the items received from GTECH to offset liquidated damages were properly valued with supporting documentation. The Lottery should offset future payments to GTECH for the value of any items it received without adequate documentation. As noted in the recommendation for Finding 1, the Lottery should discontinue the practice of accepting goods and services to offset liquidated damages.

STATE AUDITOR'S NOTE TO THE LOTTERY'S RESPONSE

The North Carolina Education Lottery (Lottery) focused much of its response on deflecting attention from the findings and recommendations instead of explaining how management planned to change its operating procedures. The Lottery elected to discuss an immaterial timeline of events and then misrepresent communications with the State Controller and the Office of the State Auditor (OSA) as well as the types of documentation maintained regarding equipment values.

The Lottery stated that it established “an understanding” with the State Controller in 2006 which permitted the use of GTECH liquidated damages “to acquire additional goods and/or services.” However, the former State Controller said he had no recollection of any such understanding. In addition, the Lottery provided no documentation to support its claim of an understanding with the former State Controller. Further, the contention that similar arrangements are “fairly common in the industry” is irrelevant when evaluating compliance with the State of North Carolina’s Cash Management Policy.

The Lottery claimed that it “promptly complied” with the State’s Cash Management Policy beginning in January 2012 based upon the December 9, 2011 written directive from the current State Controller. The State Controller’s letter confirmed the Lottery “knowingly and willfully” violated North Carolina General Statutes and demanded that the Lottery comply by reducing “the weekly scheduled payments” to GTECH “by the amount due for assessed liquidated damages immediately.” (See Attachment A) However, the Lottery defied the State Controller’s directive on January 12, 2012 when it informed GTECH of its intent to use the remaining \$189,753.09 (as of December 2011) of liquidated damages to acquire more GTECH equipment (instead of deducting it from GTECH’s invoice dated January 11, 2012 as directed by the State Controller). It was only after this transaction that the Lottery began to comply with the State Controller’s directive by taking deductions from GTECH’s monthly invoices.

The Lottery stated that it would have addressed the liquidated damages issue in 2010 had it been brought to their attention as part of a 2010 OSA performance audit. Considering the actions taken by the Lottery in the month following the State Controller’s directive, this is far from certain. Furthermore, the scope of the performance audit was service contract monitoring practices. The use of liquidated damages was referred to the State Auditor’s investigative section as a separate issue which culminated in this report.

The Lottery claimed equipment pricing from GTECH contracts with other states helped determine if GTECH’s pricing was reasonable. As such, the Lottery provided a financial analysis currently used to determine if equipment pricing is reasonable. However, the Lottery could not produce a financial analysis for the 12 Instant Ticket Vending Machines acquired in 2009 in exchange for \$195,300 of GTECH liquidated damages. Simply keeping GTECH contracts with other states in a file drawer at the Lottery does not demonstrate that they were used to evaluate the reasonableness of GTECH equipment prices in 2009.



State of North Carolina
Office of the State Controller

DAVID T. MCCOY
STATE CONTROLLER

December 9, 2011

Mr. Bill Jourdain
North Carolina Education Lottery
2100 Yonkers Rd.
Raleigh, NC 27604

Dear Mr. Jourdain:

SUBJECT: Accounting for Liquidated Damages

It has been brought to my attention that upon being notified that your office was out of compliance with the State's Cash Management Policy and North Carolina's General Statutes, you insisted that a written directive be sent to you. The facts are without dispute: 1) the North Carolina Education Lottery (NCEL) has a contract with a gaming vendor for services; 2) the contract includes a liquidated damages clause requiring the assessment of liquidated damages for lack of performance; and 3) for several years, the NCEL has knowingly and willfully permitted this vendor to hold in its accounts the funds assessed as liquidated damages due to NCEL. In light of these facts, I am notifying you that your office's management of cash due to the State violates G.S. 147-86.11(e)3 which requires that all "Moneys due to a State agency by another government or by private persons shall be promptly billed, collected and deposited." You must comply with the above cited statute and I am instructing you to do so. Your office shall reduce the weekly scheduled payment to the gaming vendor by the amount due for assessed liquidated damages immediately and shall comply with all provisions related to the State's Cash Management Policy. If you have any questions regarding this directive, please feel free to contact me or my staff.

Sincerely,

David T. McCoy

cc: Beth A. Woods, State Auditor
Alice Garland, Executive Director

SAD 12-29

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RESPONSE FROM THE NORTH CAROLINA EDUCATION LOTTERY

Robert A. Farris, Jr.
Commission Chairman

June 12, 2012

The Honorable Beth A. Wood, CPA
State Auditor
Office of the State Auditor
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0601



Alice Garland
Executive Director

Re: NCEL Response to Investigative Report issued June, 2012

Dear Ms. Wood:

We are in receipt of your Investigative Report which was personally delivered to the North Carolina Education Lottery ("NCEL") on June 7, 2012 by Assistant State Auditors Barry Long and Bryan Matthews. We were informed by Mr. Long and Mr. Matthews that we had until Wednesday, June 13, 2012 to respond to the Investigative Report. Because we addressed most of the issues that you raised in your Investigative Report in our previous Response, the following is a timeline and summary of the facts regarding the NCEL's utilization of liquidated damages ("LDs") assessed against GTECH Corporation ("GTECH") to acquire goods and services from GTECH.

