



## *California State Lottery*

The Lottery Has Not Ensured That It  
Maximizes Funding for Education

*February 2020*

**REPORT 2019-112**





**CALIFORNIA STATE AUDITOR**

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February 25, 2020  
**2019-112**

The Governor of California  
President pro Tempore of the Senate  
Speaker of the Assembly  
State Capitol  
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As directed by the Joint Legislative Audit Committee, my office conducted an audit of the California State Lottery (Lottery). Our assessment focused on whether the Lottery was maximizing its funding for education, and the following report details the audit's findings and conclusions. In general, we determined that the Lottery has not ensured that it maximizes funding for education and the State Controller's Office (SCO) is not effectively overseeing the Lottery's performance.

The Lottery has not followed state law, which requires it to increase its funding for education in proportion to its increases in net revenue. As a result, in fiscal year 2017–18, the Lottery failed to provide \$36 million in funding for education. Further, the Lottery cannot demonstrate that its current prize payout rate is optimal for maximizing funding for education, leaving it unable to know whether it is diverting too much funding to prize payments. Finally, our review of a selection of the Lottery's procurements identified that it often entered into noncompetitive agreements without adequate justification. Consequently, the Lottery may not have received the best value on these agreements, which could reduce the funding it provides to education.

Furthermore, the SCO has not effectively carried out its responsibility to oversee the Lottery's performance, which it conducts through its audits and other means. Notably, the SCO inappropriately removed a finding from an April 2019 audit report, which questioned costs of \$720,000 related to trade shows, after the Lottery requested changes to this finding. Further, the SCO's audits of the Lottery do not review the efficiency and effectiveness of the Lottery's operations. These deficiencies cast doubt on the SCO's approach to its audits of the Lottery. Finally, the SCO did not adequately assess the Lottery's performance related to changes to state law in 2010, including assessing whether Lottery's funding for education was proportional to its increases in net revenue. Because state law generally exempts the Lottery's operations from oversight by the Department of General Services and the Department of Finance, weaknesses in the SCO's oversight leave the State without effective, independent, and ongoing monitoring of the Lottery's performance.

Respectfully submitted,

A handwritten signature in black ink that reads 'Elaine M. Howle'. The signature is written in a cursive, flowing style.

ELAINE M. HOWLE, CPA  
California State Auditor

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## SUMMARY

Voters created the California State Lottery (Lottery) in 1984 to provide additional money to benefit education. In 2010 the Legislature amended the California State Lottery Act (Lottery Act) and authorized the Lottery to set its prize payout amounts in such a way as to ensure that it provides the maximum possible funding to education. For this audit, we reviewed the Lottery's revenues allocated to education, its operational practices, and the State Controller's Office's (SCO) oversight over the Lottery. This report draws the following conclusions:

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### **The Lottery has not provided required funding to education.**

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The Lottery did not adhere to a requirement to increase its funding for education proportionate to its increases in net revenue. As a result, the Lottery failed to provide required funding of \$36 million to education in fiscal year 2017–18. Further, the Lottery cannot demonstrate that its current prize payout rate is optimal for maximizing funding for education. Its only study on the optimal prize payout rate is 10 years old and the Lottery has not adhered to that study when planning its most recent budgets. Without accurate and up-to-date information about the optimal prize payout rate, the Lottery cannot demonstrate it is maximizing funding for education.

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### **The Lottery's procurement practices do not always ensure that it obtains the best value.**

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The Lottery's regulations require it to follow a competitive bidding process for its procurements unless the procurement falls under certain limited exceptions. However, the Lottery had inadequate evidence that of 15 contracts we reviewed, the Lottery had followed its contracting regulations before entering eight noncompetitive agreements—totaling \$5.7 million in value. Further, the Lottery had no evidence that it evaluated whether it obtained best value for 17 other agreements valued at about \$720,000. The Lottery is generally exempt from Department of General Services (General Services) oversight of its procurement activity. However, our review shows that regular external review by the SCO of its procurement activity would create necessary accountability.

**The SCO has not effectively overseen the Lottery's performance.**

The Lottery Act assigns primary oversight responsibility over the Lottery to the SCO. However, the SCO inappropriately removed a significant finding from a recent audit report after the Lottery disputed the finding. It also submitted a report to the Legislature about the Lottery's performance that was actually written by the Lottery, without adding its own independent analysis. Finally, its audits do not include reviews of the Lottery's effectiveness or efficiency. These gaps leave the State without effective, independent, and ongoing oversight of the Lottery.

**Other Areas We Reviewed**

We reviewed the Lottery's operational and administrative expenses for the last three fiscal years and found that the Lottery's spending in these areas remained within the limits set by the Lottery Act. We reviewed a selection of the Lottery's justifications for adding new staff positions and found that the Lottery adequately justified additions to its staff. Finally, we also reviewed 30 questionable prize claims that the Lottery investigated and paid out, and found that the Lottery's investigators took reasonable steps to investigate the claims and used similar standards of evidence when recommending that the Lottery pay the prize claims.

**Summary of Recommendations****Legislature**

The Legislature should require the Lottery to pay the \$36 million it owes to education and it should require the SCO to conduct regular audits of the Lottery's procurement processes.

**Lottery**

By August 2020, the Lottery should determine the optimal prize payout rate and use that rate when setting its future budgets.

By August 2020, the Lottery should develop procurement procedures that explain how it determines that it is exempt from competitive bidding and that require its staff to maintain documentation supporting cases where it believes it is exempt from competitive bidding.



## **SCO**

The SCO should immediately begin adopting policies and procedures that ensure that it publishes all relevant findings in its audits of the Lottery and includes effectiveness and efficiency reviews as part of its oversight of the Lottery.

## **Agency Comments**

The Lottery disagreed with our conclusion that it has not maximized funding for education and it took issue with certain aspects of our other conclusions. However, the Lottery agreed with many of the recommendations that we made. The SCO disagreed with our conclusion that it has not effectively overseen the Lottery's performance. The SCO did not address whether it would implement our recommendations.

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# Introduction

## Background

In 1984 California voters approved Proposition 37, also known as the California State Lottery Act of 1984 (Lottery Act), which established the California State Lottery (Lottery). According to the Lottery Act, the Lottery's purpose is to provide additional money to benefit education without the imposition of additional or increased taxes. The Lottery Act specifies that the funding the Lottery provides to education will be used only to supplement the total amount of money allocated to public education in California. The Lottery Act prohibits the transfer, loan, or appropriation of state funds to the Lottery. Instead, the Lottery relies solely on the revenue generated from the sales of its games to fund its operations and make prize payouts.

## The Lottery's Mission and Organization

Consistent with its purpose as set forth in the Lottery Act, the Lottery states that its sole mission is to supplement funding for California's public schools and colleges. State regulations authorize the Lottery to distribute and sell lottery tickets directly to the public. With the money it generates from ticket sales, it pays for its operational and administrative costs, makes prize payouts, and provides funding to education. The allocation of money the Lottery gives to education is governed by the Lottery Act. According to the Lottery, the State's K–12 public schools have received the majority—about 80 percent—of the funding that it has provided to education. The remainder goes to the State's community colleges, public universities, and specified educational programs. These funds, which supplement the State's allocation, are a small portion of the State's overall funding for education. In fiscal year 2017–18, the Lottery provided over \$1.7 billion to education, which was about 1 percent of the State's annual budget for public schools.

The Lottery Act also establishes the California State Lottery Commission (Lottery Commission), which consists of five members appointed by the Governor with the consent of the California Senate. The Lottery Commission is required to promote and ensure integrity, security, honesty, and fairness in the operation and administration of the Lottery. It is responsible for approving the Lottery's budget and business plans. Moreover, the Lottery Act requires the Lottery Commission to promulgate regulations that specify the types of lottery games the Lottery can conduct and to establish a system for paying prizes. There have recently been changes in the Lottery's leadership. Specifically, the Governor appointed the Lottery's current executive director in June 2019, chief deputy director in July 2019, and chief legal counsel in August 2019.

Under the Lottery Act, the State Controller's Office (SCO) is the primary entity responsible for oversight of the Lottery. The Lottery Act requires the SCO to conduct audits of the Lottery on all accounts and transactions and to perform any additional audits the SCO deems necessary. The Lottery Act generally exempts the Lottery's operations from oversight by the Department of General Services (General Services) and Department of Finance (Finance). Further, provisions of the State's Public Contract Code generally do not apply to the Lottery's expenditures,

and the Lottery is not subject to oversight by General Services for contracting services. Additionally, although the Lottery must provide informational reports on budget and revenue to Finance, the Lottery Commission, not Finance, approves the Lottery's budget.

### 2010 Changes to the Lottery Act

In April 2010, the Legislature amended the Lottery Act and changed the requirements for how the Lottery must allocate its revenue. Those amendments took effect that same month. Before those amendments, the Lottery Act required the Lottery to provide at least 34 percent of its total annual revenue to education. However, over several years before the 2010 changes, the Lottery experienced declining revenues, along with declining funding for education. Specifically, between fiscal years 2005–06 and 2008–09, the Lottery's revenues declined by \$630 million and the Lottery's funding for education decreased by \$240 million. In changing the Lottery Act in 2010, the Legislature aimed to correct this trend and provide the maximum possible funding for education. The Legislature also declared that, according to the experience of other states, increases in the share of sales revenue allocated to prizes increased lottery ticket sales, which then increased the amount of funding available to the beneficiaries of those state lotteries. In summary, the changes moved the Lottery away from a strict required percentage of revenue to education. Instead, the changes allowed the Lottery to determine what percentage of its revenues should go to support education while meeting the requirement that the Lottery maximize funding for education. Figure 1 summarizes the changes the Legislature made to the Lottery Act's funding allocation requirements. Also in April 2010, the Legislature established that—beginning in fiscal year 2015–16—the Lottery was required to increase the amount it provides to education annually in proportion to the increases in its net revenues (proportionality requirement). For the purpose of the proportionality requirement, we have defined *net revenue* as the Lottery's total sales revenue minus its administrative and operational expenses.

#### The SCO Was Required to Report on Whether These Two Conditions Occurred:

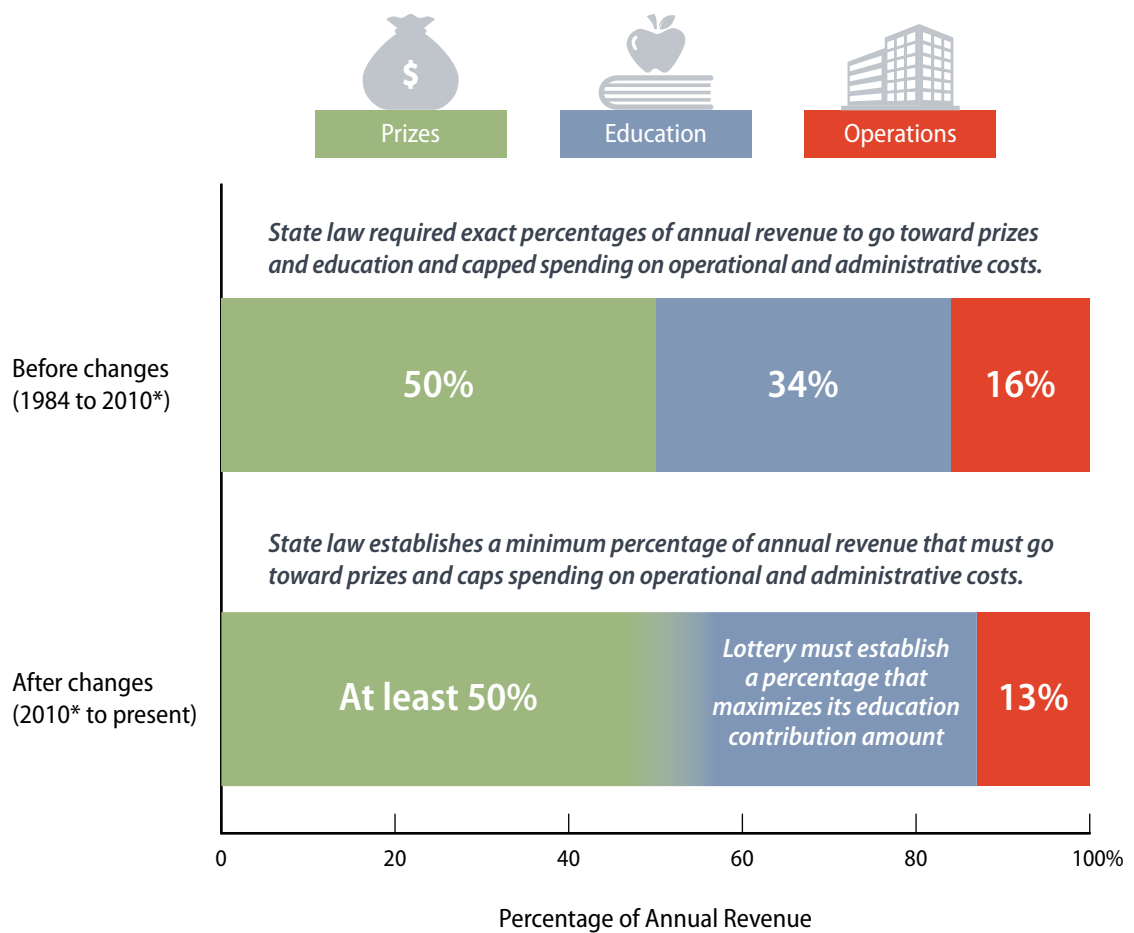
- Total net revenue allocated to education was less than the amount the Lottery provided in fiscal year 2008–09.
- The annual average total net revenue allocated to education did not increase according to rates specified in the Lottery Act.

Source: The Lottery Act.

Further, the 2010 changes required the SCO to monitor and report on the Lottery's performance for each of the first five fiscal years after the amendments took effect to determine whether two conditions were met, as the text box shows. The 2010 amendments to the Lottery Act established that if the SCO reported that the Lottery failed to meet both of these criteria, the Legislature's 2010 amendments would automatically be repealed by operation of law. The SCO concluded in March 2016 that during the five-year period the Lottery's education funding did not grow

according to the rates specified in the Lottery Act but that funding never declined below fiscal year 2008–09 levels. Therefore, the 2010 amendments became permanent when the SCO published its March 2016 report.

**Figure 1**  
**Lottery Spending Requirements Before and After Changes to State Law**



Source: The Lottery Act.  
 \* The Lottery Act changed on April 8, 2010.

Since that time, questions have remained about whether the Lottery has done all it can to maximize the revenue it directs to education. Specifically, publicly available information shows a wide gap between the Lottery’s total revenue and the amount it annually provides to education. Members of the Legislature have questioned

whether the Lottery has directed enough of its revenue to education in light of the fact that its total revenue and education funding have increasingly diverged since the 2010 amendments. The approaches the Lottery takes to maximizing education funding are the focus of this audit.

# The Lottery Has Not Provided Required Funding to Education

## Key Points

- The Lottery failed to provide \$36 million in funding to education in fiscal year 2017–18 because it did not budget to adhere to the proportionality requirement in the Lottery Act.
- Despite a requirement to maximize funding for education, the Lottery does not have an up-to-date analysis of the optimal balance between prize payouts and education funding. In other words, the Lottery does not know whether the prizes it offers result in the most possible funding for education.

