

Finance Audit Committee Meeting
New Mexico Lottery Authority
August 23, 2017
MINUTES

Call to Order: M. Koson called the meeting to order at 11:37 a.m., and asked for a roll call. Present and constituting a quorum were; Mark Koson, John Kubiak and Dan Salzwedel.

Present from NMLA were; David Barden, Sylvia Jaramillo, Michael Boland and Wilma Atencio. Also present were; Jon Zajdel and Steve Beck with Intralot; Rich Encinias and Elizabeth Nunez with CliftonLarsonAllen.

Approve Proposed Agenda: M. Koson entertained a motion to approve the proposed agenda. J. Kubiak made a motion to approve the agenda; second by D. Salzwedel. Carried; 3-0.

Public Comment: None.

FINANCE AUDIT Committee Report – M, Koson, Committee Chair:

Audit Entrance Meeting: S. Jaramillo introduced members of CliftonLarsonAllen to the committee members - Elizabeth Nunez, Sr. Associate and Richard Encinias, Associate. E. Nunez distributed a packet that outlines the audit entrance conference which includes, the engagement team, required communication, planned scope of services, timeline and other matters in the upcoming FY 2017 Financial Audit. E. Nunez stated that Matt Bone, Principal of the engagement team will also be assisting with the audit. CliftonLarsonAllen will be utilizing the Auditing Standards and Government Auditing Standards by forming and expressing opinions about the financial statements, internal controls over financial reporting, planning and performing the audit to obtain reasonable assurance that the financial statements are free from material misstatement, communicating significant and particular matters. The audit will take 2 weeks beginning August 21st. The reporting and review will occur during the month of September and submission to the office of the State Auditor is October 19, 2017.

J. Kubiak asked if this was the second year of the engagement? E. Nunez stated yes.

S. Jaramillo reported that the exit conference should take place prior to October 19th. The committee requested a couple of dates to schedule the Exit Audit Conference. No other questions.

Financial Statements: S. Jaramillo presented the fiscal year financial statements. The lottery has returned \$37.8 million to the Legislative Lottery Scholarship fund. \$8.5 million less than FY16 – the lottery returned \$46.3 million that year. The net revenue is nearly \$287,500 more than the FY17 revised budget. We have returned over \$738.7 million to the State of New Mexico for education since the inception of the Lottery.

FY17 net instant sales were approximately \$72.4 million, whereas last year they were \$83.1 million. Instant ticket sales have decreased more than \$10.7 million from last year.

Net Drawing Sales were approximately \$53.6 million, nearly \$17.6 million less than FY16 which had sales at \$71.2 million. The difference is a result of PB and instant ticket sales.

Total game expenses at the end of the year were 99.79% of the revised budget, while operating revenues at the end of the year were 100.73%; both tracking within 1% of each other. Actual game expenses were 66.57% of gross revenue and the budget was 67.22% of gross revenues.

Operating expenses ended the year at 3.41% of total gross revenue. Costs were held as much as possible and came in less than budgeted amounts. Operating expenses compared with last fiscal year shows a \$598 thousand decrease with \$259 thousand for salaries, wages and benefits.

S. Jaramillo reported that if she was calculating the numbers for 2017 using the number from 2007 of \$91.4 million and even though we would be returning 28%, the lottery would be returning after all costs, at least \$3 or \$4 million more. The average payout before the mandate was 63.13% and last year our payout was 60.75%. The 30% is hampering lottery goals of maximizing revenue for the scholarship fund.

D. Barden reported that under the direction of the board, the lottery has saved more money and generated more internal savings than any other entity in the state over a period of time.

S. Jaramillo presented the July 2017 Financial Statements. The lottery has met its statutory return of 30% for July and we have returned \$3.1 million and with July's transfer, we will return nearly \$741.9 million to the scholarship fund.

Net instant sales for July were approximately \$6.1 million whereas last year they were \$6.097 million, a \$36 thousand increase - .59% increase. They're over budget by more than \$900 thousand or 17.2%.

Net Drawing game sales for July were approximately \$4.5 million, \$186 thousand less than YTD Budget or 4% less than budget and nearly \$2.8 million less than FY17 – 38.4%. Powerball sales were \$1.9 million less than last year; Mega Millions was \$1.1 million less than last year. In July 2016, the PB Jackpot was at \$487 million and Mega Millions Jackpot was at \$536 million. As of July 2017, the PB Jackpot is at \$239 million and Mega Millions has a Jackpot of \$282 million, a significant difference in Jackpots and some Jackpot fatigue.

Roadrunner Cash sales were \$127 thousand more than last year and Hot Lotto sales were \$54 thousand more than last year.

Total game expenses were 107.08% of the YTD Budget, while Operating Revenues ended at 107.26% of Budget.

Operating expense was 2.46% of total gross revenue a \$39 thousand decrease over last year.

S. Jaramillo reported that \$170 thousand had to be used from the unclaimed prize expense to meet the 30% return to the state for July 2017.

No Further discussion or questions.

