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Auditing for a Better Oregon

February 13, 2006

Kerry Tymchuk, Chair
Oregon State Lottery Commission
500 Airport Road SE
Salem, Oregon 97301

Dear Mr. Tymchuk:

We have completed our financial statement audit of the Oregon State Lottery (Lottery) for the fiscal year ended June 30, 2005. During our audit, we did not identify any reportable conditions related to internal control or to noncompliance with applicable laws and regulations. Professional auditing standards define reportable conditions as matters relating to significant deficiencies in the design or operation of internal control over financial reporting that, in our judgment, could adversely affect the Lottery's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements. We did identify the following issue, which we determined was not a reportable condition, but warrants consideration by the Lottery Commission. We previously met with Lottery commissioners and management to discuss this issue.

Retailer Commissions

Lottery's current contract with video lottery retailers designates two options for retailer compensation based on net receipts per year, as follows:

Option A (three tiers):

Net receipts	Retailer commission percentage
Up to $175,000.00	32.5%
$175,000.01 to $475,000.00	26%
$475,000.01 and up	17%

Option B (two tiers):

Net receipts	Retailer commission percentage
Up to $650,000.00	26%
$650,000.01 and up	19%

Lottery's computer system calculates video lottery retailer commissions based on net receipts during a business week (Sunday through Saturday). If, during a business week, a video lottery retailer's net receipts reach the next commission percentage tier within the retailer's selected option, it is Lottery's business practice to change the commission rate at the start of the next

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business week. Consequently, in these instances, a retailer is compensated at the higher percentage rate until the start of the next business week. According to Lottery management, the system has calculated commissions in this manner since the video lottery program commenced. Although the current contract does not include explicit language detailing Lottery's current business practice for commission calculations, previous retailer contracts have specified in writing that retailer commissions would be calculated in this manner. Lottery management stated omission of this language in the current contract was not intended by management to change the business practice or contract requirements. Lottery's legal counsel concluded that under contract law, the compensation calculation method is an implicit term of the current retailer contract because this method had been used in the past.

While Lottery's current business practice for calculating commissions is legally allowed in current contracts, during our testing we noted those practices do not result in equitable retailer compensation for video lottery receipts. Our review of all video lottery retailers found that in more than 300 instances, Lottery's compensation method created inequities in fiscal year 2005 commissions received by the video retailers. For example, one retailer had $8,510 more in video sales than another retailer but received $363 less in commissions, yet both retailers selected option B. Had commissions been calculated at the precise tier percentages (i.e., the commission percentage rate is decreased at exact net receipts thresholds), the first retailer would have received $1,617 more in commissions than the other retailer.

We also noted net revenues to the state of Oregon might have been increased if Lottery's retailer contract allowed commissions to be calculated at the precise tier percentages. We reviewed detailed information for 53 video lottery retailers. This included all 20 retailers that received more than $300,000 in commissions during the fiscal year, and 33 retailers randomly selected from retailers that received between $6,000 and $300,000. Of the 53 retailers reviewed, 30 had net receipts that passed into the next commission percentage tier during a business week. We compared the 53 retailers' commissions calculated using Lottery's current method with commissions calculated at the precise tier percentages. We projected the results of the comparison to the entire sample population. Based on projected results, we concluded that the fiscal year 2005 video lottery commissions could have exceeded commissions calculated at the precise tier percentages by approximately $650,000.

According to ORS 461.100, the Lottery Commission shall act to insure fairness in the operation and administration of the state lottery. Further, ORS 461.200 requires the Oregon State Lottery to be operated so as to produce the maximum amount of net revenues to benefit the public purpose.

We recommend, for purposes of entering into a new retailer contract in 2010, the Lottery Commission (1) review the current method of determining retailer commissions, and consider the costs and benefits of either changing the video system programming, or making manual adjustments on a periodic basis, to limit commissions to the precise commission percentage rates and, (2) modify the next retailer contract to ensure precise commission percentage rates are applied to retailer video commission calculations.

We will follow up on the Lottery's progress in addressing this issue during our audit of fiscal year 2006 financial statements. Should you have any questions, please contact me at 503-986-2354.

Sincerely,
OREGON AUDITS DIVISION

Nancy L. Young, CPA, CISA, CFE
Audit Manager

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cc: Dale Penn, Director
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