## The Lottery Failed to Meet a Critical Requirement for Education Funding

As illustrated in Figure 1 in the Introduction, in 2010 the Legislature adjusted the requirement for how much of its revenue the Lottery is required to provide to education. Before these changes to the law, the Lottery Act required the Lottery to provide a specified percentage of its revenue to education. The 2010 changes placed the Lottery under less prescriptive requirements, which the text box describes. It is critically important that the Lottery adhere to these requirements because they are safeguards that ensure that the Lottery's education funding increases as the Lottery's revenues increase and that the education funding is at its highest possible level and does not decline sharply from one year to the next.

### Lottery Act Requirements for Education Funding

The Lottery must do the following:

- Increase funding in proportion to any increase in net revenue.
- Maximize total net revenue allocated to education.
- Provide at least as much funding to education annually as the average of the past five fiscal years.

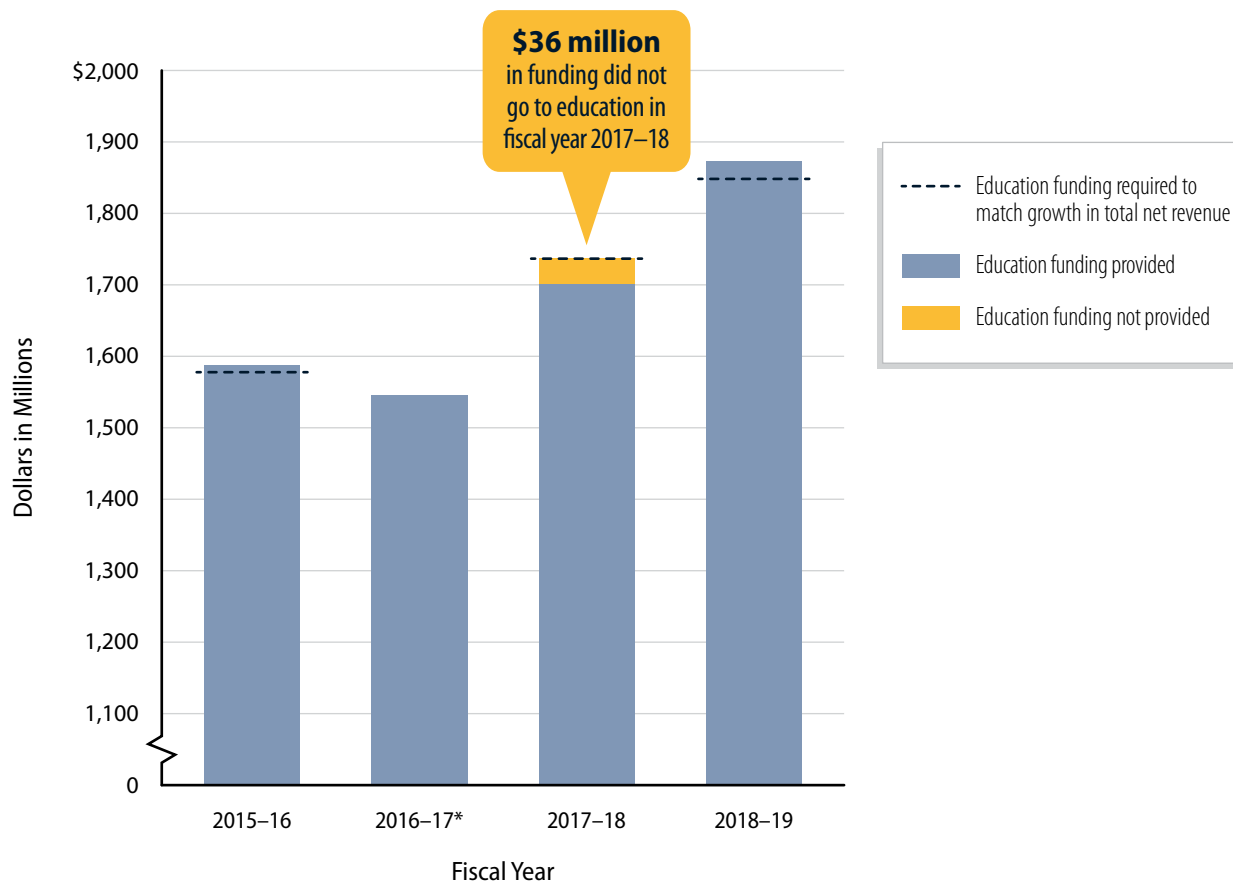
Source: The Lottery Act.

Despite their importance, the Lottery has not ensured that it follows all of these requirements, and as a result, it failed to provide \$36 million to education. As we discussed in the Introduction, since fiscal year 2015–16 the Lottery Act has required the Lottery to increase its annual education funding in proportion to the increases in its net revenues—which we define as total sales revenue minus the Lottery's administrative and operational expenses. If the Lottery had adhered to this proportionality requirement, it would have provided education with \$36 million more than it actually provided during fiscal year 2017–18. We calculated this dollar value by reviewing the changes in the Lottery's net revenues, determining the education funding that would have resulted from an increase in proportion to the change in net revenues, and then comparing that to the actual amount the Lottery provided to education. As Figure 2 shows, the Lottery exceeded its required

education funding in two fiscal years where the proportionality requirement was applicable, but it also failed to provide the required funding in the other year.

**Figure 2**

**The Lottery Has Not Met Required Education Funding Levels, Totalling \$36 Million in Funds That Did Not Go to Education**



Source: State law, audited financial statements from the Lottery fiscal years 2015-16 through 2017-18, and unaudited financial data from fiscal year 2018-19.

\* The Lottery is required to match growth in total net revenue only in fiscal years where net revenue has increased from the previous fiscal year. In fiscal year 2016-17, net revenue had decreased so the Lottery did not need to match growth.

In response to our conclusion about its education funding, the Lottery's deputy directors of finance and business planning stated that the Lottery does not believe that the 2010 changes to the Lottery Act require a direct proportional relationship between net revenue and education funding. We disagree with the Lottery's interpretation and believe that the Lottery has not accepted the commonly understood meaning of proportionality. Under its interpretation, the Lottery could satisfy the proportionality requirement by simply raising the amount of education funding by a small fraction of the increase in its total net revenue rather than the maximum amount.



According to these deputy directors, the Lottery believes it has met the intent of the 2010 changes to the Lottery Act by increasing the gross dollar amount of its annual funding for education. They argued that the Lottery is able to provide this higher level of funding because of the larger percentage of its revenue it is now allowed to devote to prize payouts. These deputy directors shared their belief that if the Lottery reduced the amount of revenue it directs to prize payouts, players would reduce their spending on lottery products, and therefore total revenue and the amount available to direct to education would decline. Based on the experience of the Lottery and documentation we reviewed related to lotteries in other states, the relationship between increased prize payouts and increased sales revenue that the deputy directors shared with us seems correct. However, as we discuss in the following section, the Lottery has not determined whether its current prize payouts are at an optimal point.

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**The Legislature could require the Lottery to pay the \$36 million that it failed to provide to education.**

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Changes to the Lottery Act are needed to align the Lottery's education funding with both the requirements and the intent of the 2010 amendments to the Lottery Act. Although it was initially passed by the voters as a ballot proposition, the Legislature can amend the Lottery Act under certain conditions. To amend the Lottery Act, the Legislature must approve a bill with at least a two-thirds majority vote and the amendments must further the purpose of the Lottery Act. First, the Legislature could require the Lottery to pay the \$36 million that it failed to provide to education. As described in the Introduction, the Lottery is allowed to allocate 13 percent of its revenue for operational and administrative costs. The Lottery does not carry a fund balance from year to year, and the only other categories of spending are its prize payouts and its education funding. Therefore, the Lottery has only two cost categories from which it can pay the \$36 million: prize payouts and its administrative allowance. We believe a requirement to pay the \$36 million from the administrative allowance provides the best balance between reimbursing education the funding it is owed and allowing the Lottery to continue managing its prize payout amounts in a way that maximizes its current year revenue. The Lottery's operational and administrative costs include costs that are directly linked to overall sales, such as its retailer compensation. Because of this, the Lottery would likely need to repay the

\$36 million from the portion of its administrative allowance that it reserves for its own operations. In its fiscal year 2019–20 budget, the Lottery estimated that it would spend about \$279 million on its operations.

Further, although we do not believe the proportionality requirement is unclear, to ensure that the Lottery understands its obligations under the law and adheres to the 2010 amendments, the Legislature could amend the Lottery Act to further clarify the proportionality requirement. As we previously indicated, the Lottery's deputy directors believed that the 2010 amendments to the Lottery Act did not require a directly proportional relationship between its net revenue growth and its funding for education, a position that we do not agree with. A change to the Lottery Act to specify that education funding must grow at a rate identical to the rate of growth in total net revenue would make clear the expectations for how education funding should increase in response to such gains. The changes we recommend would be consistent with the earlier Legislative intent to increase and maximize the lottery net revenues that the Lottery provides to education. Because of that, in our view, such amendments to the Lottery Act would also be consistent with the purpose of the act.

### **The Lottery Has Not Prioritized Funding to Education When Setting Its Budgets**

The Lottery has not funded education at the required level in part because it has not used a budgeting process that is designed around meeting the Lottery Act requirements. The Lottery Act requires the Lottery Commission to establish the percentage of its total annual revenues that it will allocate to education at a level that maximizes total net revenues for education. The Lottery Act also requires the Lottery to maximize education funding, which is a requirement that the Lottery can only meet by knowing that it is providing the most possible funding to education every year. Therefore, it is essential for the Lottery to annually determine what the optimal balance point is between prize payouts and education funding. Since the 2010 amendments to the Lottery Act, the Lottery's total operating revenue has increased by 115 percent and its funding to education has increased by 66 percent. In addition, the Lottery has decreased the proportion of total sales revenue that it directs to education from 33 percent in fiscal year 2010–11 to between 24 and 25 percent in fiscal years 2016–17 through 2018–19. Given the requirements in the Lottery Act, as well as the significant decrease in the overall percentage allocated to education, we expected that the Lottery would be able to explain how it determined that between 24 and 25 percent was the portion of its total revenue that ensures that it maximizes education funding based on the optimal balance point.

When we asked the Lottery to provide its determination of the optimal balance point, the deputy directors stated that the Lottery contracted with a consultant to determine whether increased prize payouts would increase overall revenue. The consultant's study concluded that increased prize payouts would increase revenue and also contained an estimated optimal balancing point between prize payouts and education funding. The consultant delivered the results of that study in January 2010—making it now a decade old. In the study, the consultant identified the optimal prize payout percentage as 62 percent of the Lottery's total sales revenue, which at the time represented about a 10 percentage point increase to the percentage that the Lottery allocated to prize payouts. In addition to being 10 years old, the consultant's determination about the optimal prize payout percentage is based on assumptions that are likely no longer valid. For example, when calculating the optimal prize payout percentage, the consultant assumed that the Lottery's administrative costs would equal 13.5 percent of its total sales revenue—an amount that exceeds the current legal limits by one-half of a percentage point. The deputy director of business planning shared with us a statement from that consultant that confirmed that the study would lose validity as it became older. In other words, the consultant acknowledged that the study would have less relevance as it aged.

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**We assessed whether the Lottery had adhered to the consultant's identified optimal prize payout percentage when setting its budgets.**

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Despite these problems with the consultant's study, according to the deputy directors of finance and business planning, it is the only study of this type that the Lottery has performed to establish an optimal balance point between prize payouts and education funding. Accordingly, we assessed whether the Lottery had adhered to the consultant's identified optimal prize payout percentage when setting its budgets since fiscal year 2015–16 and found that it has not. Specifically, in its budgets for fiscal years 2015–16 through 2019–20, the Lottery has held the percentage of its total annual revenue that it budgets towards prize payouts at about 64 or 65 percent, or approximately 2 to 3 percentage points higher than the optimal prize payout percentage identified by its consultant. In terms of dollars, this means that the Lottery had planned to pay out in prizes between about \$110 million to \$248 million more per year than the consultant's study indicated it needed in order to maximize

revenue for education. In fiscal years 2015–16 through 2018–19, the actual percentage of total revenue paid in prizes was within about 1 percent of the budgeted percentages.

Because of the significant difference between the consultant’s study and the Lottery’s actual planning, combined with the fact the study is outdated, the Lottery must perform a new analysis to know whether it is optimally balancing prize payouts and funding for education, and therefore fulfilling the mandate in the Lottery Act to maximize education funding. The deputy directors believe that the consultant’s study is still relevant to current economic conditions. However, as we describe earlier, the Lottery has not adhered to that study’s optimal prize payout percentage when setting its budgets. The deputy director of business planning also stated that it was difficult to apply an optimal balancing point in large part because of the unpredictable nature of large multistate jackpot games in which the size of prize payouts—and therefore player participation in the games—is not controlled. Although we acknowledge the unpredictable nature of these games, during its budget setting process the Lottery makes assumptions about the revenue it will receive in an upcoming fiscal year and the prizes it expects to pay out. Therefore, at a minimum the Lottery is able to plan to achieve a prize payout percentage that would provide the maximum amount of funding to education. Until the Lottery determines the correct percentage, California will not know whether education is receiving all of the funding from the Lottery that it should and the Lottery Commission cannot ensure that it is meeting the intent of the Act.

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**Until the Lottery determines the correct prize payout percentage, California will not know whether education is receiving all of the funding from the Lottery that it should.**

.....

Further, the Lottery’s budget process does not ensure that it is adhering to the proportionality requirement because it does not budget its funding for education to increase in proportion with increases from the previous fiscal year’s net revenue. We expected the Lottery to be preparing its budgets in such a way as to identify any increases the Lottery expects to experience in net revenue from the previous fiscal year and then plan to increase the amount it provides to education in proportion with those net revenue increases. If the Lottery began its budget process with a review of the expected year-to-year changes in its net revenue, it could accurately determine how much it would need to provide to

education in the upcoming fiscal year to satisfy the proportionality requirement. However, the Lottery's budget process does not include such a step.

The Lottery's deputy director of finance stated that the budgeting process begins with a discussion of the education funding goal the Lottery would like to meet for the upcoming fiscal year. However, the Lottery could not provide evidence that its goal is informed or determined by a review of the requirements in the Lottery Act. Further, this assertion contradicts the statements the deputy director made over the course of the past few fiscal years when he presented the Lottery's budget to the Lottery Commission for consideration. In multiple years at Lottery Commission meetings, the deputy director explained to the commission that the Lottery's budget development process begins with his budget team meeting with each of the Lottery's divisions to develop a division-specific budget for administrative expenditures. When we questioned the deputy director on the discrepancy between these statements, he explained that he did not see the two processes as mutually exclusive, and while the Lottery is establishing and refining its education goal for the coming year's budget, his budget team is holding meetings with each Lottery division to discuss their estimated administrative expenditures.