- March 2006 through December 2011 - The NCEL has been acting in good faith based upon an understanding between the State Controller at the time of Lottery inception (2006) and the NCEL, that we may utilize GTECH LDs to acquire additional goods and/or services. All the goods and/or services that were acquired through LDs were necessary for the continued successful operation of our Lottery. Most of the equipment (about 90%) acquired through LDs is still being used daily by the NCEL to sell and/or promote Lottery sales for the benefit of North Carolina which generated over \$7.56 Billion in sales, and \$2.35 Billion contributed to specified North Carolina educational programs (through March 2012).
 - NOTE: As of November 2011, eleven (11) of the twenty (20) State Lotteries that have GTECH as their Gaming System Vendor utilize LDs for goods and/or services. This practice is fairly common in the industry.
- December 1, 2009 – An Assistant State Auditor from your Office met with various NCEL staff to inquire about our process for accounting for LDs and tracking of specified equipment acquired through LDs. We previously provided you with a copy of an email that was sent in December 2009 in response to the Assistant State Auditor's request regarding our asset listing for the GTECH equipment utilizing LDs. We did not receive any follow-up from the Assistant State Auditor regarding the use of LDs for GTECH goods and services.
- October 10, 2011 – NCEL Executive Director Alice Garland was informed by Orace Pollard and Bryan Matthews that your Office will be investigating the NCEL's use of GTECH LDs because of an anonymous hotline call to your Office.
 - NOTE: You stated in your Investigative Report that you initiated this investigation due to the "Performance Audit Report titled *Service Contract Monitoring Practices* issued by the Office of State Auditor in November 2010." However, there were no Findings or reference to the NCEL in the November 2010 Performance Report. We would have addressed this issue if it was brought to our attention at that time.
- December 9, 2011 – The State Controller's Office notified the NCEL that we must reduce GTECH's invoices by the amount of LDs assessed, which we promptly complied beginning with the first invoice in January 2012 for the November 2011 LDs assessed.
- May 30, 2012 – Assistant State Auditors Barry Long and Bryan Matthews hand-delivered a Draft Investigative Report to the NCEL, which the NCEL provided a written Response received by your Office on June 5, 2012.

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2100 Yonkers Road • Raleigh, North Carolina 27604
www.nc-educationlottery.org

1. *"THE NORTH CAROLINA EDUCATION LOTTERY FAILED TO COLLECT LIQUIDATED DAMAGES FROM GTECH IN VIOLATION OF STATE LAW."*

The NCEL has detailed accounting regarding the assessment of liquidated damages for GTECH since May 2006. As stated earlier in our previous Response, the NCEL did not "fail to collect." All assessed LDs have been spent by the NCEL for goods and services in the best interest of the Lottery and the State. We acknowledge that not all LDs assessed were spent immediately, but all LDs were fully tracked by the NCEL to ensure that we received all values arising from those LDs. The NCEL has already complied with the State's Cash Management Policy by reducing GTECH's monthly invoice against LDs assessed, beginning with the January 2012 GTECH invoice.

2. *"THE NORTH CAROLINA EDUCATION LOTTERY FAILED TO VERIFY AND DOCUMENT THE VALUE OF CERTAIN ITEMS RECEIVED IN PAYMENT FOR ASSESSED LIQUIDATED DAMAGES" [in particular, 12 instant ticket vending machines ("ITVMs")].*

As we informed your Office in our previous Response, the NCEL cannot verify the "market" value of certain equipment provided by GTECH for the following reasons:

- Most of GTECH's equipment, including the ITVMs, is proprietary to GTECH. The terms of GTECH Contracts vary from lottery-to-lottery, making it difficult to get an apple-to-apple comparison on proprietary equipment.
- In 2008, the NCEL conducted due diligence by obtaining copies of Contracts from other State Lotteries with GTECH as their Gaming System provider to determine what rates were quoted by GTECH for any particular equipment/services. These quotes are comprehensive price packages which take into account the percentage of sales paid to GTECH. Because there is not one other State Lottery that has the same terms as the NCEL's Contract with GTECH, it is difficult to compare GTECH's quoted rate to obtain the "market" value of the equipment. All we could do is examine what other State Lotteries may be paying for any particular GTECH product and determine whether the NCEL quote is reasonable. Because we have copies of other State Lotteries' Gaming System and Instant Ticket Printing Contracts on hand, we have a readily available resource for reference in order to determine whether a quoted rate by GTECH would be reasonable. Your Office determined that the quoted rates from other State Lotteries were not "adequate documentation." We welcome any suggestion on what we need to do in order to improve documentation in this area.
- With respect to the "value" of GTECH's products, and in particular the 12 ITVMs, we reiterate that we did obtain the best value out of the ITVMs based upon what we paid for the machines (\$195,300) and the potential sales we will receive from those 12 ITVMs throughout the life of GTECH's Contract (\$4.3 Million).

We believe that the items we received from GTECH were properly valued, based upon the Contract that we have with GTECH, and comparing quotes from other GTECH State Lotteries. Therefore, we will not need to offset future payments to GTECH for the value of items received.

If you have any questions, please contact Executive Director, Alice Garland at (919) 301-3600.

Sincerely,



Robert A. Farris, Jr.
North Carolina Education Lottery Commission Chairman

RAF/qtq

Cc: Alice Garland, Executive Director

ORDERING INFORMATION

Copies of this report may be obtained by contacting the:

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