Audit and Legal Committee, Arkansas Lottery Commission
Draft Record
6.30.2011

Commissioner Malone, Chair, called the meeting to order. Commissioners present were Committee members Commissioner Engstrom, Faris, and Pickard, along with Commissioners Frazier and Campbell. Present for the ALC staff were Director Ernie Passailaigue, Internal Auditor Michael Hyde, Vice Presidents David Barden and Ernestine Middleton, Bishop Woosley, Julie Baldridge, Patricia Vick, Lance Huey, Mike Smith, Philip Miley, Rick Lee, and Whitnie Hall.

Commissioner Malone welcomed new Commissioner Frazier and asked Michael Hyde to discuss the Audit plan for Fiscal Year 2012. He briefly outlined the plan (information included in file) and said he would report more formally in the future. He noted a special project, the DF&A Risk Assessment, which he will facilitate; and he said that a review of the Intralot gaming system is now in progress. Legislative Audit and Internal Audit were involved in the planning process for this review. He reported preliminary work on the financial statements and CAFR Review; and noted that Legislative Audit would be working at Lottery headquarters, with his assistance, beginning in mid-July for the next couple of months. He said that the second independent quality review of the Scientific Games instant tickets would take place. He talked about FY2012 first quarter endeavors such as reviews of revenue and prize payments for instant tickets; retailer sweeps; and the revenue and prize payment reserves for the online games. They plan to review high-tier prize payout documentation at all the Claim Centers. He said the monthly reviews would continue, including the Education Trust, travel, and MSR Reimbursement and that he would begin the additional audits when possible.

Commissioner Engstrom noted that he had received a copy of the Intralot service audit report from April 2010 and pointed to the recommendation of a source code escrow. He said it was his understanding that this was accomplished during the last week of June 2011,noting that he had leaned heavily of Auditor Hyde as he learned the ropes as a new Commissioner. He recommended the Commission consider a motion to allow any Commissioner to ask the Internal Auditor for information, protecting his ability to complete his regular audit work by instructing him to speak up if he believes any Commissioner request would impair his day-to-day progress. The motion was seconded by Commissioner Pickard. Discussion followed, with Commissioner Campbell expressing a desire to streamline the audits and Auditor Hyde assuring him that once startup is accomplished over the next two or three cycles the process should be easier. Commissioner Engstrom noted that audits of orderly operations with auditors receiving full cooperation go faster. The vote to approve the motion was unanimous, and the matter will be referred to the full Commission.

Mr. Hyde next followed up on the Legislative Audit of FY 2010, noting that 9 of the 13 findings have been cleared and 24 of his 30 objectives had been met. The ineligible player database is in place, he said, and the comp time issue is expected to be cleared by the end of July. In response to a question from Commissioner Malone, he said the updated report is sent to the Legislative Oversight Committee on a monthly basis. (The report is included in the file.)

Mr. Woosley reported that the escrow agreement for the Intralot source codes was signed on June 28 with National Software Escrow. Commissioner Engstrom asked how long Intralot would need to be inoperable before the ALC can access the source code, citing contract mention of 60 days. Mr. Woosley said it would be immediately accessible. Commissioner Engstrom asked Mr. Woosley when he was asked to be involved, and he said around the first of June. The Director noted that the RFP in which the escrow requirement for the source code originated, which he wrote and in fact was brought in to write, was silent on the date for the escrow. He said that for a launch lottery, the build-out of the online gaming system is unknown at the beginning and is totally different for every lottery. He said that he was

surprised that the first online game—Powerball—was operational by October 31, 2009, just over one month after the first ticket was sold, noting that was very different from South Carolina, which took over three months to launch its first online game. He said the goal was to have the complete infrastructure for this system built out prior to escrow. Commissioner Engstrom compared the delay to building a house before insuring it. The Director said he was not trying to make analogies and that the RFP was drafted without a date for a specific reason. Commissioner Engstrom said his questions arose from his recent appointment to the Commission and from his trying to understand the process. He asked when the Intralot back office system was first used and was told September 28, 2009. He asked if it would have been wiser to set up the escrow as soon as the Lottery became dependent at all on their software in case for some reason Intralot ceased operations. Mr. Passailaigue said, in his best professional judgment, he believes the escrow should not be put in place until the rollout is mature. Commissioner Engstrom said that he did not see the advantage to waiting and cited an exception raised by external auditors a year ago. The Director answered that the method was typical and that there was little exposure. He said implementation before the system was developed was not the rationale of the Commission and the LOC at that time.