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**The Lottery has a long-term goal to contribute \$2 billion to education in fiscal year 2020–21.**

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Although it does not begin each fiscal year's budgeting process with a goal for education funding, the Lottery has a long-term goal to contribute \$2 billion to education in fiscal year 2020–21, which is a 7 percent increase from the amount it provided in fiscal year 2018–19. The deputy directors of finance and business planning indicated the goal was not based on specific sales tactics that the Lottery expected would result in that amount of education funding nor on a specific formula that the Lottery uses when setting education funding goals. Rather, they explained that the Lottery's staff selected the \$2 billion amount because they believed it was a monumental goal that would inspire sales staff to increase revenue yet still be reasonable for the Lottery to meet in the given time period. Email correspondence from August 2018 shows that the Lottery believed this goal was achievable based on its recent performance. Specifically, the deputy director of business planning shared with others at the Lottery that based on the average growth in the Lottery's gross dollar contributions to education, he believed

that the goal of \$2 billion in fiscal year 2020–21 was “not too far out of reach.” Although setting a goal for education funding is a positive step, the Lottery must ensure that it considers the Lottery Act’s requirements when it develops its goals. Moreover, the goal should be based on actual analysis rather than an inspirational goal without analytical support.

Because its budget process does not begin with the Lottery setting a specific target for education funding as would comply with the requirements of the Lottery Act, the Lottery is not properly planning to fulfill its sole purpose—to maximize the funding it provides to education. If the Lottery began by establishing a target for education funding that was informed by the Lottery Act requirements—to maximize funding for education and keep growth in education funding proportional with increases in net revenue—it would have a goal around which to plan when budgeting for its other expenses. For example, if the Lottery selected a funding target of \$1.9 billion, it would plan its prize payouts to ensure that it meets that target. In addition to budgeting to meet the funding requirements, the Lottery would also need to regularly monitor its expenses and prize payouts to ensure that it is adhering to its budget and can meet the requirements by the end of each fiscal year. Until it adopts a budget process that includes setting a funding goal that is informed by the statutory requirements, the Lottery will likely continue underfunding education and undermining its own purpose for existing.

## **Recommendations**

### ***Legislature***

To ensure that the Lottery provides the required amount of funding to education, the Legislature should require that the Lottery pay—from its administrative expense category—the \$36 million to education it should have provided in fiscal year 2017–18.

To ensure that the Lottery adheres to the meaning of the 2010 amendments to the Lottery Act, the Legislature should amend the act to specify that the relationship between increases in its net revenue and increases in its education funding should be directly proportional.

**Lottery**

To ensure that it provides the maximum amount of funding to education in future fiscal years, the Lottery should do the following:

- By August 2020, determine the optimal amount of prize payouts that maximizes the funding for education.
- By August 2020, establish a policy to annually reconsider the optimal amount of prize payouts that maximizes funding for education.
- Use this optimal prize amount when setting its budgets, beginning with the budget for fiscal year 2021–22.

To adhere to the Lottery Act's education funding requirements, beginning with fiscal year 2020–21, the Lottery Commission should require its staff to demonstrate that they have planned for education funding to be maximized and aligned with the proportionality requirement of the Lottery Act, and approve only those budgets that plan for such funding. It should then monitor actual education funding and ensure that it complies with the requirement.

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## The Lottery's Procurement Practices Do Not Always Ensure That It Obtains the Best Value

### Key Points

- The Lottery did not ensure that it followed its regulations for noncompetitive agreements. In eight of the 15 procurements we reviewed—worth \$5.7 million—the Lottery had inadequate justification for its decision to noncompetitively select its vendor.
- A lack of safeguards at the Lottery for noncompetitive procurements creates concern around all of the noncompetitive agreements it has entered into. Over the past three fiscal years, those agreements totaled \$13.8 million in value.
- From fiscal years 2014–15 through 2017–18, the Lottery entered into 17 agreements with hotels—worth \$720,000—for its retailer trade shows but cannot show that it evaluated other options before entering into these agreements. Several of these agreements contained excessive costs for food and beverages.

### The Lottery Entered Noncompetitive Agreements Without Adequate Justification

The Lottery's contracts development services unit (contracts unit) has not ensured that the Lottery follows its contracting regulations when it chooses to enter into agreements without competitive bids. As a result, the Lottery lacks a critical safeguard for ensuring that it always obtains competitive pricing, which is important because every dollar of its revenue that the Lottery spends on administrative costs is a dollar that it cannot provide to education. Lottery contracts must be approved by either the contracts unit manager, the Lottery's executive director, or the Lottery Commission, depending on the dollar value of the agreement. The Lottery's regulations generally require it to use a competitive bidding process for its procurements. For procurements valued at more than \$100,000, the regulations require a formal process of publicly soliciting bids and announcing a selected vendor. For procurements valued at or under \$100,000, the regulations prescribe an informal process but still require the Lottery to obtain multiple price quotes unless doing so is not possible. The Lottery's regulations allow it to forgo these processes under certain circumstances regardless of the value of the agreement. In such circumstances, the Lottery must cite one of the allowable exceptions that we show in the text box. Before entering an agreement with a vendor, the Lottery's divisions submit procurement justification memos to the contracts unit that explain the steps the division took to identify the preferred vendor and, if relevant, explain the reasons why an exception to competitive bidding is applicable.

#### Allowable Exceptions to the Lottery's Competitive Bidding Requirements

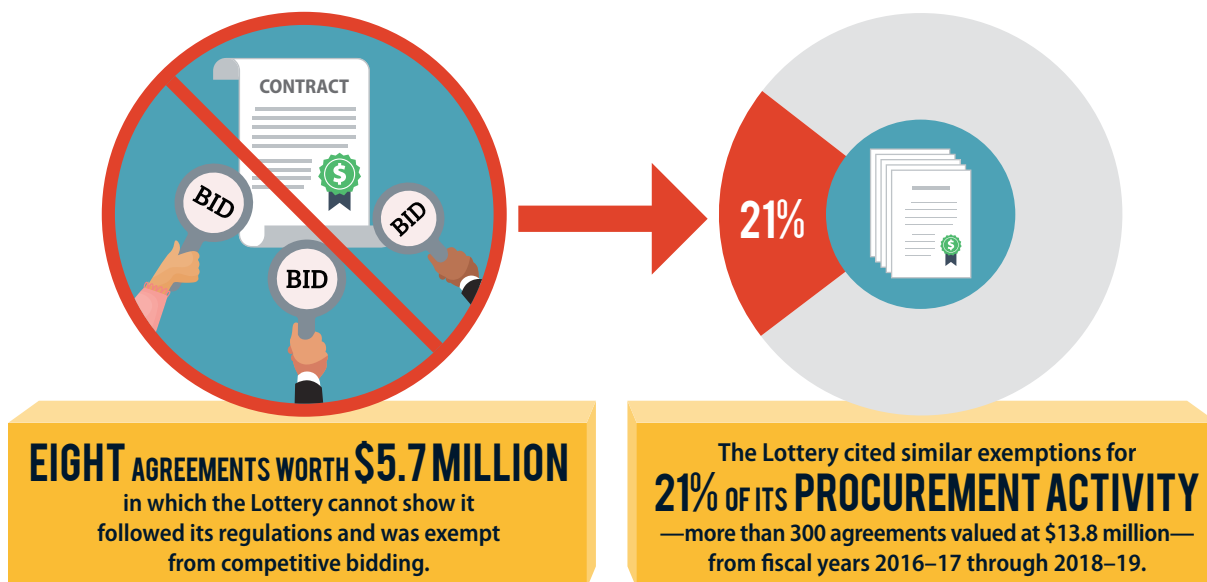
- An urgent and compelling need.
- An interagency or intergovernmental agreement.
- A master services agreement or multiple award schedule.
- After a good faith effort to identify vendors, a determination that only one viable source exists for the goods or services.
- Retention of legal counsel or a uniquely qualified expert.

Source: Lottery regulations.

We reviewed 15 of the Lottery’s purchase orders and contracts from fiscal years 2016–17 through 2018–19. Among these agreements were eight in which the Lottery did not use its formal or informal competitive bidding process. As Figure 3 indicates, we found that for all eight of these agreements—valued at a total of \$5.7 million—the Lottery cited an exception to its competitive bidding requirements without adequate documentation showing that it had adhered to its regulations. The largest of these procurements was a \$4.6 million contract with an existing IT vendor to upgrade the Lottery to a newer version of the vendor’s financial software. The Lottery did not use competitive bidding to identify the financial software it would use, and when it decided not to formally consider other software options, it cited two reasons why it believed that switching to another product was not cost-effective: the cost of pursuing price quotes and the costs associated with switching to a different product. However, the presumption that other options will not be cost-effective is not an allowable exception to competitive bidding under the Lottery’s regulations and is not a sound business practice. In fact, the Lottery’s regulations state that it will use competitive bidding to ensure that it obtains the best value. Further, efficiency, financial viability, and price are some of the elements that the regulations describe as factors that the Lottery will evaluate during a competitive process. Therefore, the Lottery should not have disqualified other vendors or products before engaging in a competitive review of its options.

**Figure 3**

The Lottery’s Inadequate Contracting Processes Do Not Always Ensure That It Obtains Best Value



The contract for financial software was significantly larger than the other seven contracts with which we found problems. However, most of the other contracts featured similar issues. We found that the Lottery often appeared to predetermine a product or service it wanted to purchase and then determined that there was only one vendor from which it could purchase that product or service. However, the documentation that supports these determinations usually showed only that the vendor was the proprietary owner of the selected product rather than that it was the only vendor that could provide a solution that met the Lottery's needs. For example, the Lottery contracted for email distribution software from an IT vendor for \$200,000 without seeking multiple bids. To exempt itself from the competitive bidding requirement, the Lottery stated that only one viable source existed for the software. However, the justification memo for this contract does not indicate that the Lottery's decision to select the vendor was the result of a good faith effort to identify other vendors that could provide email distribution software. Instead, the memo noted that the Lottery would reassess its options for email distribution as part of a larger project that it would begin within the upcoming 12 months. Nevertheless, a preference to delay consideration of other viable options is not an allowable exemption from competitive bidding under the Lottery's regulations.

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**To exempt itself from the competitive bidding requirement, the Lottery stated that only one viable source existed for the software.**

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The problems we identified with the Lottery's procurement activity are the result of weak processes and a lack of formal guidance for its staff. The Lottery has a contracts unit that, according to its manager, is the central unit responsible for ensuring that its procurement activities align with applicable requirements. However, the contracts unit did not fulfill this role for any of the eight procurements with which we found issues. Although we expected to see that the contracts unit was requiring Lottery divisions to submit evidence that they had adhered to procurement requirements, it was not doing so. For example, when we asked for supporting documentation showing that the Lottery appropriately concluded that it had no other options besides noncompetitive procurement, for a few of the contracts with which we found problems the contracts unit manager responded that her unit did not maintain that documentation and referred us to the Lottery division that had originally requested the goods or services. Because

it does not always require other divisions to demonstrate that they are following the Lottery's procurement regulations, the contracts unit provides limited assurance that the Lottery is always obtaining the best possible value in its agreements.

Further, the Lottery lacks sufficient formalized guidance for its procurement staff. Although the contracts unit manager and the Lottery's former chief counsel provided us with the Lottery's policies and procedures for procurements, the contracts unit manager informed us that these documents were outdated. She stated that, when procuring goods and services, her unit and Lottery legal staff provide guidance to the program seeking to procure the good or service about how to justify a noncompetitive agreement. When we spoke with procurement staff from several Lottery divisions, one indicated that the Lottery has required different support for different contracting decisions and that consistency in required support could be better. Other procurement staff indicated they would find it beneficial if the Lottery provided its program units with procurement guidance. According to the Lottery's deputy director of finance, the Lottery's current executive director made it a top priority for members of executive management to update and unify all of the Lottery's policies and procedures and to ensure that its staff are trained on them. The Lottery's deputy director of operations indicated that discussions about the procurement guidance occurred only recently. Therefore, as of January 2020 the Lottery has not ensured that its staff have up-to-date and appropriate guidance for conducting procurement activities. Because obtaining the best possible rates on its procured goods and services will help the Lottery ensure that it is funding education at the maximum possible level, it is critical that it create and implement updated policies and procedures.

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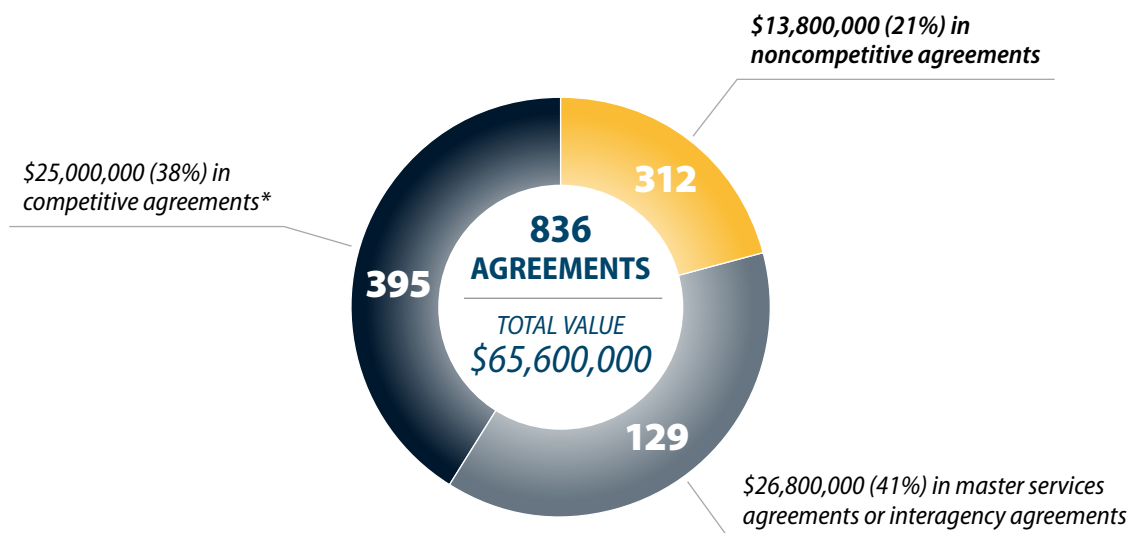
**The Lottery has not ensured that its staff  
have up-to-date and appropriate guidance  
for conducting procurement activities.**

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The frequency with which the Lottery uses certain exemptions from competitive procurement processes concerns us. We reviewed the Lottery's procurement records to assess the significance of the noncompetitive procurements that it engaged in over the last three fiscal years. According to its records, the Lottery did not use a competitive process for about \$40.6 million—or about 62 percent of its new agreement procurement activity from fiscal

years 2016–17 through 2018–19.<sup>1</sup> Although, as shown in Figure 4, \$26.8 million of this amount is from contracts and purchase orders that were entered into under master agreements or interagency agreements where the Lottery has some assurance that it is getting a good price, the Lottery did not competitively bid the remaining agreements, which were worth \$13.8 million—or 21 percent of its overall procurement activity. Given that our review of a selection of the Lottery’s contracts found problems with the Lottery’s support for its decisions to not seek competitive bids, the proportion of the procurement activity that these agreements comprise is significant. Insufficiently vetted decisions to not seek competitive bids increase the risk that the Lottery will spend more than it needs to for goods or services and thereby reduce the revenue available for education.

**Figure 4**  
21 Percent of the Lottery’s Procurement Activity Involved Noncompetitive Agreements



Source: Lottery contract records from fiscal years 2016–17 through 2018–19.

\* The competitive agreements exclude one contract that was 30 times larger in value than the next highest contract.

