December 13, 2017

Michael Cohen, Director
California Department of Finance
915 L Street
Sacramento, CA 95814

Dear Mr. Michael Cohen,

In accordance with the State Leadership Accountability Act (SLAA), the California State Lottery Commission submits this report on the review of our internal control and monitoring systems for the biennial period ending December 31, 2017.

Should you have any questions please contact Nicholas Buchen, Deputy Director, Finance Division, at (916) 822-8300, nbuchen@calottery.com.

BACKGROUND

In 1984, Proposition 37 amended the California Constitution to authorize the establishment of a statewide lottery. As an initiative statute, the California State Lottery Act of 1984 (Lottery Act) created the California State Lottery Commission and gave it broad powers to oversee the operations of a statewide lottery. The purpose of the Lottery Act was to provide supplemental monies to benefit public education without the imposition of additional or increased taxes. The California State Lottery (Lottery) is administered by a five-person Commission appointed by the Governor and confirmed by the State Senate.

The Lottery Act initially required that 50 percent of total annual revenues be returned to the public in the form of prizes and at least 34 percent of total revenues be allocated to the benefit of public education. No more than 16 percent of total revenues were to be used for administrative costs.

In 2010, the Lottery Act was changed to allow the Lottery flexibility to pay out more money in prizes and reduce the administrative cost limit to 13 percent of total revenues. The new law required the Lottery to return at least 87 percent of total revenues to the public in the form of prizes and net revenues to benefit public education. Revenues to education are placed in a special fund, known as the California State Lottery Education Fund, which holds revenues until they are allocated on a per capita basis, using prior year certified Average Daily Attendance data, to the following categories: K-12 education, Community Colleges, the California State University, the University of California, and other educational entities.

The Lottery has experienced significant growth in both sales and contributions to public education since the Lottery Act was amended in 2010. To achieve continued growth in sales and profits and become the largest lottery in the nation in terms of both sales and profit, a foundation for the Lottery’s most recent three-year Strategic Plan was formed based on five objectives. All of the Lottery’s current major initiatives tie back to one or more of these five objectives:

• Build sales in jackpot games and Hot Spot.
• Clear up myths about the Lottery and elevate the brand perception.
• Be a responsible corporate citizen.
• Put more fun and entertainment into the product.
• Become customer-focused and improve the customer experience.
The Lottery sells its products (tickets for both instant and draw games) through a network of more than approximately 23,000 retailers throughout California. The Lottery has approximately 840 employees operating out of various facilities across the state: headquarters located in Sacramento; nine district offices located in Sacramento, San Francisco, Hayward, Fresno, Van Nuys, Santa Fe Springs, Santa Ana, San Bernardino, and San Diego; and two distribution centers located in West Sacramento and Rancho Cucamonga. The Lottery is organized into eight divisions that report to the Director: Executive (which includes Legal Services and Contracts Development, Internal Audits, Legislative and External Affairs, Business Planning, and Equal Employment Opportunity), Finance, Human Resources, Operations, Corporate Communications, Security and Law Enforcement, Information Technology Services, and Sales and Marketing.

Maintaining public trust is vital for a lottery to remain successful. Lottery staff demonstrates integrity, honesty, and fairness in the operation and administration of the organization. This is crucial in reassuring players that games are operated fairly and that winning tickets will be honored. Accordingly, the Lottery maintains a comprehensive audit program. The Lottery not only employs internal auditing staff, but also contracts with the State Controller’s Office (SCO) and independent firms to further ensure the integrity of all operations and transactions.

Annually, an independent audit firm performs financial audits of the Lottery’s financial statements. Since the inception of the Lottery, the annual financial statements have cited unqualified opinions. Further, in recognition of the Lottery’s commitment to prepare financial statements reflecting transparency and full disclosure, the Government Finance Officers Association of the United States and Canada has awarded a Certificate of Achievement for Excellence in Financial Reporting to the Lottery for the past 14 consecutive fiscal years. Additionally, the SCO conducts quarterly and annual post-audits of all accounts and transactions of the Lottery including quarterly transfers to education, vendor claim schedules, and all prize payments.

In addition, an independent audit firm witnesses and reviews every lottery draw (at least four draws occur each day of the year) to ensure accurate completion of the draw procedures, including the verification of technology systems, draw machinery, and draw items such as lotto balls.

Although the Lottery Act requires the review of the Lottery’s adopted security measures on a biennial basis, the Lottery has opted for more frequent reviews. Specifically, World Lottery Association/International Organization for Standardization auditors conduct a review of Lottery security annually, and perform a comprehensive audit every three years. The audit includes a comprehensive study and evaluation of all aspects of security in the operation of the Lottery.