Commissioner Faris said he found it difficult to imagine a scenario in which the Legislative Oversight Committee, had they known the escrow had not been set up, would have agreed with the method. He questioned the timing of the escrow contract in conjunction with the questions from the Legislative Auditors and the Commissioners. He said the contract, in his opinion, could have been held up a few days in order to bring it before the Commission; and that stronger perhaps efforts should have been made to place the contract inside Arkansas. He said while he accepted the Director's explanation, he was disappointed. The Director said that there were other back-ups in place with Intralot but that the source code escrow was typically accomplished in two years, after development of the system. He said that while the external McGladrey auditors had brought it up, the Legislative Auditors did not express concern nor ask the ALC to implement the escrow right away. He said that the ALC had been on track in January to get the escrow accomplished when it was learned that current Arkansas law affected implementation of the *Decades of Dollars* game. Following a change in that law during the 2011 General Assembly, the game was put in place, thus building out the online game offerings for the escrow. Thus, he said, work began in January but was stalled until *Decades* could be added.

Commissioner Faris also expressed concern that the recent letter from Legislative Audit relating to this matter was not provided to Commissioners in their packet for the meeting. Commissioner Engstrom produced the letter and read into the record, "As of June 13, 2011, the online gaming vendor has not fulfilled the escrow account requirements of the contract." In answer to Commissioner Faris' concern about the contract being signed prior to the meeting, the Director said that he had placed calls to both the Chair and to the Chair of the Audit Committee (Commissioners Lamberth and Malone) and was unable to reach either. Commissioner Faris emphasized the need for communication. Commissioner Malone confirmed that he had received a call message and commented that, on the one hand, the Director was asked why the contract had not been signed and, on the other, why it was signed prior to the meeting. Commissioner Faris said he meant this to be constructive criticism and that he accepted the explanation.

Commissioner Malone asked how the code would be updated, and Mr. Woosley said that the process was laid out so that the Lottery would be notified in a reasonable time each time there is a change or update. Commissioner Frazier asked what the harm would have been had the document been dated July 1. Commissioner Engstrom asked Mr. Woosley asked whether execution of contracts such as this required Commission approval; Mr. Woosley said the RFPs and RFQs require Commission approval and that the Commission had delegated most other matters to the Director, other than certain matters such as a procurement of more than $75,000 in value. He said that this matter did not require Commission approval.

Commissioner Malone recommended that all Commissioners take a new look at this delegation, which is on the website, and consider whether changes should be made.

Commissioner Pickard recalled that when this process started, when the original RFPs were written, they were quite specific and complicated and that Mr. Passailaigue's familiarity with these matters was why he was hired. He said that it would have been easy to miss under those circumstances, that there may be other matters as yet unearthed, and that he shares Commissioner Faris' regret that the Commission was not brought into the process of the escrow contract.

Commissioner Malone opened the discussion of the Retailer Licensing database at the Department of Information Systems (DIS) that is being closed down in favor of the now-developed Intralot system in that area of business. The Director said that the escrow matter and the DIS matter are two totally separate matters. Commissioner Engstrom said that he understood the difference between data and the source code, but that since the Intralot data cannot be extracted without the source code, he believed they were not separate matters. Mr. Smith said that there were back-ups of the Intralot data and that some of the data would be available. Mr. Barden suggested calling on the Intralot officials present, and Mr. Steve Beck, Regional Director of Intralot, addressed the Commission. He said that there are two systems at their offices in North Little Rock, and a third in Strawnsville, Ohio. He said there was a thorough disaster recovery plan. He said that their retailer database includes the names and addresses of the businesses, the sales, and all of that kind of data. He said that if everything went down, the protective standards of the agreement have been met. Commissioner Engstrom asked what would happen if Intralot employees walk out and asked whether the source code required to use the data on the DIS system. Mr. Beck said that the DIS database was a very small piece of the Intralot system. Director Passailaigue said the multiple audits included risk assessments, and nothing has been brought forth that indicates a risk exists. Commissioner Engstrom brought up the McGladrey SAS 70 audit. Mr. Barden explained that there were emails back and forth with the Legislative Audit on the matter, discussions with Mike Smith, and a discussion in late May or early June with Internal Auditor Hyde.