<sup>1</sup> We focused our analysis on new agreements or procurements because amendments to existing agreements are generally not subject to the same requirements as new agreements and are, by definition, noncompetitively sourced. Further, our analysis excludes one competitively bid contract that was an outlier because it skewed the summary level data about the Lottery’s procurement activity. That contract was over 30 times larger in value than the next highest valued contract.

## The Lottery Did Not Minimize Retailer Trade Show Expenses and Spent Excessively on Food and Beverages

### Requirements of the Lottery's Informal Competitive Bidding Process

When possible, the Lottery must do the following:

- Directly contact potential bidders with the goal of eliciting competition.
- Communicate contract terms to potential bidders.
- Document all contacts with potential bidders.
- Receive verbal or written bids.
- Accurately record and evaluate actual bids.
- Determine which bidder is qualified to perform the contract and submitted the best bid.

Source: Lottery regulations.

The problems we identified in our review of 15 procurements also extended into contracts the Lottery entered into with hotels for its retailer trade shows. Until Spring 2018, the Lottery hosted retailer trade shows in an effort to educate retailers about its products and services, such as training on how to sell lottery products. As we describe earlier, the Lottery's regulations require it to use an informal competitive process for procurements at or under \$100,000 in value. Specifically, the Lottery's regulations require it to take all of the actions in the text box when possible.

We reviewed 17 contracts—worth about \$720,000 in total—that the Lottery entered into with the hotels where it hosted its retailer trade shows, and the results of our review are summarized in Figure 5. These contracts usually included expenses

for food and beverage catering, event space, and lodging for Lottery staff. Each contract was under \$100,000 in value, meaning that the Lottery was required to follow its informal competitive bidding process before it entered into them. However, the Lottery cannot demonstrate that it followed its regulations. It had no documentation showing that it accurately recorded and evaluated competing bids or determined the best value for any of the contracts. Only for one agreement—for a 2015 trade show in Ontario—could the Lottery provide a spreadsheet listing comparable hotels that included pricing information; however, this spreadsheet did not accurately record the pricing information and did not provide sufficient evidence that the Lottery had obtained best value for the agreement, as one of the comparable hotels on the spreadsheet had a lower listed price than the one the Lottery selected and there was no indication why the lower-priced option was not selected. Therefore, the Lottery has no evidence that it followed its informal competitive bidding process and took reasonable steps to minimize trade show expenses.

As part of all but one of these agreements, the Lottery agreed to pay a food and beverage minimum to the hotel, but some of these minimums appear to have been excessive. For example, one agreement was for a 2014 trade show in Orange County that lasted one day and had about 320 registered attendees. The contract with that hotel required the Lottery to pay a \$45,000 food and beverage minimum averaging \$141 per guest per day. Another agreement for a 2016 single-day trade show in Santa Clara contained a \$40,000 food and beverage minimum for about 180 registered guests, which is an average of about \$220 per guest per day. Although

the targeted audience of these conferences was retailers and not state employees, to assess the reasonability of these food costs we used the standard state per diem meal rate of \$41 per person per day. Even if we use double the state rate, the costs of some of these food and beverage minimums are very high in comparison. Further, although some of the food provided under these agreements was for meals, other food expenses were for unreasonably priced snacks. For example, for the trade show in Orange County, the Lottery agreed to pay \$60 for a dozen granola bars and \$45 for a dozen cookies. By obtaining multiple price quotes, the Lottery may have found more reasonably priced hotel packages or at least would have been better able to negotiate with hotels for these higher-priced items. For example, some of the hotel agreements we reviewed contained food and beverage minimums closer to \$10,000 with average per-guest amounts of between \$28 and \$48 per day.

**Figure 5**  
The Lottery Entered Into \$720,000 in Hotel Agreements for Trade Shows Without Ensuring That It Minimized Expenses



Source: Lottery contract records and hotel invoices.



The Lottery's sales and marketing division had the primary responsibility for planning the retailer trade shows. When we asked for bidding documentation demonstrating that the sales and marketing division obtained the best value for the agreements with hotels, a manager within the division stated that the division did not maintain this documentation and could not provide it. The manager provided us the spreadsheet we reference earlier, which he asserted the Lottery's primary gaming vendor had provided to the Lottery as a list of hotels suitable for hosting the Lottery's trade shows. However, as we explain earlier, although the spreadsheet listed pricing information for comparable hotels for a 2015 trade show in Ontario, it did not provide adequate proof that the Lottery obtained best value for this agreement. Additionally, the spreadsheet listed potential venues only for 2015 trade shows and also lacked critical pricing information for some venues, making it inadequate support for the remainder of Lottery's hotel selections. Lastly, the deputy director of the sales and marketing division provided a justification memo for the three hotel agreements the Lottery entered into in 2018, which explained what factors the Lottery considered when entering into these agreements, such as available meeting space and the quantity of retailers in the surrounding area. However, these justification memos did not include any pricing information or similar documentation for alternative comparable hotels, which would have demonstrated that the Lottery contacted multiple bidders with the goal of eliciting competition. The Lottery was therefore unable to demonstrate that it followed its own contracting requirements and received the best value when selecting hotels for its events.

After the sales and marketing division decides to enter into an agreement with a hotel to host a trade show, the Lottery's contracts unit must review the proposed agreement. According to the Lottery's contracts unit manager, her unit's regular practice is to require a justification memo for any procurements valued at more than \$2,000. However, she confirmed that her unit did not require justification memos or other supporting documentation for any of the 17 hotel selections because these agreements were paid for by credit card and did not go through the Lottery's regular procurement system. Because the contracts unit is responsible for ensuring that the Lottery adheres to its contracting regulations, it plays an essential role in controlling the Lottery's costs and making sure that the Lottery directs all possible funding to education.

### **Amending the Lottery Act Would Create Greater Accountability for the Lottery's Procurement Processes**

The Lottery is not subject to General Services' oversight with regard to its contracts and procurement activity. In 1984, when voters—through Proposition 37—approved the Lottery Act, the



proposition granted the director of the Lottery the authority to purchase or lease goods and services that were necessary to achieve the purpose of the Lottery Act without generally being subject to specific provisions of state law that governed procurement. Less than two years later, the Legislature added language to the Lottery Act that more expressly stated that the Lottery's contracts and procurements were not subject to General Services' oversight. The Legislature prescribed specific requirements for the Lottery's procurement activities, such as a requirement that the Lottery develop competitive bidding procedures for the awards it makes valued at more than \$100,000. In 2008 the Legislature further amended the Lottery Act to specify that the Lottery was not subject to the requirements of the Public Contract Code.

However, the Lottery's approach to its noncompetitive procurements provides little assurance that it is meeting the intent of the voters and the Legislature. In 1984 voters approved the creation of the Lottery on the basis that the Lottery would provide funding for education. When it amended the Lottery Act in 1986, the Legislature declared that its intent was to foster and promote full competition in contracting and that it expected that full competition in contracting would ensure that more of the funds generated by the Lottery Act would go directly to education. The results of our review—as well as a 2016 SCO review that concluded that the Lottery did not have limitations on the monetary and time increases for contract amendments, which means it had no limitations on how much it could increase a contract's dollar value or duration—show that the Lottery has not applied enough safeguards to its procurement activities to enable it to direct the most funding possible to education.

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**The Lottery has not applied enough safeguards to its procurement activities to enable it to direct the most funding possible to education.**

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Amending the Lottery Act in such a way as to subject the Lottery to regular reviews of its procurement processes would create necessary accountability by addressing a gap in the State's oversight of the Lottery. As we describe in the Introduction, the SCO is the primary oversight entity over the Lottery. Although the Lottery Act assigns the SCO broad authority to conduct audits of the Lottery, it does not specify that the SCO must regularly conduct audits of the Lottery's procurement processes. In contrast, the Public Contract Code requires General Services to conduct audits

of the departments to which it delegates purchasing authority and specifies that these audits should occur at least once every three years. Therefore, a requirement that the SCO perform regular procurement audits of the Lottery would align the oversight of the Lottery with the oversight the State requires of other departments without disrupting the existing express exemptions from the regular state contracting requirements. To amend the Lottery Act through legislation, the Legislature must approve a bill with at least a two-thirds majority vote, and the amendment must further the purpose of the act. The changes we recommend would create greater accountability for contracting decisions and be consistent with the earlier Legislative intent to encourage competition and thereby maximize the funding to education. As a result, they would also be consistent with the purpose of the act.

#### **The Lottery Does Not Know Whether the Millions It Spends on Its Fairs Program Have Been Effective**

The Lottery also cannot demonstrate that its spending for its fairs and festivals program (fairs program) is consistent with its mandate to maximize the amount of funding for education. The Lottery's regulations allow it to sponsor activities or functions in furtherance of its mission when the value received by the Lottery in return for the sponsorship is commensurate with the expenditure. Further, the regulations also allow the Lottery to give away promotional items including free tickets and branded merchandise in an effort to maintain awareness of lottery products and motivate future purchases of lottery tickets. Under these provisions, the Lottery has maintained its fairs program for the past 20 years, attending events such as the Orange County Fair and the California Strawberry Festival, which connect it to local communities. During these fairs, the Lottery sells tickets and allows customers who purchase a certain number of its products to spin a wheel where they can win additional promotional lottery tickets. Attending these fairs is one of the marketing tactics that the Lottery uses to reach and interact with consumers.

However, the fairs program does not generate a direct profit, and the Lottery cannot demonstrate that the program leads people to play lottery games again in the future. In April 2019, the Lottery conducted an analysis of the fairs program that included evaluating the program's profitability. Specifically, the Lottery identified that in 2017 the fairs program cost the Lottery \$5.7 million but directly generated only \$5.5 million in sales, leading to a loss of \$200,000. Any Lottery expense that does not directly tie back to increased revenue may be an ineffective use of Lottery funds because that expense is money that otherwise would be available to fund

education. Therefore, to justify the expenses of the fairs program, we expected that the Lottery would be able to demonstrate that it receives some other value commensurate with its expenses.

When we asked the Lottery how it measures whether it receives commensurate value, it could not show that it had performed such a measurement any time before our audit. After we asked the Lottery to demonstrate additional value, the sales and marketing deputy director provided us with an analysis that concluded that the Lottery would need to have purchased at least \$1.3 to \$3.7 million in advertising to reach the same number of consumers it did at the fairs. Regardless, the Lottery's April 2019 analysis stated that the intention of the fairs program was to increase certain intangible benefits, such as brand strength, improved customer experience, and increased customer loyalty; and the Lottery could not demonstrate that participating in the fairs increased these intangible benefits. According to the sales and marketing deputy director, the Lottery participates in these events to connect with the community and increase brand awareness, which overall has impact on these intangible benefits. She explained that by increasing these intangible benefits, the Lottery will encourage infrequent Lottery players to play more frequently or attract new customers who may not have interacted with the Lottery previously, thereby increasing sales revenue. She also stated that the Lottery is not currently tracking these intangible benefits and that it is very difficult to directly attribute the effect of one fair and festival interaction on long-term brand measures as the impact is not always realized immediately.

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**The Lottery could not demonstrate that participating in the fairs increased brand strength, improved customer experience, and increased customer loyalty.**

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Notwithstanding those challenges, the Lottery is unable to demonstrate that it is receiving the benefits it hopes to get from its fairs program, which we agree would likely benefit education if the Lottery were to attain them. The Lottery must ensure that its activities, in aggregate, maximize its funding for education. Without the assurance that the fairs program generates additional funding for education, the Lottery does not know whether this money would be better spent on other activities. Every dollar the Lottery spends on the fairs program is a dollar that the Lottery can either provide directly to education or use to engage in activities that it

knows generate additional funding for education. Therefore, the Lottery would be in a better position to justify its fairs program as essential to its mission if it could demonstrate a direct relationship between the two—for example, by surveying customers about their experience with and opinions about the Lottery after having attended the fair.

## **Recommendations**

### ***Legislature***

To ensure that the Lottery is subject to oversight of its procurement practices, the Legislature should amend the Lottery Act to direct the SCO to conduct audits of the Lottery's procurement process at least once every three years.

### ***Lottery***

To ensure that it conducts procurements in a way that preserves all possible funding for education, by August 2020, the Lottery should develop procurement procedures that, at a minimum, do the following:

- Provide examples of when products are truly available from only one source and examples of when the Lottery should consider whether alternative products can also fulfill its needs.
- Require its staff to collect and maintain documentation supporting any exception to competitive bidding and provide examples of adequate and inadequate documentation.
- Instruct its contracts unit to deny all procurement requests that do not demonstrate adherence to contracting requirements.

To ensure that it receives value for the funding it spends on its fairs program, by January 2021, the Lottery should determine whether the program has increased its brand strength, customer loyalty, customer satisfaction, ticket sales, and profits. If the analysis determines that the Lottery has not achieved these benefits, it should terminate the program.

## The SCO Has Not Effectively Overseen the Lottery's Performance

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### Key Points

- The SCO inappropriately removed a finding from an April 2019 audit report after the Lottery requested changes to the report. That finding questioned the costs of \$720,000 in hotel agreements, an issue we discuss earlier in this report.
- The SCO relied solely on the Lottery to prepare a report for the Legislature on the Lottery's performance without assessing the thoroughness of the report, and therefore the Legislature has gone without independent analysis of whether the Lottery has fulfilled the purposes of the 2010 changes to the Lottery Act.
- To provide more effective oversight of the Lottery, the SCO will need to significantly adjust its approach to audits to focus on effectiveness and efficiency of the Lottery's operations.

### The SCO Inappropriately Removed a Significant Finding From a Recent Audit Report After the Lottery Requested Changes

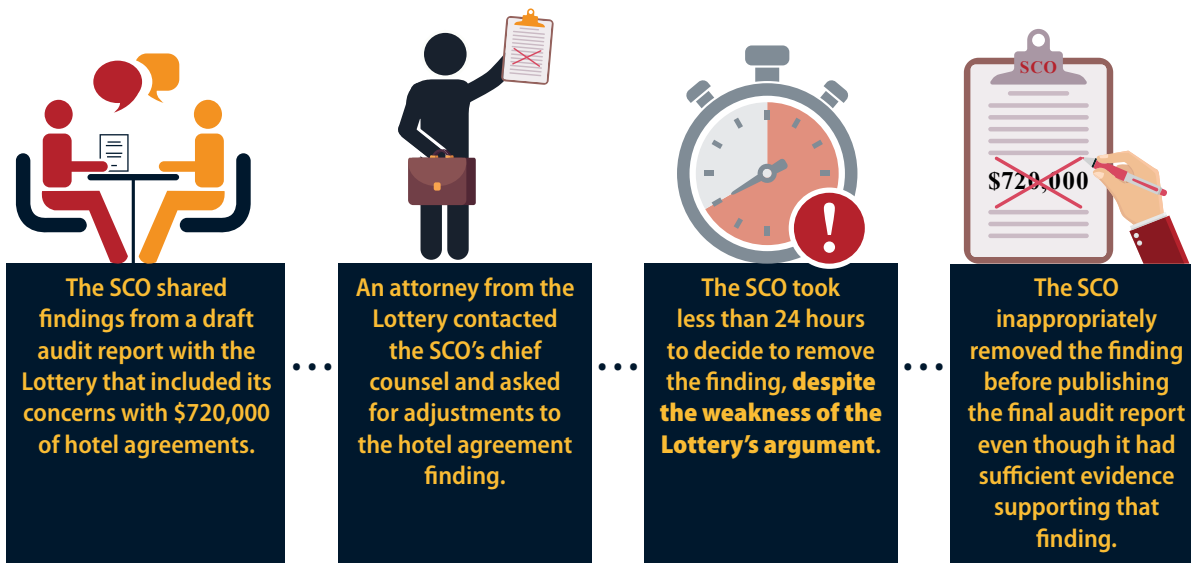
The SCO inappropriately removed a finding questioning hotel costs of about \$720,000 from an audit report in 2019. Figure 6 summarizes the timeline of events that led to this removal. The Lottery Act requires the SCO to conduct audits of the Lottery as the SCO deems necessary. Under this mandate, the SCO conducted an audit of the Lottery's Office Revolving Fund and Travel Expenses and published the related report in April 2019. Before publishing its report, the SCO met with the Lottery in February 2019 to share the findings it planned to report. Included was a finding we describe earlier in this report: that the Lottery had insufficient justification to show that it had obtained the best value when entering into 17 hotel agreements worth about \$720,000. The SCO informed the Lottery that it planned to report that the Lottery erred because it did not maintain documentation showing how it knew it had obtained the best value for these agreements—concerns that are essentially identical to those we raised earlier in this report.