Banking Resolution – Line of Credit: S. Jaramillo reported that the resolution and certificate of incumbency is for a Line of Credit that the lottery has with Wells Fargo Bank. The Line of Credit has been in place since May 2012 for \$4 million dollars and renews annually. This resolution is part of the lottery's Banking and Related Services agreement with Wells Fargo. This line of credit was established in the event that for whatever reason the lottery's cash balance isn't sufficient to pay for our prizes, vendor fees or other costs, we have access to these funds so we don't go NSF. There are no fees if the line of credit isn't used.

This year, Wells Fargo requested that this document be approved by the Board of Directors and provided an initial resolution which stated that any one person can implement the line of credit via telephone or written communication. After internal discussion between the CEO and Director of Administration, it was determined and in the best interest of the lottery if the resolution would require "ANY TWO" of three

individuals must be in agreement to implement the line of credit through written communication only. Copies of the new resolution were distributed to the committee members.

D. Salzwedel made a motion to approve the Banking Resolution – Line of Credit document as presented; second by J. Kubiak. Carried; 3-0.

Online Gaming System Vendor Penetration Testing Report: M. Boland presented an overview of the Online Gaming System Vendor Penetration Testing report. As part of the NMLA's Online Gaming System RFP and contract, the online vendor is required, at a minimum to perform annual security assessment and penetration testing to assess and test the security and integrity of their online gaming system. This annual activity is critical due to the ever-changing and increasingly complex nature of cyber-security.

The first penetration test was due Nov. 2016, but was delayed until the second quarter of 2017. PriceWaterhouseCooper's (PWC) conducted a penetration testing report issued May 18, 2017 and made available on May 30, 2017. A total of 21 risk findings were found ranging from 1 high risk, 12 medium risk and 3 low risk findings. Lottery staff shortly thereafter met with PWC and Online Vendor to discuss issues, including remediation.

The high-risk finding was partially remediated on August 14th with full remediation expected by August 18th; Eight medium risk findings were remediated over two days - August 14th-15th. Because of significant game enhancements to Powerball, Mega Millions, Hot Lotto and Lotto America the remaining 12 risk findings were deferred for remediation until after all online game changes had been tested and deployed.

Internal Audit's conclusion based on the testing performed, the gaming system will appear to have sufficient controls present and functioning to mitigate risks and vulnerabilities to an acceptable level. Internal Audit recommended two best practice recommendations:

1. Complete the next scheduled penetration test by November 20, 2017 to comply with the NMLA Online Gaming System RFP.
2. Complete remediation of penetration testing findings in a more timely manner.

Board members questioned aspects of the penetration testing, including frequency. M. Boland stated that each individual lottery determines the penetration testing based on their preferences and risk assessment they have received from Cyber-security.

D. Barden reported that "vendor penetration testing" was not required of the vendor in the past and has only occurred during his tenure. The vendor has a closed in system which is slightly different from the lottery as far as the security level. Beginning next year, Intralot will be going to an ISO System – International Standard. Intralot will be certified through an international certification program for this type of penetration testing. This will be another layer of security on top of what we currently do, which is somewhat redundant. The scope of future penetration testing will be reviewed in the future. Some states conduct testing regularly and some don't. The RFP states yearly testing, which was arbitrarily picked by the lottery during the RFP process. The lottery has four (4) software releases per year to implement programming changes. The vendor chooses the most critical action items for deployment based on the CEO's priority list.

D. Salzwedel asked to define "closed in" system? S. Beck with Intralot reported that a closed in system is a system that has no interaction with its external environment. Does not interact with or receive input from other systems. Intralot's system is monitored by two (2) individuals 24 hours a day.

M. Koson asked Internal Audit what type of action is required with this report. M. Boland reported that he is requesting approval and acceptance of this report. M. Boland reported that the report was issued prior

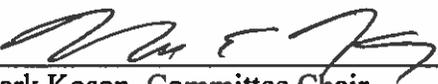
to the date listed on the follow up, but as of today – August 23, 2017 at this committee meeting the finding has not been fully remediated, only partially remediated. After more discussion, the committee recommended changes to the report prior to proceeding with the acceptance of this report. Internal Audit was asked to make the required changes prior to the Board meeting at 1pm.

D. Salzwedel made a motion to accept the Online Gaming System Vendor Penetration Testing report with the conditions identified by the Internal Auditor; second by M. Koson. Carried; 3-0.

Lottery Bucks Compliance Audit Recommendation Update: M. Boland reported this is a follow up report that S. Baragiola requested at the previous Board meeting. It was recommended that Intralot consider increasing the number of lottery buck's distributed in the field by the FSR's. This goal has been achieved. Intralot significantly increased its distribution to players by 400% increase in a two-month period. Intralot is committed to maintaining these distribution level. This matter is remediated and closed.

Other: None

ADJOURNMENT: M. Koson entertained a motion to adjourn the finance audit committee meeting. D. Salzwedel moved to adjourn the meeting; second by J. Kubiak. Carried; 3-0. The meeting adjourned at 12:56 a.m.



 Mark Koson, Committee Chair
 Date 11/15/17