Director Passailaigue pointed to a comprehensive section of the Intralot RFP that deals with licensing. He referred to it as the Intralot Back Office System (BOS), and said all of the data that is generated through Lottery operation flows through this system. As part of the Intralot agreement, they are required to maintain a system to support the licensing of retailers. He said that the DIS system, as developed by former IT Infrastructure Director Mary VanLeer's department, came later on. He said that the system worked, but that in the middle of 2010, Ms. VanLeer, the former Licensing Manager, and Vice President Middleton came to him to discuss the first licensing renewal process. The licenses were at that time for one year, and the end of the first year was approaching. He said they wanted to work out a system to facilitate this process. As part of that discussion, he said there was in-house capability to handle the build-out in-house, with negligible cost, and that he approved it. He said the Intralot system was running perfectly well but that when his managers want to try something different to enhance a system such as the renewals with negligible cost, he trusts them.

The Director said that Ms. Middleton recently told him that the DIS licensing project had cost about $75,000. He said that he had understood that they would only do the hosting and that the lottery staff would do most of the work, and that that was not the case. Also, he said, a person with Lottery experience and an IT background had recently been promoted to the Licensing Manager position, and had the skills to utilize the Intralot system. He said that the two systems required dual entry, which raised the possibility of error and might even require the hiring of another person to input data. He said that since the Intralot system had worked perfectly well with the original licensing process, he was confident it would work perfectly well for renewals, and that with the above information, he made the decision to stop it.

Commissioner Engstrom said that he had interviewed Ms. VanLeer and that she said the original licensing was performed on a simple Excel spreadsheet and that with 2000+ retailers, the process was cumbersome. She said that Intralot, when presented with the need to improve on the spreadsheet, said that they could not do anything with the retailer application until after the 2010 year end, he said, and that this was the reason the DIS system was developed. He brought forth the Infrastructure Status Reports and Licensing Status Reports, obtained from Mr. Hyde, and said that reading through them, there were glowing reports on how much more streamlined and accessible the retailer information had been made, and on how DIS as a state agency was a stable repository for the information. In that light, he said, when he learned that the process had been reversed, he was not satisfied with the answers he received in the DIS meeting he attended. Director Passailaigue said that he personally had decided to start the project and then had recently decided to discontinue it. He said that the Lottery has projects going with DIS at all times and that he viewed starting and ending some of those projects as routine.

Commissioner Engstrom referred to the DFA analysis on payroll record-keeping and said that he would have liked to see a similar analysis on the licensing record-keeping. He asked why Intralot told Ms. VanLeer that they could not create this licensing application until after the end of 2010. The Director said that he did not know who would have told her that. He said the system had worked for retailer licensing from the beginning. He said this was an experiment to facilitate the renewal process. Commissioner Engstrom said that he was under the impression that the DIS system could be used to check DFA compliance by retailers. The Director said he was unaware of any audit findings that found that the Intralot system out of compliance with state law. Mr. Smith said that a separate debt offset system was in place in the Claim Centers and that DFA could not give Intralot access to their information. Mr. Passailaigue said the Lottery follows up on all retailers that have a bounceback for taxes. Commissioner Engstrom repeated that he would like to see an analysis similar to the payroll analysis. The Director said that both systems can be maintained if it is the will of the Commission.