**ONGOING MONITORING**

As the head of California State Lottery Commission, Hugo Lopez, Director, is responsible for the overall establishment and maintenance of the internal control and monitoring systems.

**EXECUTIVE MONITORING SPONSOR(S)**

The executive monitoring sponsor responsibilities include facilitating and verifying that the California State Lottery Commission internal control monitoring practices are implemented and functioning as intended. The responsibilities as the executive monitoring sponsor(s) have been given to: Vincent Espinosa, Chief Enterprise Risk Officer.

**MONITORING ACTIVITIES**

Through our ongoing monitoring practices, the Lottery management team ensures our internal control
systems govern as required to meet our objectives related to programs, operations and administrative functions. As part of our ongoing monitoring practices we evaluate our internal controls when new mandates, maintenance or enhancements are added, which ensures updated information is communicated and recorded for departmental staff across the enterprise. In addition, we utilize external resources such as the State Controller’s Office, World Lottery Association and Vendors to serve as independent evaluators of our internal control practices, which assists in maintaining a balance of impartiality and ensures the department’s integrity with our stakeholders.

Monitoring at the Lottery is in practice and the department does recognize the need for enhancement to evolve with the various aspects change brings. We consider this activity partially implemented but with the addition of the Chief Enterprise Risk Officer in April 2017 we are constructing a plan to have fully implemented internal monitoring activity in practice by December 2019.

The approach to implement a fully functional internal monitoring process will incorporate the policies as defined in Government Code 13400 thru 13407

**Addressing Vulnerabilities**
The Lottery’s current monitoring practices identify potential vulnerabilities based on the tracking of reports related to sales, inventory, marketing, user surveys, system availability and the performance of our retailers and vendors. When a potential for improvement is identified based on performance metrics we devise plans to implement an improvement or restructure of current processes to address the issue that has been identified. The Lottery works towards establishing well defined preplanning in order to stay ahead of those items that may potentially impede our mission of maximizing supplemental funding for schools through responsible sales of our products.

**Communication**
The Lottery has defined roles to monitor programs, operations and administrative functions across the enterprise. Some of the practices are defined below:

- On a weekly basis a status report is provided from the directorate to the enterprise as to the performance of Lottery sales and recent efforts that have taken place ranging from implementation of new changes to ongoing maintenance activities that have enterprise impact.
- Project portfolio activity is presented to stakeholders on a monthly basis and that information is then shared amongst the divisions.
- Divisions communicate amongst each other and report as to their latest activities in various change management meetings.
- Communication is presented to the department with information technology alerts that inform the enterprise of upcoming activities or issues that require action to resolve.
- The Information Technology Service Division chairs a release management meeting that communicates items that are being released to production prior to the activity being executed.

**Ongoing Monitoring Compliance**
The California State Lottery Commission is in the process of implementing and documenting the ongoing monitoring processes as outlined in the monitoring requirements of California Government Code sections 13400-13407. These processes include reviews, evaluations, and improvements to the California State Lottery Commission systems of controls and monitoring.
RISK ASSESSMENT PROCESS

The following personnel were involved in the California State Lottery Commission risk assessment process: Executive Management, Middle Management, Front Line Management, and Staff.

Risk Identification
The Lottery currently identifies risk in its day to day operations through various practices: Strategic Planning, Portfolio Governance & Project Management practices, Information Security Committee risk evaluations, managing of its contracts with vendor supported items and daily operational monitoring and infrastructure monitoring. The method used to perform a risk gathering for the SLAA report was to present department deputies with the question of what would prevent their division from obtaining their objectives. The procedure was to have deputies ask themselves and their staff the following: What are the objectives of my division? What will prevent my division from obtaining those objectives? What is the likelihood the risk could take place? What would be the impact? How do I control the risk?

Risk Ranking
Based on the description of the risk, its likelihood to occur and the impact it would have against the department’s mission a recommendation was made by the Chief Enterprise Risk Officer to the directorate as what should be considered most concerning. The risks are listed under the risk and controls portion of this report.

RISKS AND CONTROLS

Risk: Operations - External - Technology—Data Security
If external sources infiltrate the Lottery’s various systems and databases, it could lead to financial loss, reputation damage and threaten the Lottery’s confidentiality, integrity and availability of the services offered.

In today's technology world one of the biggest threats that all organizations face is from parties looking to exploit vulnerabilities to infiltrate a department’s infrastructure. In addition, employees unwillingly introduce cyber risks by not following policies and procedures when accessing external information or inputting devices that can introduce malware into the network.