After that meeting, the SCO provided the Lottery with a final draft copy of its audit report so that the Lottery could prepare a written response to the audit. During its response period, in March 2019, an attorney for the Lottery emailed the SCO's chief counsel and expressed concerns about the hotel agreements finding. Specifically, the attorney was concerned that the SCO's audit team had based the finding on outdated requirements instead of the Lottery's more up-to-date procurement requirements, which she indicated were found in the Lottery's regulations. Over the course of several hours, the Lottery's attorney sent emails sharing information with the SCO's chief counsel about the effective date of the Lottery's procurement regulations and her interpretation of the regulations. For example, the attorney argued that the regulations hold the Lottery to a less strict standard than the outdated requirements

the SCO had relied on during its audit because the regulations stated that the Lottery would perform activities such as contacting multiple bidders and determining which bidder was best qualified, *where possible*—implying that it was not an absolute requirement to perform these activities in all cases. It was her belief that, as a result, the entire finding was questionable and she suggested modifications the SCO should make to its report. Less than one day after the attorney from the Lottery and the SCO’s chief counsel first communicated via email about these issues, the SCO told the Lottery that it would adjust its audit report as a result of the Lottery’s objections. Subsequently, the SCO removed this finding from its report entirely.

**Figure 6**

**The SCO Inappropriately Removed an Audit Finding After the Lottery Requested Changes to a Draft Audit Report**



Source: SCO and Lottery email correspondence, and SCO audit records.

At a minimum, removing the finding related to the hotel agreements represents a significant lapse in analytical rigor. When we asked the chief of the SCO’s audits division why the SCO removed the hotel agreements finding, he stated that the procurement regulations did not support keeping the finding in the audit report. However, the SCO’s audit records do not include documentation or any analysis that explains why the regulations did not support the finding. To address this gap in the audit records, we asked the SCO’s audit chief to explain his reasoning. According to the audit chief, he decided

the regulations did not support the audit finding because they contained the phrase “where possible,” which he believed meant that the Lottery was not always required to use competitive bidding. The SCO’s audit files contain no analysis or evidence showing that it was impossible for the Lottery to follow its regulations. Further, the audit chief could not explain to us what the SCO expects the Lottery to document to show compliance with the regulations. Moreover, the audit manager carefully documented her conclusion that the finding should stand. We question how the SCO could conclude that there was not a reportable finding if it cannot explain what it expected the Lottery would do to comply with its procurement regulations.

There is little meaningful difference between the outdated requirements that the SCO originally used to support its hotel agreement finding and the regulations it should have used as its standard. As we discuss earlier in this report, we have concluded that the hotel agreements were problematic. Both the old requirements and the regulations instruct the Lottery to seek multiple bids and keep a record of all contacts with bidders. Further, both require the Lottery to have recorded the bids submitted by potential vendors. The SCO had confirmed during its audit that the Lottery’s contracts division had no evidence that the Lottery had taken these steps. Therefore, we question why the audits division chief determined that he could no longer include this finding in the SCO’s report.

Further, the manner in which the SCO made its decision to remove the finding is troubling because neither the audit team nor the audits division chief responsible for removing the audit finding from the report directly communicated with the Lottery about its objections. If either the audit team or audits division chief had directly interacted with the Lottery, those conversations might have produced a different result, especially given the audit manager’s opinion that the finding should still be included. All communication related to the removed finding that we reviewed between the Lottery and the SCO took place between the Lottery’s attorney and the SCO’s chief counsel. Even though the audits division chief made the ultimate decision to remove the finding, he never communicated directly with the Lottery. Additionally, no member of the audit team communicated with the Lottery or had an opportunity to directly address the Lottery’s objections to the finding even though the audit manager in charge of that audit believed the Lottery had insufficient support to demonstrate that it had obtained best value when entering into the hotel agreements; therefore, she believed that the finding should have been included in the final report. Given that the audit team had a large amount of experience regarding the audit subject, SCO’s decision to remove the finding without allowing the audit team to respond directly to the Lottery’s concerns about the finding is troubling.



Finally, the changes the SCO made to its report before issuing it to the public raise concerns about it strictly adhering to auditing standards, including those pertaining to an audit entity's independence. In its April 2019 report, the SCO stated that it conducted its audit in accordance with generally accepted government auditing standards. Those standards require the SCO to avoid any appearance of a compromise to its independence and that it perform its audits without being affected by influences that compromise its professional judgment. This independence is important because it gives reasonable assurance to informed third parties that the findings of an audit will be impartial. However, the emails exchanged between the SCO and the Lottery, the SCO's decision to not involve the audit team in direct conversation with the Lottery, the lack of analysis of the regulations by the SCO, and the fact that the regulations the Lottery shared did not contradict the finding, create the appearance that the SCO removed these findings because of pressure from the Lottery and not because of its own independent judgment of the evidence it had collected. Such a deficiency in independence may cast doubt on the integrity of the SCO's audits of the Lottery.

### **The SCO Did Not Adequately Assess the Lottery's Performance After Changes to State Law**

The SCO did not fulfill an important responsibility to report to the Legislature about the Lottery's performance after significant changes to the Lottery Act. As we discussed previously, the Legislature amended the Lottery Act in 2010 to permit the Lottery to increase the proportion of its revenue it pays out as prizes. The 2010 amendments also required the SCO to convene a review group—consisting of the State Controller, the chair of the Lottery Commission, and the Superintendent of Public Instruction. Under the SCO's lead, the Lottery Act required the lottery review group to report to the Legislature by no later than the end of March 2016 on whether the 2010 amendments furthered the purposes of the Lottery Act. However, the SCO—despite its position as the lead entity responsible for convening the lottery review group—did not submit this report to the Legislature until October 2019, after we determined that it had never submitted the report.

Because the SCO did not ensure that it submitted the review group's report to the Legislature, the answer to a significant question about the 2010 amendments went unaddressed for more than three years. The intent of the 2010 amendments was to further the purpose of the Lottery Act by giving the Lottery the authority to determine the percentage of its total revenue to allocate to prize payouts so that it would maximize funding to support education. The expectation of the Legislature was that with



this authority, the Lottery would be able to raise more funding for education. In requiring the review group report, the Legislature clearly indicated an interest in knowing whether its expectations were realized. The SCO coordinated a public meeting of the review group in March 2016, and the SCO's records and statements made to us from the SCO's chief counsel indicate that the review group approved a draft version of its report for final submission at that time. Because the 2010 amendments required the SCO to convene the lottery review group, it is reasonable to conclude that the SCO was responsible for submitting the report on the review group's behalf. However, no record we reviewed shows that the SCO ever submitted the report to the Legislature in the period of time shortly following that meeting. The SCO agreed that it had no record of having submitted the report in 2016 or subsequently thereafter and stated that because it did not, it sent the report to the Legislature in October 2019—a claim that we validated.

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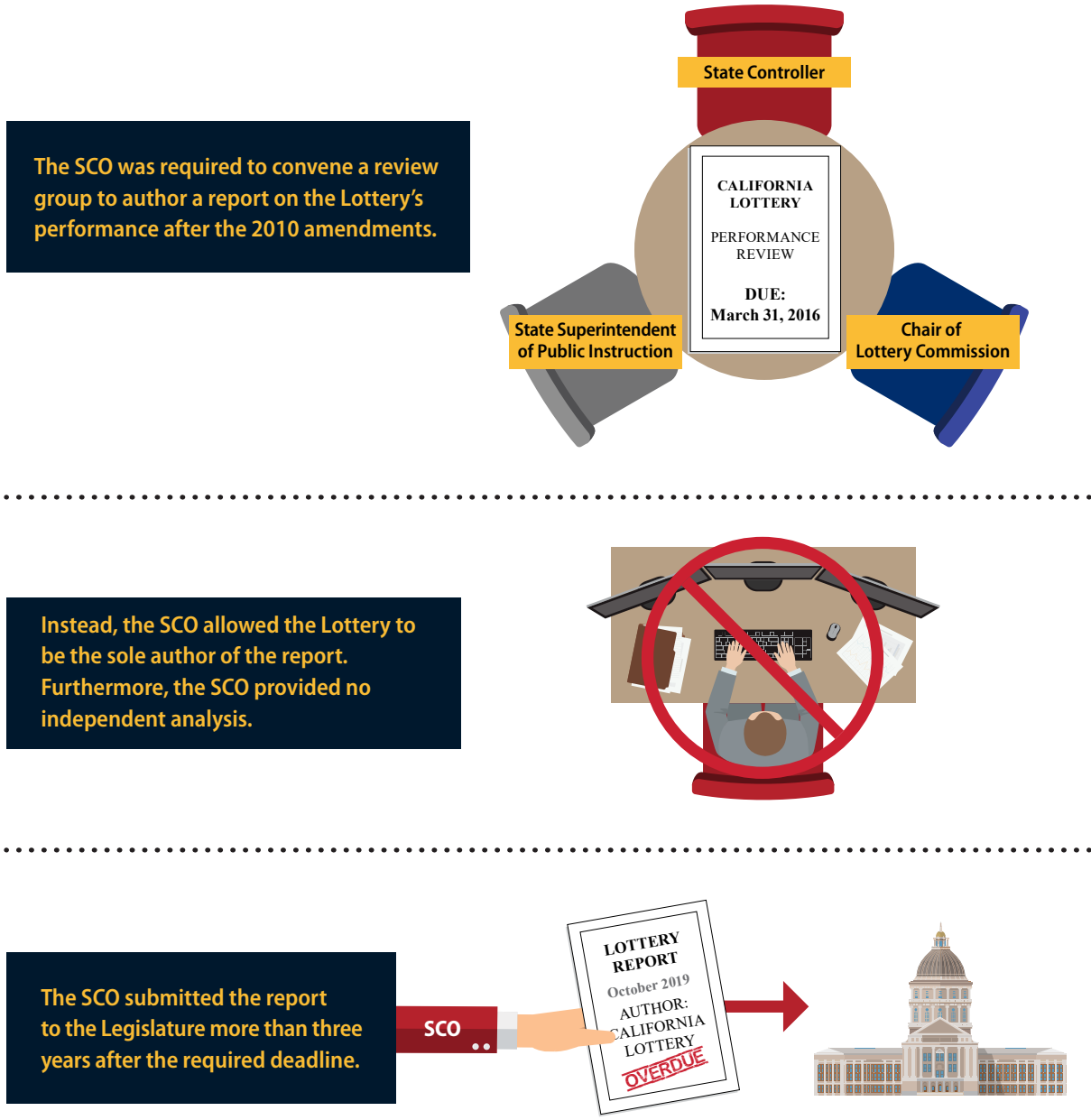
**The SCO submitted a report written by the Lottery about whether the Lottery was adequately fulfilling its mandate.**

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However, as shown in Figure 7, the report the SCO submitted was written by the Lottery. When we spoke with the Lottery's deputy director of finance at the beginning of our audit, he provided us a draft version of the review group report and indicated that he authored the draft of the report with the assistance of the Lottery's staff and the chair of the Lottery Commission. In subsequent conversations, the chief of the SCO's audits division also stated that the Lottery drafted the report that the review group voted to send to the Legislature. We compared the report the SCO submitted to the Legislature in 2019 with a draft copy of the report the Lottery provided to us and confirmed that the reports are in all substantive ways identical. In other words, the SCO submitted a report written by the Lottery about whether the Lottery was adequately fulfilling its mandate, which raises clear concerns about the objectivity of the report. Further, the SCO could not demonstrate that it performed any due diligence to ensure that the report accurately reflected the Lottery's performance after the 2010 amendments or that the report's comments about the 2010 amendments were aligned with the legislative intent. We find it concerning that the SCO would submit a report to the Legislature—stating that the analysis in the report was prepared by the review group—that contained no third-party analysis of the Lottery's performance from either the SCO or the Superintendent of Public Instruction.

**Figure 7**

The SCO Submitted a Report on the Lottery's Performance to the Legislature That Had No Independent Analysis and Was Three Years Late



Source: SCO email correspondence, interviews with SCO and Lottery staff, and draft and final versions of a report to the Legislature.

The content of the report demonstrates why a more objective review of the Lottery was essential. The report's analysis and conclusions are very favorable toward the Lottery. According to the amendments, the Legislature's purpose when it enacted the 2010 changes to the Lottery Act was to increase the total amount of net revenue available for the Lottery to supplement funding for education and to maximize the amount of net revenue that the Lottery directs to education. The report states that the changes to the Lottery Act clearly accomplished the first of these goals. However, when it discusses the second goal, the report states that making a determination about whether funding has been maximized can be difficult, and it reaches no conclusions about whether the Lottery achieved the goal. As we describe earlier, the Lottery has no analysis demonstrating that it has determined the optimal balance between education funding and its other expenses. Without such an analysis, the Lottery has no assurance that it is maximizing its contribution to education—an observation that is missing from the review group report.

Further, the review group report also discounts the importance of the proportionality requirement, wherein the Lottery must increase education funding in proportion to increases in its net revenues; and the proportionality requirement is one of the key safeguards that the Legislature added to the Lottery Act in 2010. Instead of determining that the Lottery has not met this requirement—a conclusion we presented earlier in this report—the review group report, drafted entirely by the Lottery, argues that such proportionality is not possible. Instead, the report states that to meet the intent of the 2010 changes to the Lottery Act, the Lottery would need to increase the share of its revenue allocated to prizes so that the gross dollar amount of funding for education would increase. The report concludes that increasing the share of revenue allocated to prizes disrupts the proportionality between sales revenue and growth in the funding for education. However, the report offers no evidence proving that increasing the percentage of sales revenue allocated to prizes precluded the Lottery from increasing education funding in proportion to increases in net revenue. Because it dismisses this requirement as impossible, the review group report is missing a critical conclusion about the Lottery's adherence to the Lottery Act.

That the SCO did not participate in creating the content of the review group report is another indicator that it has not acted as an independent and objective oversight entity. Although the responsibility for the review group report collectively belonged to the SCO, the Lottery, and the Superintendent of Public Instruction, the SCO is arguably the most objective member of this group with respect to the Lottery's performance. The Lottery cannot be an independent reviewer of its own performance, and the

school system, overseen by the Superintendent of Public Instruction, is the largest beneficiary of the Lottery's education funding.