Commissioner Malone asked where the information is maintained today, and the Director said it was with Intralot. Commissioner Malone asked that whether there was a decision that the Commission needed to make. The Director said that a second, DIS system could be created. Ms. Middleton said that the purpose of the DIS meeting was simply to request a copy of the historical data from DIS in order to fulfill any requests that might come from the auditors. Commissioner Faris said that those unfamiliar with the Lottery could be uncomfortable seeing information taken away from the safeguard of a nearby state agency to save $900. He said there should be a meeting time every month to bring the Commission up to date on detailed matters to avoid questions arising down the road. Commissioner Engstrom moved to give Ms. Middleton authority to get a copy of the data now with DIS; and not to depopulate the database; and that management prepare an analysis similar to the payroll analysis by DFA comparing the risk, rewards and costs of having all the Lottery retailer information with Intralot, all with DIS, or some level of backup between the two. The Director reminded the Commissioners that Intralot is required by contract to maintain this information. The motion was approved unanimously.

The Director said that as a result of the FY2010 Legislative Audit, the Lottery had two management concerns: payroll and the Peachtree system. He said the Lottery has corrected the issue with the Peachtree system, and is now looking at the payroll system, having to do with the number of fields available. The question arose, he said, whether the Lottery should use AASIS for payroll. He noted the Lottery's good working relationship with DF&A, particularly with the Director of the Office of Accounting Paul Louthian. DF&A produced an analysis offering several options for finance, HR, payroll, and/or all other options, and the associated upfront and ongoing costs. He said they also produced other options for payroll, available in the private sector. Commissioner Engstrom said that he had the analysis reviewed by an expert at his accounting firm, who recommended Peachtree Quantum as the

lowest cost choice with the ability to accomplish all that is needed. He said, based on the Audit comments, that some internal controls should be buttoned up.

The Director said that he was seeking guidance from the Commission to reach a solution to the deficiency with the least possible cost, and that he would work with the Internal Auditor to do the needed buttoning up. Commissioner Malone noted that representatives from Legislative Audit were present in the audience and invited any comments, which they declined. He asked Mr. Hyde for a response, who deferred to Commissioner Engstrom's recommendation and said that Ms. Middleton had put a number of internal controls in place, with a review every pay period. Ms. Middleton confirmed that the procedures were in place to address issues raised in the FY2011 audit, for example to control the number of positions and assure no one is on the payroll in error. Mr. Hyde said those actions should address the Legislative Audit findings. Commissioner Engstrom moved to recommend option 6 with the additional internal controls as discussed, with a second from Commissioner Pickard. The motion passed unanimously.

The issue of retaining outside legal assistance was brought forth. Commissioner Pickard noted that the matter had been discussed on a number of occasions by the Legal Committee prior to the recent merger with the Audit Committee and noted that at that time there was an attorney on the Legal Committee. He said his background with this type of situation is as a member of the Arkansas Student Loan Authority Board, another self-funding state agency. The ASLA Board attorneys on retainer work with the Attorney General's staff, he said. He commended the work of Bishop Woosley, ALC Chief Legal Counsel, and said the proposal is not connected to Mr. Woosley, in whose abilities he has confidence. He said a private firm would provide institutional memory that would hold the agency in good stead for the long term, beyond current staff and current Commissioners. The firm would also, he said, give ALC Counsel assistance and another set of eyes to review contracts and legislation in addition to the LOC, which would provide additional backup for the agency; would give Commissioners and the Internal Auditor another contact for a legal opinion when a particular issue puts Mr. Woosley in a position of answering to both the Commission and top lottery managers; and he brought in the ASLA Board RFP as a model for a similar document for the ALC. He reported the ASLA Board annual budget for private counsel is $85,000, which includes a monthly base retainer and grows above that only when they are called on for specific work. He gave as an example the current ASLA Board litigation over federal legislation in Virginia, which their private firm is handling in conjunction with a firm in that state. He said that as a Commissioner, he wanted that kind of experience, the institutional memory and the extra set of eyes. Commissioner Faris agreed and said it would be good to have in place when there arises a conflict for existing legal counsel and pointed out that the firm would not be relied on all the time but would be in place when the help is needed.