The result is a compromise of the Lottery’s confidentiality, integrity and availability with our customers and stakeholders that have an expectation of trust in the products we provide and the information we house. In addition a cybersecurity incident can impede day to day business activities of Lottery staff.

Control A
Lottery continues strengthening its cyber risk and threat posture to reduce risk of cybersecurity incidents. During the first half of FY17-18, the Lottery strengthened its controls by improving activity event logging, the practice of identification management, and system configuration of public-facing assets. These controls placed requirements on strengthening the department's ability to maintain positive visibility in the cyber risk threat landscape, permitting proper network access control, and remediating and blocking external risks and threats. For the last half of FY17-18, the Lottery will focus on strengthening the management of identity and access control and hardening of system and endpoint configuration. Identity and access controls will include management of privileged accounts, enabling of multiple factors of authentication for network access, and establishing single sign-on. System and endpoint configuration hardening will include the upgrade of endpoint protection software, collection and review of all workstation and server logs, enabling of additional security controls around
emailing services, and review of gaming/Draw management systems.

**Risk: Operations - Internal Staff - Key Person Dependence, Workforce Planning**

If the Lottery fails to plan for loss of employees with essential knowledge, skills, and abilities then the department could become vulnerable to unsupported workloads. Additionally, if the Lottery fails to source, recruit and internally develop an adequate supply of leadership and key talent it could critically impair the organization’s ability to effectively adapt to changes in the industry and business environment.

The cause of the risk is largely contributable to changing workforce demographics. The large post-war baby Boom generation is now reaching retirement age and although many are deciding to continue to work, there is a high volume of retirements. This is resulting in staff transfers due to increased internal and external promotional opportunities and greater mobility within the state government workforce. It is predicted that in the next five to 10 years, the majority of the U.S. workforce will be composed of workers over the age of 40 and that a greater number of generations will be present in the workforce than ever before. Another significant element is the increased cultural diversity present within the state of California’s workforce. The combined generational and cultural diversity will require Lottery management to learn how to take advantage of the cultural and generational differences while mitigating friction and developing practices to promote collaboration within a diverse workforce.

The result of not having knowledgeable staff with the required competencies will impact the delivery of services and operations for the Lottery and its customers. Ultimately, it may seriously impact the profitability of the Lottery and therefore, the department’s ability to fulfill its mission.

**Control A**

As a department the Lottery has taken the initiative to implement a practice to participate in regular workforce and succession planning exercises to ensure we are proactively addressing the risk. Each January and July, the Lottery evaluates current vacancies and the generational demographics reflected within its workforce. This information is shared with the Deputy Director of each program during scheduled bi-annual workforce and succession planning meetings. During the July meetings, programs are asked to do an in-depth analysis of the business environment, review the strategic objectives, assess both current and future staffing needs, and identify workforce planning risks. This information is documented on a Lottery form called the Division Risk Assessment Worksheet (DRAW), a Workforce and Succession Planning tool that summarizes the business issues and risks that have been identified through the analysis. The form also provides management with a framework to create, document and track a plan of action to address each risk. During the biannual January meeting managers meet with Human Resources to discuss identified risks, challenges and brainstorm possible solutions.

**Risk: Operations - External - New System Implementation (Other Than FISCal)**

The California Lottery participates in draw games that include multiple states and have no control over changes that may occur. Therefore, the risk is, “Unforeseen multi state game changes”.

External governing gaming bodies require changes that California Lottery must comply with to remain a participant.

The changes mandated by the external source places the Lottery in a predicament that requires resource allocation and pushes out other Lottery priorities that arguably would have a larger impact on sales and supplemental funding to education.
We practice preplanning and resource management to the best of our abilities to assist in the need to support the items we have no control over. We periodically reach out to those governing bodies and inquire on any planned upcoming changes so we can better prepare our planning processes.

CONCLUSION

The California State Lottery Commission strives to reduce the risks inherent in our work and accepts the responsibility to continuously improve by addressing newly recognized risks and revising controls to prevent those risks from happening. I certify our internal control and monitoring systems are adequate to identify and address current and potential risks facing the organization.

The Lottery is committed to evaluation of our processes and is dedicated to move forward in the improving of ongoing and internal monitoring practices. We are dedicated to run our programs as efficient and secure as possible.

Hugo Lopez, Director

CC: California Legislature [Senate (2), Assembly (1)]
California State Auditor
California State Library
California State Controller
Director of California Department of Finance
Secretary of California Government Operations Agency