Therefore, the SCO's failure to contribute an impartial analysis to the review group report represents a significant gap in effective oversight of the Lottery and the quality of the information the Legislature has about the Lottery's operations.

### **The SCO's Current Approach to Auditing the Lottery Will Not Identify Shortcomings in the Lottery's Performance**

The SCO's current approach to its audits of the Lottery will not ensure that the SCO reviews the Lottery's operations for efficiency or effectiveness. The Lottery Act requires the SCO to conduct quarterly and annual audits of the Lottery's accounts and transactions and allows the SCO to conduct any other audits it deems necessary. Although on its own that authority is broad, for the past several years the SCO has also been subject to a provision in the annual Budget Act that prohibits it from conducting performance-related audits—which are reviews of effectiveness and efficiency—unless given express statutory authority. We believe the SCO has that authority under the Lottery Act. The SCO's audits division chief indicated that the SCO has never made a determination that the authority to audit in the Lottery Act is the type of express statutory authority to which the Budget Act refers. Therefore, the SCO has reviewed the Lottery only for compliance with narrow sets of laws or regulations. By their nature, these types of reviews will not identify all areas for improvement needed in an organization or address efficiency problems.

The SCO determines what elements of the Lottery to audit through a risk assessment process that it has conducted periodically every three to five years. This risk assessment identifies relatively small issue areas, such as individual contracts and the operations of a single unit within a larger division of the Lottery, as the potential topic for audits. The risk assessment also identifies areas that are larger in scale, such as the Lottery's procurement process or management of its investments, as potential audit topics. To assess the depth of the SCO's audits, we reviewed the audits during 2015 through 2018 that the SCO conducted of the Lottery for which it published a report. These audits generally had as their objectives determinations of compliance with applicable laws or regulations, rather than a broader assessment of operational effectiveness or efficiency, and none of the audits related their findings to the Lottery's mission to provide supplemental funding to education. The SCO also conducts quarterly audits of the transfer of funds the Lottery makes to public education. Those audits verify whether the Lottery adheres to the requirement in the Lottery Act to spend no more than 13 percent of its annual revenue on its operational and administrative costs. However, these quarterly audits do not review whether the Lottery has maximized funding to education.

Although we acknowledge that the SCO's audits have covered important subject matter—such as whether the Lottery has appropriately managed its retailer network or has adequate safeguards over its prize payment processes—the SCO's recent audits have not reviewed whether the Lottery has maximized its contribution to education; this is significant in light of the fact that providing supplemental funding to education is the reason the Lottery exists. To fulfill its role as an effective oversight agency over the Lottery, the SCO must take significant corrective action. The Lottery Act exempts the Lottery from the oversight mechanisms that other state agencies are subject to, including General Services' oversight over contracting and procurement practices and Finance's oversight of the Lottery's budgets. Therefore, the gaps in the SCO's audit approach and general oversight of the Lottery that we note in this report have left the State without effective, independent, and ongoing monitoring of the Lottery's performance. When voters approved the creation of the Lottery, oversight responsibility was assigned to the SCO. To provide effective oversight of the Lottery, the SCO will need to adjust its approach to its audits of the Lottery. As it does so, it will be important for the SCO to apply safeguards against threats to its independence and ensure that it reviews the Lottery for operational effectiveness and efficiency.

### **Recommendation**

To ensure effective oversight of the Lottery, the SCO should immediately begin taking steps to improve its audits of the Lottery by doing the following:

- Develop and follow procedures that ensure that objections to audit findings are addressed by the audit team that worked on the audit. The procedures should provide the audit team sufficient time to interact directly with the Lottery about its objections and should direct the audit team to fully document its rationale for making any adjustments to the audit's findings before the audit report is published.
- Revise its risk assessment of the Lottery to include issues of efficiency and effectiveness of the Lottery's operations.
- Select high-risk areas of the Lottery's operations and conduct performance audits to assess the effectiveness and efficiency of those areas. In all audits of the Lottery, consider how the audit findings relate to the Lottery's purpose of providing education with the maximum possible funding.

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## OTHER AREAS WE REVIEWED

To address the audit objectives approved by the Joint Legislative Audit Committee (Audit Committee), we looked at three other issues. Specifically, we examined the Lottery's overall spending in operational and administrative areas, including whether these expenses were for necessary purposes; we assessed its justifications for hiring additional staff; and we reviewed its processes for determining whether to pay prize claims and allocations of unclaimed prize money. The following sections show the results of our review of these areas.

### Operational and Administrative Spending Levels

Since 2010 the Lottery Act has required the Lottery to keep its total administrative and operational costs to within 13 percent of its total annual revenue. The Lottery's spending on operational and administrative costs remained within that limit during fiscal years 2016–17 through 2018–19. To assess the reasonableness of the Lottery's spending in these areas, we compared the Lottery's expenses to those of lotteries in Arizona, Florida, New York, North Carolina, and Texas. We selected these states because of either their comparable size or the similar nature of their lottery systems. Although the percentage of its overall revenue the Lottery spent on operational and administrative costs over the past three years was similar to those of North Carolina and Arizona, it was higher than those of Texas and Florida. However, the publicly available information on the Florida and Texas lotteries' operations and administrative costs is not sufficient to identify why these lotteries had lower costs than California. In addition, we identified New York as an outlier to the other lotteries because the percentage of its revenue spent in all major cost categories was different from the others. Further, we reviewed evidence that the Lottery compared itself to other state lotteries in certain areas, including the reasonableness of advertising costs, the number of consumers who purchase lottery tickets, and the amounts individual consumers spend on tickets.

Finally, the major contributor to growth in the Lottery's operational and administrative costs have been its gaming costs and retailer compensation. Because retailer compensation is linked to overall sales, including bonuses to retailers when they sell winning tickets, the increases in this cost category are attributable to the large increase in overall sales revenue and not to mismanagement by the Lottery.

To further assess whether the Lottery's operational and administrative costs were justifiable, we reviewed 30 expenses from these cost categories from fiscal years 2016–17 through 2018–19. We found that all but one of these expenses were for justifiable purposes because they were reasonably tied to a necessary function the Lottery must perform. The one expense we question was an \$8,300 purchase of training tools that the Lottery made for a retailer trade show. Although the justification for the purchase described these items as training tools, the items included lip balm, T-shirts, and first aid kits. According to the deputy director of sales and marketing, the Lottery held

its last retailer trade shows in spring 2018, and it is not currently a priority for the Lottery to resume them. Therefore, we have no recommendation for eliminating this type of spending in the future.

### Staffing Justifications

The Lottery has adequately justified additions to its staffing levels, which we reviewed in three key divisions over the past three fiscal years. From fiscal years 2016–17 through 2018–19, the Lottery increased its staff by 5 percent, or 37 employees, giving it a total of about 770 permanent employees as of June 2019. For all position requests made before September 2019, according to the deputy director of finance, when proposing to add new staff, each lottery division was required to prepare a budget revision proposal (budget revision). These budget revisions required approval from the deputy director of finance, the chief deputy director, and the executive director before Lottery staff presented them to the Lottery Commission, which has final approval authority. Budget revisions must have included a justification for the new staff positions, reasons why the problem cannot be resolved through current resources, and an analysis of all feasible alternatives. The deputy director of finance indicated that since September 2019, the Lottery divisions also have the option to bring new position requests to the Lottery Commission throughout the year as the business need arises rather than wait until Lottery staff present the annual budget to the Lottery Commission. In these instances, the requesting division prepares a justification document, which contains the same type of justification as the budget revision and requires the same approval as a budget revision before it is presented to the Lottery Commission.

We reviewed five Lottery budget revisions in which the operations, sales and marketing, and security and law enforcement divisions requested permission to add new staff positions. We determined that these divisions generally provided a reasonable justification for adding all of the positions they requested in those budget revisions. For example, the operations division requested a chief engineer position. The associated budget revision justified this position by indicating that the Lottery's engineering and maintenance workload would increase beyond what the current manager could manage after the Lottery converted seven of its leased facilities to owned facilities. In addition, the Lottery indicated that it needed to add the chief engineer position because the minimum qualifications required for the current manager's position did not require the knowledge necessary to manage and make decisions regarding the engineering and maintenance positions and their assigned duties. The Lottery believed that the leader of this section should have that knowledge, which further supported its decision to add the position.



## Prize Claims and Unclaimed Prize Money

The Lottery's security and law enforcement division investigates all prize claims over a specified dollar amount, all ticketless claims, and all prize claims that the Lottery has identified as questionable, such as late claims. The Lottery Act requires the Lottery to determine whether "substantial proof" exists for validating ticketless claims before payout. The Lottery's policies and procedures for investigating prize claims appear reasonable for ensuring that the Lottery is performing appropriate actions to gather and evaluate evidence before paying investigated claims. We examined 30 investigated prize claims for which the Lottery approved payment, and we found that the Lottery's investigators took reasonable steps to investigate the claims and used similar types of evidence and investigative approaches to support their recommendations to pay the claimant.

The Lottery directed about \$286 million in unclaimed prize money to education from fiscal years 2016–17 through 2018–19. The Lottery Act requires the Lottery to distribute all unclaimed prize money to education 180 days after the conclusion of a Lottery game or, for multistate games, up to one year after a jackpot or grand prize drawing. Two primary mechanisms ensure that unclaimed prize money is distributed to education. First, according to the chief of the Lottery's financial reporting branch, two supervisors at the Lottery who oversee accounting of prize money review the work of their employees to ensure that the Lottery has accounted for all unclaimed prize money that should go to education. Second, both the SCO and an outside accounting firm audit all of the Lottery's unclaimed prize money. Neither of these entities has identified any issues with the Lottery's contributions of unclaimed prize funds over the past three fiscal years.

We conducted this audit under the authority vested in the California State Auditor by Government Code 8543 et seq. and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the Scope and Methodology section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,



ELAINE M. HOWLE, CPA  
California State Auditor

February 25, 2020

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# APPENDIX

## Scope and Methodology

The Audit Committee directed the California State Auditor to review the Lottery. Specifically, the Audit Committee requested that we review the Lottery’s expenses and its contracting practices, and whether the Lottery considers the effect on education funding when analyzing its business practices and expenses. The table below lists the objectives that the Audit Committee approved and the methods we used to address them.

### Audit Objectives and the Methods Used to Address Them

AUDIT OBJECTIVE	METHOD
<p>1 Review and evaluate the laws, rules, and regulations significant to the audit objectives.</p>	<p>Reviewed relevant laws, regulations, and other background materials applicable to the Lottery.</p>
<p>2 Evaluate Lottery revenues and expenditures for at least the past three fiscal years and determine the following:</p> <ul style="list-style-type: none"> <li>a. Whether the Lottery’s overall operational and administrative expenditure levels are appropriate.</li> <li>b. For a selection of operational and administrative expenditures, whether the Lottery properly spent the funds for necessary purposes.</li> <li>c. Whether the Lottery’s staffing levels and expenditures are justifiable.</li> </ul>	<ul style="list-style-type: none"> <li>• Compared the Lottery’s expenditure levels to five other states’ lotteries: Arizona, Florida, New York, North Carolina, and Texas.</li> <li>• Reviewed the Lottery’s operational and administrative costs since 2015 and found that for the past three fiscal years the Lottery complied with the 13 percent cap on these costs established in the Lottery Act.</li> <li>• Reviewed 30 Lottery expenditures for fiscal years 2016–17 through 2018–19 to determine whether these expenditures were justifiable and for necessary purposes.</li> <li>• For fiscal years 2016–17 through 2018–19, reviewed the Lottery’s overall staffing levels and, for three lottery divisions, reviewed justifications for adding new staff positions.</li> </ul>
<p>3 Review and assess the Lottery’s process for verifying that prize claimants are actual winners, and determine whether it has properly distributed unclaimed prize winnings to public education.</p>	<ul style="list-style-type: none"> <li>• Reviewed the Lottery’s prize claim investigation procedures.</li> <li>• Assessed the completeness of the Lottery’s record information management system. We identified one error in our testing, but otherwise determined that the data were complete for the purpose of selecting investigated prize claims to test.</li> <li>• Reviewed 30 prize claims from fiscal years 2016–17 through 2018–19 that the Lottery investigated and paid out.</li> <li>• Documented the Lottery’s process for distributing unclaimed prize winnings, reviewed the controls for this funding, and determined the amount of unclaimed prize money that went to public education.</li> </ul>
<p>4 Determine whether Lottery functions are operating efficiently, and identify any potential cost-saving measures.</p>	<ul style="list-style-type: none"> <li>• For three of the Lottery’s divisions, reviewed whether the division’s activities aligned with the goals and objectives contained within the Lottery’s strategic and business plans. From discussions with the division directors and review of applicable documents, found general alignment of the divisions’ goals with the Lottery’s overall goals.</li> <li>• Considered the results of the work performed under objective 2.</li> <li>• Reviewed whether the Lottery could incorporate new technology into games to operate more efficiently and effectively. We identified federal and state restrictions for online gaming and found that state law limited the Lottery’s use of technology in its games.</li> <li>• Reviewed the Lottery’s fairs program to determine whether the Lottery could demonstrate that it has received the benefits from this program that it expects to gain.</li> </ul>

AUDIT OBJECTIVE	METHOD
<p>5 Evaluate the Lottery's contracting practices to determine whether its purchase of goods and services are in compliance with applicable state law and best practices.</p>	<ul style="list-style-type: none"> <li>• Reviewed General Services' requirements for procurements and compared these to the Lottery's requirements.</li> <li>• For 15 total contracts from fiscal years 2016–17 through 2018–19, determined whether the Lottery awarded these contracts according to its regulations.</li> <li>• Reviewed hotel agreements and associated trade show expenses for Lottery trade shows held from fiscal years 2014–15 through 2017–18.</li> <li>• Assessed the reliability of a report from the Lottery's e-procurement system. We relied on this report to determine the total number, type, and dollar value of the Lottery's new procurements from fiscal years 2016–17 through 2018–19 as well as to assist in our selection of Lottery procurements to test for objectives 2b and 5. We performed completeness and accuracy testing of the data in the report and found that the data were sufficiently reliable for our purposes.</li> </ul>
<p>6 Assess whether the Lottery considers the impact on education funding when analyzing its business practices and expenditures.</p>	<ul style="list-style-type: none"> <li>• Reviewed the Lottery's three most current budgets and identified the amount it budgeted for education.</li> <li>• Obtained documentation and interviewed staff to determine whether and how the Lottery set the budgeted amount of funding for education.</li> </ul>
<p>7 Review and assess any other issues that are significant to the audit.</p>	<ul style="list-style-type: none"> <li>• Reviewed the work the SCO did to support its April 2019 audit of the Lottery and interviewed SCO staff.</li> <li>• Interviewed Lottery and SCO staff and reviewed documentation related to the report to the Legislature that contained an assessment of the Lottery's performance under the 2010 amendments to the Lottery Act.</li> <li>• Reviewed the SCO's audits of the Lottery and its risk assessment process.</li> </ul>

Source: Analysis of Audit Committee's audit request number 2019-112, planning documents, and analysis of information and documentation identified in the table column titled Method.