Commissioner Engstrom also praised Mr. Woosley's abilities and helpfulness. He said he had felt uncomfortable discussing some issues with him so as to avoid putting him in an awkward situation, especially since ALC legal counsel has been terminated before. He also pointed out that Mr. Woosley had more than enough work to fill each day, and that outside counsel could be called in should a specific and complicated issue arise, permitting the in-house counsel to fulfill his regular responsibilities. He also said that he does business with a number of attorneys in Arkansas and, should one of those firms submit a proposal, he would recuse from the selection process. Mr. Woosley said that, as the Commission is aware, he worked at the Attorney General's Office for a time prior to coming to the ALC, that they provide free legal counsel to state agencies, and that he visits with them several times each month in the manner described above for private counsel. Commissioner Pickard moved to recommend that the Commission prepare and issue an RFQ for the retention of outside legal counsel, seconded by Commissioner Faris. Commissioner Campbell asked why the Attorney General's office could not do this work. Commissioner Engstrom said that he saw a variety of reasons: the AG's office has about 90 attorneys, and a lot of issues could arise where there is no one there with the particular expertise needed; that once a firm is retained, the attorneys

develop a knowledge of the history and practice of the agency; and it would avoid involving internal counsel in some issues. Commissioner Malone pointed out that this is merely a motion to recommend preparation of an RFQ and that there would be ample time to discuss the fine points prior to issuance. The Committee approved the motion without dissent.

Commissioner Malone noted that the Commission and the Committee are two years into its operation. He said he felt privileged to be a member of the Committee and to serve as its Chair, and commended Mr. Hyde for his good work for all nine Commissioners. He said it was time for the newly constituted Legal and Audit Committee to elect a Chair and Vice Chair. He declined to be re-nominated and opened the floor for nominations. He asked Commissioner Pickard to serve in some capacity because of his institutional knowledge and hard work. Commissioner Engstrom thanked Commissioner Malone for taking the reins and sacrificing a great deal of time during startup. Commissioner Engstrom then nominated Commissioner Pickard for Chair, with a second from Commissioner Faris, which motion was approved without dissent. Commissioner Faris nominated Commissioner Engstrom for Vice Chair, seconded by Commissioner Pickard, and approved without dissent.

Commissioner Pickard assumed the Chairmanship. The Director reported that there had been two replies to the RFQ for the CAFR process. Mr. Woosley said one firm had emerged as the top contender and that he expected to bring the information to the Commission to refer to the Audit and Legal Committee. He said he would get the information to them prior to the next meeting, including the executive summary, after the evaluation is firm. Commissioner Engstrom asked whether the Commissioners would have an advantage of being able to re-inspect the process and rankings. Mr. Woosley said they would have the scoring and the evaluation criteria and that he would be available to answer any questions. Commissioner Pickard asked for a status update on the two matters under litigation. Mr. Woosley said one was under appeal at the Arkansas Court of Appeals on a sovereign immunity issue and that the Commissioners had received the documents on that. He said that a motion to dismiss had been filed in the matter involving Ms. Frazier, that a response has been filed by plaintiff, and that he expected action by Judge Wright on the motion in August or September.

Commissioner Pickard distributed a copy of an analysis of changes in the ALC Organizational Chart from the one that existed when the Personnel Manual was completed and the one prepared within the past few weeks. He said that he had asked the Internal Auditor to outline the numerous changes for ease of use by the Commission.

Commissioner Malone asked for an update on the FY2011 budget from the Director, who reported that he had just marked his two-year anniversary and that he appreciated the opportunity. He recalled the record startup time, not because it was a record but because it got the scholarship money rolling in. How have we done so far? He quoted Ms. Baldridge noting gross sales of more than $800 Million, and he examined what that had meant for scholarships. He said the FY2011 budgeted sales were $465 Million and that he expected to be spot on. He said that the original projection of $104.8 Million for scholarships, which was reduced to $100 Million in January, would likely come in at around $98 Million. He pointed out that this was still far in excess of the originally predicted $55 Million. The outcome, he said, was caused by the unexpectedly high percentage of instant ticket sales and the related loss of gross profit from sales skewed to the less profitable and higher prize-cost instant tickets. He said that the budget was not off on projected expenses including marketing and administrative expenses. He said a carryover of $1 Million in unclaimed prize funds would be utilized in a judicious manner. He said that while the Lottery may not have met its own goal for the year, it had exceeded the state's earlier stated goals when the doors opened, of a January 2010 startup and $55 Million in annual scholarship revenue. He noted that there were about 6000 Challenge Scholarships in FY 2009 and expressed gratitude that, with the Lottery dollars, there were more than 30,000 Challenge Scholarships in FY 2010. This year, he said that the ADHE was sorting through 155,000 applications, which is a good thing. He said he was mindful that there was a social responsibility with the lottery, as a game of fun

and entertainment and not with the expectation of winning a prize. He said that for the future he wanted the entire staff to redouble its efforts, treat each day as a learning experience, and do a better job. He acknowledge the Commission, stating that the staff works at their direction, and said whatever the Commission's will is, the staff will undertake to follow. It was reported that ADHE and Director Broadway will present a comprehensive report on scholarships at the next full Commission meeting.

Commissioner Engstrom referred to an annual report on the South Carolina Education Lottery showing that the cost for gaming vendor services appeared to be higher in Arkansas than in South Carolina. The Director said that the online and instant ticket costs in South Carolina are low because state law requires a fixed fee rather than a percentage payment to the vendors, who always underestimate how much the SCEL will sell. He said to get the Arkansas Lottery started early, the percentage bid was a better way to go. Commissioner Engstrom confirmed that there was only one bidder, Intralot, for the online contract and asked whether they knew they were the only bidder. The Director said that they did not.

Commissioner Engstrom said that using the percentage vs. the fixed fees, Arkansas was taking a huge hit. He also asked for clarification on the unclaimed prizes. The Director said there were two elements of unclaimed prizes: the instant tickets, which accrue unclaimed prizes 180 days after end-of-game announcement; and the online games, when the unclaimed prizes accrue 180 days after the draw. The Lottery does not control the online prizes but does control when an instant ticket game closes out. He noted that the Lottery now is getting closer to a mature cycle, which can still produce unpredictable profits because of circumstances such as an unclaimed million dollar winner. He said that the unclaimed prize percentage in South Carolina, after the Lottery there matured, was about 2 per cent. The original legislation gave the Lottery the ability to use unclaimed prize money for business needs, such as promotional activities to generate more sales. Most lotteries use their unclaimed prizes for similar purposes, he said. Then, in the 2010 fiscal session, the unclaimed prizes were classified as net profit and transferred immediately to scholarships. The 2011 session resulted in the unclaimed prizes being released to the Lottery in the amount of $2.5 Million, with a $1 Million holdover at the end of each year allowable. Commissioner Engstrom asked why these amounts couldn't be handled in the same way as regular revenue and run through the budgeting process. The Director said that no unclaimed prizes would be spent without coming before the Commission. Commissioner Engstrom said that he would oppose keeping the unclaimed prizes in a separate pot outside of the budget process, to keep the focus on what the Lottery is spending and why. The Director said that a reserve fund was prudent because of unpredictable liabilities caused by, for example, an Arkansas *Decades of Dollars* jackpot winner shortly after the game was introduced, putting the Lottery temporarily into a deficit situation until future *Decades* profits can come in.

Commissioner Pickard added his voice to express appreciation to Commissioner Malone for his extraordinary service as Chair of the Audit Committee. He also thanked Mike Hyde and Whitnie Hall for their service. He suggested a monthly meeting on a set date, which could be cancelled if there are no agenda items. Commissioner Engstrom expressed an interest in a teleconference system that would allow those calling in to see all other participants. He said that such a system would reduce the need for staff travel for conferences with vendors and could also assist Commissioners, the press, and the public in attending or observing Commission meeting when they could not be present. The Director said that there had been some study done on conferencing and Ms. Middleton said that she could look into video conferencing. It was remarked that the Parole Board had that system. It was agreed that Ms. Middleton would further look into adaptations to accommodate those calling in, including availability to members of the press and the general public. The Committee members then agreed to meet each month on the first Friday at 10 a.m., with the first meeting in August. They also agreed on the name Audit and Legal Committee.

There being no further business, the meeting was adjourned.