February 6, 2020

Elaine M. Howle\*  
 California State Auditor  
 621 Capitol Mall, Suite 1200  
 Sacramento, California 95814

**Re: California State Lottery Response to Draft Audit Report 2019-112**

Dear Ms. Howle,

The California State Lottery (Lottery) offers the following responses regarding the recently concluded audit conducted by the California State Auditor (CSA). The audit scope was focused on the Lottery's performance and compliance with the Lottery Act (Government Code section 8880 et. seq.). We thank you for the opportunity to provide feedback on this report, which specifically examined our revenue allocations to education, and our operational and procurement practices. ①

We are pleased that CSA found no issues with the Lottery's operational and administrative spending levels, its staffing levels, and investigative approaches for awarding prize claims. The Lottery works hard to ensure that its administrative expenses are well within the statutory limit, resulting in an efficient organization that will effectively achieve its mission of maximizing supplemental funding for California public education. The Lottery also assigns a high level of scrutiny and control in awarding Lottery prizes, which is critical to ensuring public trust in the Lottery's operations. ②

The Lottery agrees with certain findings and recommendations included in this report. The findings that address ways to strengthen and improve the Lottery's internal controls and documentation practices will be adopted, where appropriate and consistent with the Lottery's mission.

The Lottery *strongly disagrees* with CSA's findings that it owes \$69 million to education because compliance with a year-over-year proportionality requirement would be inconsistent with the Lottery's mission to maximize funding for education. These findings arise from a fundamental difference of opinion over interpretation of the California State Lottery Act, and Chapter 13 of 2010 (AB 142, Hayashi), which amended the Act in 2010. Because it is not clear what the Legislature intended by "Lottery net revenues" in subdivision (d) of Government Code section 8880.4.5, and because a direct proportionality requirement between Lottery revenues and contributions to education would require the ③  
④  
⑤

\* California State Auditor's comments begin on page 69.

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⑥

Lottery to artificially reduce its contribution to education in some years, the Lottery has continued to focus on the intent of subdivision (d) and the Lottery's core mission of maximizing *funding* for education. Since subdivision (d) has gone into effect, the Lottery has continued to grow the amount of *absolute dollars* contributed to public education, meeting the purpose of AB 142 (Government Code §§ 8880.4; 8880.4.5; 8880.63; and 8880.64) and operating in accordance with the California State Lottery Act.

Consistent with the Lottery's Statement of Revenues, Expenses, and Changes in Net Position set forth in its financial statements, which are audited by an external independent certified public accounting firm pursuant to the Lottery Act, the Lottery determines its annual contribution to public education by the total sales revenue, less prize expenses and administrative expenses, plus interest earnings and unclaimed prizes.

During the four fiscal years that the proportionality requirement has been in effect, the Lottery provided \$6.7 billion to education, which is an increase of more than \$1.3 billion from the previous four fiscal years and more than \$2.2 billion from the four fiscal years prior to the first full year of changes under AB 142.

We appreciate the opportunity to respond to the draft report. The enclosed document sets forth the Lottery's detailed response to CSA's audit report findings and recommendations.

Should you have any questions, please feel free to contact our Chief Internal Auditor Roberto Zavala at (916) 822-8358 or by email [rzavala@calottery.com](mailto:rzavala@calottery.com).

Sincerely,



Alva V. Johnson  
Director

Encl. California State Lottery Management Response to CSA Audit Number 2019-112; Appendix

## California State Lottery Response to California State Audit 2019-112

### BACKGROUND

The Lottery takes its mission to provide supplemental funding to education very seriously and is committed to continuing a culture of transparency. In addition to the CSA's audit, the Lottery frequently undergoes audits by its Internal Audits Office, submits mandated financial reporting to the Legislature and Lottery Commission, and is subject to Government Code (GC) section 8880.46.6, which authorizes the State Controller's Office (SCO) to conduct quarterly and annual audits of all accounts and transactions, as well as special audits as it deems necessary. Past SCO audits have focused on a broad array of issues, including procurement and contract practices, prize validation, financial management practices, internal and administrative controls, review of the Lottery's budget process, and audits on administrative operating expenses. On average, the Lottery undergoes 17 audits per fiscal year. ⑦

It is important to note the unique nature of the California State Lottery. Unlike other state departments, the Lottery does not utilize General Fund money; its revenue is derived solely from the sale of Lottery products. Thus, the Lottery must continually incentivize and persuade California adults to voluntarily purchase Lottery tickets in order to meet the mandate to maximize supplemental funding for public education. Unlike other state agencies, the public is not required to interact with the Lottery for necessary government services. Instead, the Lottery competes with other consumer goods and entertainment options for discretionary spending. To motivate consumers to purchase Lottery tickets, we must continually invest in a variety of marketing strategies and tactics that engage consumers and our retailer partners.

A report prepared by the Legislative Analyst's Office (LAO), dated August 21, 2019, summarized factors that could influence revenue generated for education. The LAO specifically stated, "The prize structure and prize amounts offered similarly appeal to different demographics of customers. Customers' willingness to purchase specific products depends how attractive they find the potential prize."

The Legislature recognized this lottery industry nuance when it approved amendments to the Lottery Act in 2010 via AB 142 (GC §§ 8880.4; 8880.4.5; 8880.63; 8880.64), which provide added flexibility in prize payouts to maximize supplemental funding for public education. Among other changes, the amended language struck the fixed 50 percent requirement for prizes, and instead specified that not less than 87 percent of the total annual revenues from the sale of Lottery tickets shall be returned to the public in the form of prizes and net revenues to benefit public education. With the prize flexibility granted by AB 142, the Lottery is able to incentivize players to higher priced tickets, which increases sales and results in increased dollars to education. ⑧

## California State Lottery Response to California State Audit 2019-112

Prize payout flexibility has been critical to the success of Scratchers® sales in California. Unlike most Draw Games (e.g., Super Lotto Plus®, Powerball®, and Mega Millions®) the prize structure and payout for Scratchers can be controlled to drive consumer participation. This heavily impacts the Lottery's sales revenues and ongoing contributions to education. Over the last eight years, Scratchers sales have grown over 205 percent and currently generate approximately 73 percent of the Lottery's annual revenue. On the other hand, prize payouts for Draw Games are unpredictable because player participation is dependent on the size of the jackpot.

- ⑥ Assembly Bill 142 has unquestionably been successful in growing funds for public education. As a result of this legislation, annual Lottery sales revenues in California have increased by an average of \$483 million per year over the nine years following full implementation of AB 142, resulting in a total of \$13.2 billion in additional funding for education.

### RESPONSE SUMMARY

#### I. Required Funding to Education

- ③ • Application of the Lottery Act's proportionality requirement would undermine the Lottery's sole mission – to maximize supplemental funding for education. Applying a strict proportionality requirement between Lottery revenues and the funding provided to education would require the Lottery to intentionally suppress sales of games with lower profit margins in some years, thereby reducing its overall contributions to education.
- ⑤
- ④ • CSA's definition of "net revenues" as "total sales revenue minus the Lottery's administrative and operational expenses" mathematically forces the prize payout percentage to remain at relatively constant levels. This runs counter to the flexibility afforded to the Lottery under AB 142 to increase prize payouts to increase the amount of funding provided to education.
- ⑨ • The Lottery disagrees that it does not prioritize funding to education when setting its budget. Although CSA cites a few years where prize payouts exceed an outside consultant's recommendation from 10 years ago, the Lottery did use updated industry sales and prize payout data similar to what the prior consultant obtained as well as other market research studies to the prize payout for the years questioned in the report. Additionally, those years generated contributions to education that were between \$250 and \$550 million more than what the consultant's annual projection was using their recommended payout rate.
- ⑩



## California State Lottery Response to California State Audit 2019-112

**II. Procurement Practices**

- The Lottery believes that its competitive bidding exceptions are not improperly utilized and that the information provided to the CSA demonstrated that use of these exceptions was appropriate. However the Lottery agrees it needs to strengthen contracting controls and procurement practices and improve supporting documentation for use of competitive bidding. ⑪
  - The Lottery is currently revising its policies and processes relating to its procurement program; specifically, the rules and documentation requirements for sole source purchasing, use of the emergency contracting exception from competitive bidding, and determining best value when awarding a purchase.
- CSA's analysis of the Lottery's overall procurement activity omitted a significant agreement that was competitively bid. The Lottery's procurement activity chart reflects the omitted figure and shows that 89 percent of its agreements are competitively bid. ⑫
- The Lottery agrees that the contracts associated with the retailer trade shows lacked sufficient documentation to support its evaluation of best value for lodging, catering, and event space.
  - While the retailer trade show program had tremendous value, the Lottery previously suspended the program as a result of an internal audit that identified similar issues. While retailer trade shows are not currently being planned by the Lottery, maintaining positive engagement with our retailers remains a priority. Should the program resume, the Lottery will ensure that proper procurement processes are followed and documented.
- The Lottery disagrees with CSA's underlying conclusions on the value of the Fairs and Festivals program. CSA's determination does not factor in the advertising value that outweighs the accrued out-of-pocket expenses associated with the program. ⑬
- The Lottery concurs with CSA's recommendation to better measure the intangible benefits of the Fairs and Festivals program.
  - The Lottery is in the process of developing metrics to ascertain these intangible benefits.

## California State Lottery Response to California State Audit 2019-112

### **III. Other Areas Reviewed**

- CSA found that the Lottery's operational and administrative spending limits were justifiable and remained within its operational cost limits.
- ⑭ • CSA contends the Lottery's staffing additions were adequately justified.
- CSA found no issues with the Lottery's procedures in investigating prize claims.

Below are the Lottery's responses to the specific findings and recommendations provided in the audit report dated January 31, 2020. The Lottery will develop a work plan as part of the CSA follow-up process to ensure corrective actions are implemented.

### **LOTTERY RESPONSE**

#### **I. Required Funding to Education**

##### **Conclusion 1- Requirement for Education Funding**

##### **Recommendation:**

*The Legislature should require the Lottery to pay to education, from its administrative expenses, the \$69 million it should have provided from fiscal years 2015-16 through 2018-19. To ensure the Lottery adheres to the meaning of its 2010 amendments to the Lottery Act, the Legislature should amend the act to specify that increases in its net revenue and increases in its education funding should be directly proportional.*

##### **Response:**

##### **A. The Lottery Disputes CSA's Application of a Proportionality Requirement to the Lottery's Performance.**

Application of GC section 8880.4.5(d) in the manner proposed by CSA would undermine both the Lottery's sole mission – to maximize supplemental funding for education – and the Legislature's purpose in implementing AB 142.

- Consistent with the Lottery's mission, the purpose of AB 142 was to give the Lottery greater flexibility in its allocation of revenues, allowing it to offer higher prize games to stimulate lagging sales and maximize the overall funding provided to education. As explained below, a practical application of a strict proportionality requirement between Lottery revenues and the funding provided to education, in the manner proposed by CSA, would require the Lottery to intentionally suppress sales of games with lower profit margins in some years, thereby reducing its
- ⑤

## California State Lottery Response to California State Audit 2019-112

overall contributions to education. Since this result is inconsistent with the purpose of the Lottery Act, AB 142, and GC section 8880.4.5(d) itself, CSA's interpretation cannot be correct and must not be applied.

When AB 142 was enacted, sales of Scratchers tickets had declined by more than 16 percent over the preceding three years and virtually all of this decline was attributable to small prize payouts. With a statutory limit of prize payouts at 50 percent<sup>1</sup> (limited by the requirement that at least 34 percent of total annual revenues be allocated to education), California lawmakers decided to follow the lead of lotteries from states like New York, which experienced years of substantial revenue growth under revised statutory provisions similar to AB 142. The California Lottery modeled its implementation of AB 142 after the successful programs implemented by these states through increasing prize payouts for its existing \$1, \$2, and \$5 Scratchers games and expanding its Scratchers product line to include higher priced tickets (\$10, \$20, and \$30) with higher prize payouts.

Increased prize payouts drove sales and offered a path to continued growth. However, it was understood that raising prize payouts necessarily reduced profitability and eliminated proportionality between revenues and dollars to education. CSA notes that there is a wide gap between the Lottery's total revenue and the amount it annually provides to education and that some members of the Legislature have questioned this. Similar gaps have occurred in other states, which the Legislature intended the California Lottery to emulate when it enacted AB 142. This is the natural result of increasing prize payouts to allow for deployment of less profitable games, and was the best strategy available to stop the Lottery's sales decline and realize continued growth. This phenomenon is present in all states that have implemented higher prize payouts, and the California Lottery is in close alignment with other state lotteries in this regard. ⑥

The Lottery's performance under AB 142 was subjected to a "five-year test period." If the Lottery failed to successfully meet certain growth criteria during this time, the statute would be automatically repealed and the previous 34 percent requirement would be reinstated, effectively limiting prize payouts to a fixed 50 percent of revenues. It was the abandonment of that 50 percent prize payout cap that made possible the Lottery's great success in increasing funding to education from \$1.129 billion in fiscal year (FY) 2010-11, the first full year of implementation of AB 142 changes, to \$1.392 billion in FY 2014-15, the end of the five-year period. In the four fiscal years after the test period (FY 2015-16 through 2018-19), the Lottery has provided approximately \$6.7 billion to education, which is an increase of more than \$1.3 billion from the previous four fiscal years, and an increase of more than \$2.2 billion from the four fiscal years prior to the first full year in which AB 142 was effective.

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<sup>1</sup> During this time, the Lottery chose to use a portion of its then 16 percent administrative funding to supplement prize payouts, resulting in an overall prize rate of approximately 52 percent.

## California State Lottery Response to California State Audit 2019-112

- ③ It does not make sense to interpret subdivision (d) of GC section 8880.4.5 to impose a strict proportionality requirement immediately after the Lottery successfully completed a test period during which, unimpeded by a proportionality requirement, it had dramatically increased education dollars. Surely, the Legislature could not have intended that this subdivision immediately change the rules that had worked so well during the preceding years in a way that actually undermines the clear intent behind AB 142 – to transfer *more dollars* to education.
- ④ The Lottery notes that during the five-year test period, the SCO defined “net revenues” as gross revenues (i.e., the Lottery’s total sales). This is the definition the SCO applied to determine whether or not the Lottery had met the “tests” in each of the first five years of AB 142. The Lottery expected this same definition would therefore apply in the years following AB 142. Knowing it would be impossible for growth in funding for education to be proportional to growth in total sales, the Lottery chose to focus on its primary mission of maximizing supplemental funding - the *dollars* provided - to education, giving no effect to the proportionality requirement.
- ⑥
- ⑤ The requirement for proportionality would defeat the overall intent of AB 142 and the Lottery’s sole mission to maximize funding to education because it would require the Lottery to artificially suppress sales and associated contributions to education during some years. These circumstances are not hypothetical. They have occurred in the past and will occur in the future. The following are examples of years in which a strict proportional requirement would have undermined the Lottery’s overarching mission of maximizing funding to education.

From FY 2016-17 to FY 2017-18, using CSA’s definition of net revenues, the actual year-over-year net revenues increased by 12.4 percent while the year-over-year funding for education increased by 10.1 percent. Consequently, under CSA’s analysis, the growth in net revenues and education funding was not proportional.

The year-over-year increase in sales was primarily driven by the fact that \$30 Scratchers games were only introduced half way through FY 2016-17, but were sold during the entire FY 2017-18. Despite the fact that sales for the Lottery’s remaining games (which have a significantly lower prize expense than Scratchers) increased by more than \$236 million from FY 2016-17 to FY 2017-18, and that the \$30 Scratchers sales contributed an estimated \$118 million to education, the lower profit margin on the \$30 game caused the funding for education to grow at a lower rate than net revenues.

In order to meet a requirement to have strict proportionality between these two year-over-year growth rates, the Lottery would have needed to bring both growth

## California State Lottery Response to California State Audit 2019-112

rates down to 7.9 percent by completely eliminating the \$30 Scratchers game for the entire FY 2017-18 and scaling back sales of the \$20 Scratchers game. This would have decreased net revenues (as defined by CSA) for FY 2017-18 by an estimated \$242 million and decreased prize expense by an estimated \$209 million. But most significantly, it would have reduced funding to education by an estimated \$33 million from what education actually received from the Lottery that year. Requiring strict proportionality thus flies in the face of the Lottery Act's overarching mission – to maximize funding for education. The table appended to this response details the figures used in this comparison. ⑦

This same situation would apply in fiscal years following extremely large jackpots. Because the jackpot games have a lower prize payout and thus, on a per-dollar basis contribute more to education, the Lottery would need to take action to purposely suppress sales, and therefore funding for education, in any fiscal year following extremely large jackpot levels. Although the Lottery cannot predict when this will occur, it is not uncommon. ⑥

In FY 2015-16, the Powerball jackpot reached a then-historic \$1.5 billion midway through the fiscal year. This resulted in unprecedented Powerball sales. Because FY 2016-17 had only average jackpots in both Powerball and Mega Millions, net revenues (again using the CSA's definition) actually *decreased* from FY 2015-16 to FY 2016-17. Since Powerball has among the lowest prize expense of Lottery games, the funding for education decreased disproportionately from FY 2015-16 to FY 2016-17.

The CSA report indicates that the Lottery would only have met (in fact, surpassed) the proportionality requirement in FY 2015-16 and FY 2018-19. The only reason the Lottery would have met its proportionality requirement in those two fiscal years is because FY 2015-16 had a then-historic \$1.5 billion advertised jackpot in Powerball and FY 2018-19 had a record \$1.6 billion advertised jackpot in Mega Millions (resulting in an exponential increase in sales in these games). This situation sets the Lottery up to fail the proportionality requirement in the following year as explained above. ③

CSA apparently assumes that the Lottery can increase year-over-year growth in funding for education upward to match the rising year-over-year growth in net revenues. This is not possible because the only realistic way to achieve strict proportionality is to reduce sales in higher payout Scratchers games or Hot Spot®, the only games over which the Lottery has sufficient control to achieve proportionality, and forgo the additional money that the Lottery would have earned for education. If the Lottery did not artificially limit or reduce revenues, there would be more dollars available for education, but the increased prize expense would exacerbate the disproportionality between net revenues and funding for education. ⑥

## California State Lottery Response to California State Audit 2019-112

- CSA concluded that: “If the Lottery had adhered to this proportionality requirement, it would have provided education with \$69 million more than it actually provided during fiscal years 2015-16 through 2018-19.” This statement ignores the fact that strict adherence to a proportionality requirement would have resulted in losses to education, not gains, because the Lottery would have had to purposely reduce Scratchers sales and, therefore, the funding for education, to maintain a strict proportionality.
- ⑤ Because it has the effect of undermining AB 142 and the entire mission of the Lottery, subdivision (d) cannot be interpreted to cause an artificial reduction in education funding to meet an arbitrary, and in some applications, irrational proportionality requirement. This is particularly true because subdivision (d) already included another provision that actually serves the subdivision’s stated purpose – “to ensure continued growth in lottery net revenues allocated to public education.” Such growth is ensured by the portion of subdivision (d) which provides “net revenues allocated to public schools [must be] at least as much as were allocated on average in the prior five fiscal years.” Unlike proportionality, this provision will never require suppression of revenues and loss in education funding to achieve an artificial balance between the two in any given year. It requires a certain amount of growth based on prior years’ performance like the standards in the five-year test period, but it also recognizes that there will be down years due to circumstances beyond the Lottery’s control (poor jackpot levels, the inevitability of slowing sales, colossal natural disaster, faltering economy, etc.) and that, at some point, growth will slow.
- CSA states that it is critically important that the Lottery adhere to the proportionality requirement among others “because they are safeguards that ensure that the Lottery’s education funding increases as the Lottery’s revenues increase, is at its highest possible level and does not decline sharply from one year to the next.” As shown above, the proportionality requirement neither ensures that education funding increases as the Lottery’s revenues increase nor ensures that education funding is at its highest possible level.
- ③
- ⑮ The Lottery’s interpretation of subdivision (d) is informed by factors that are specifically within its knowledge and expertise, and is entitled to more weight than that of an outside agency. Where an alternative interpretation is offered for a statute that a state agency is charged with implementing, courts have held that the responsible state agency’s interpretation is entitled to great weight unless it is clearly erroneous. (See *Whitcomb Hotel, Inc. v. California Employment Com.* (1944) 24 Cal.2d 753.) The Lottery is responsible for the interpretation and implementation of AB 142. In the Lottery’s opinion, AB 142 must be interpreted in a way that will never have the effect of artificially suppressing growth in education funding. Against this background the Lottery’s interpretation is reasonable and should be accepted.
- ③



## California State Lottery Response to California State Audit 2019-112

**B. Even if Strict Proportionality were Required, the Lottery Disputes CSA's Conclusion that the Lottery Owes Education \$69 Million**

④

**1) In Reaching the \$69 Million Figure, the CSA Applied a Definition of "Net Revenue" that is Not Supported by Statute or Common Usage.**

④

⑬

Government Code section 8880.65 specifies: "The funds remaining in the State Lottery Fund after accrual of all revenues to the State Lottery Fund, and after accrual of all obligations of the Lottery for prizes, expenses, and the repayment of any funds advanced from the temporary line of credit for initial startup costs and interest thereon shall be deemed to be the net revenues of the Lottery." Thus, Lottery net revenues are defined as the funding available for education.

If the definition of the Lottery net revenues from G C section 8880.65 were applied to Subdivision (d) of G C section 8880.4.5, it would require the Lottery to ensure that the funding available for education be increased in proportion to any upward increases in the funding available for education. This makes the proportionality requirement meaningless since it would be impossible to fail. In short, the Legislature's precise intent with respect to this requirement, and specifically the intended meaning of "Lottery net revenues," is unclear.

③

④

CSA has defined "net revenues" as "total sales revenue minus the Lottery's administrative and operational expenses." This definition appears to be arbitrary and the Lottery could find no rationale to support it.

④

CSA concedes that applying their definition of "net revenues" for purposes of meeting the proportionality requirement necessitates that the Lottery's net revenues be equivalent to the sum of the Lottery's education funding and prize payout. There is an inherent flaw in this definition since, mathematically, this forces the prize payout percentage to remain at relatively constant levels. This runs counter to the flexibility that the Legislature intended to add under AB 142.

After exploring the challenges with CSA's definition of "net revenues," the Lottery would propose to define "Lottery net revenues" in the context of AB 142 as sales revenues net of cost of goods sold, which are the expenses the Lottery incurs paying prizes, retailers, and game costs. This alternative definition is appropriate for three reasons: First, it is consistent with the Lottery's Statement of Revenues, Expenses, and Changes in Net Position in its financial statements, which are audited by an external independent certified public accounting firm pursuant to the Lottery Act and display Lottery sales less prizes, retailer costs, and game costs as "income before operating expenses." Second, in the private sector, a company's net sales revenue minus its cost of goods sold is its gross margin, which is used to assess the company's financial health. Third, this is a more meaningful comparison since it better isolates the administrative expenses that the Lottery has more direct control over (i.e., the salaries, wages, and benefits paid to its employees, advertising and marketing expenses, non-gaming

④

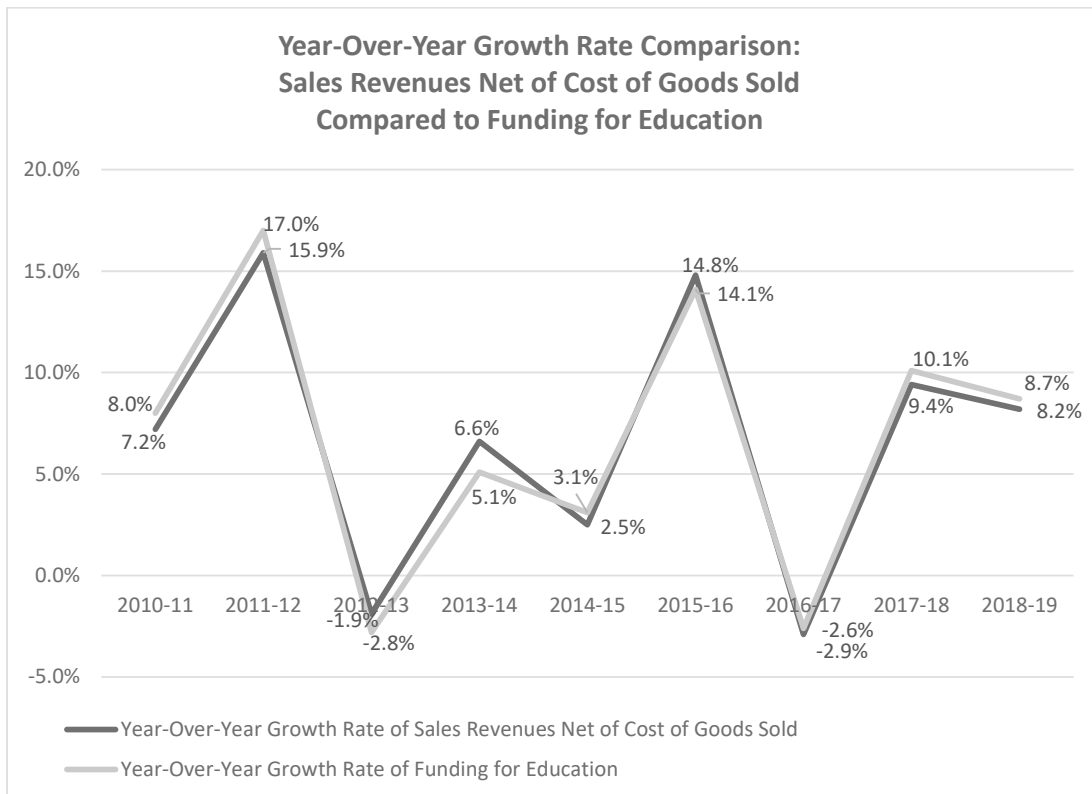
⑰

## California State Lottery Response to California State Audit 2019-112

contractual services, depreciation, and other general and administrative expenses). In other words, if the Lottery is not mindful of minimizing these operating expenses, the funding it provides for education would clearly be disproportional to its net revenues.

As shown in the graph below, the year-over-year growth pattern of funding for education is very close to the pattern of sales revenues net of cost of goods sold from FY 2015-16 (the first year of the proportionality requirement) through FY 2018-19. This similarity in patterning, as opposed to strict proportionality, is what the Legislature must have had in mind when it used the “in proportion to” language.

③



④

**2) Regardless of the Definition of Net Revenues, there is no Reasonable Calculation in Which Lottery Underfunded Schools by \$69 Million.**

⑤

**a) CSA’s Calculation Does Not Take Into Account the Suppression of Funding to Education that Would Have Been Required to Achieve Strict Proportionality in FY2016-17 and FY 2017-18.**



California State Lottery Response to California State Audit 2019-112

CSA’s calculation ignores the fact that to achieve proportionality in FY 2016-17 and FY 2017-18, the Lottery would have had to suppress education funding as discussed in detail above. For example, had strict proportionality been required in FY 2017-18, education would not have gained the \$53 million as alleged by CSA; it would have instead *lost* \$33 million – a swing of \$86 million.

**b) CSA’s Calculation Ignores Aspects of Subdivision (d) that do Not Support its Finding.**

④

Subdivision (d) of G C section 8880.4.5 specifically requires funding for education to increase “...in proportion to any upward increases in lottery net revenues” (emphasis added). Because net revenues actually declined from FY 2015-16 to FY 2016-17, there was no “upward increase” in net revenues and the proportionality requirement does not apply. This language alone would remove nearly \$16 million from the California State Auditor’s \$69 million finding.

④

**3) CSA’s Analysis Does Not Acknowledge that the Lottery Consistently Spent Less on Administrative Expenses than the 13 Percent Allocation Allows; These Savings Augment Education Funding**

⑥

⑱

The Lottery has authority to allocate up to 13 percent of gross revenues to administrative expenses. Many of those expenses are essentially a fixed percentage of sales revenues (e.g. retailer compensation and gaming costs) and cannot be reduced. These have accounted for approximately 9 percentage points of the 13 percent in each of the last seven fiscal years. Even so, while the remaining 4 percent is an extremely low administrative budget for an organization the size of the Lottery, it has transferred approximately \$250 million to education from its administrative allocation in the last four fiscal years. Further, the Lottery has managed to supplement its contribution to education from its administrative allocation almost every year since its inception, totaling over \$1 billion since 1985.

**Conclusion 2- The Lottery Has Not Prioritized Funding to Education When Setting Its Budgets.**

**Recommendation:**

*The Lottery should (1) By August 2020, determine the optimal amount of prize payouts that maximizes the funding for education; (2) By August 2020, establish a policy to annually reconsider the amount of prize payments that maximizes funding for education; and (3) Use this optimal prize amount when setting its budgets, beginning with the budget for fiscal year 2021-22.*

## California State Lottery Response to California State Audit 2019-112

**Response:**

- ⑨ The Lottery disagrees with the finding that it does not prioritize funding to education when setting its budgets. However, the Lottery agrees with the recommendation that the Lottery update the 2010 study referenced by the CSA which established an average optimum prize payout percentage.

- One basis for the CSA's assertion is that the Lottery did not responsibly establish the level of prize payout for its games. In support of this allegation, the CSA points to (1) an outside analysis, which projected an optimum prize payout of 62 percent, that has not been updated since 2010 and (2) the Lottery established prize payouts that were \$110 million to \$248 million in excess of the consultant's recommended rate. The implication is that because prize payouts were higher than needed to sell tickets, profits that fund education were lower than they should have been. The CSA, in essence, concludes that the Lottery could not responsibly establish prize payouts without an updated report from an outside source. This analysis fails to include some key information that demonstrates the Lottery did prioritize funding to education when making these decisions.
- ⑨

First, the Lottery's decision to increase its average prize payout above 62 percent coincided with the introduction of a \$30 game and increased sales of its \$20 Scratchers product. Both of these efforts required an upward adjustment of the average prize payout, because purchasers of \$30 games had to be incentivized to pay a higher price for the ticket, and an increase in the number of \$20 tickets distributed added more higher priced tickets to the Lottery's product mix.

- ①⑨ CSA speculates that because the Lottery exceeded 62 percent in prize payouts for FY 2015-16 to FY 2018-19, it paid out between about \$110 million to \$248 million more per year in prizes than it had to, and that this money should have gone to education. However, empirical evidence shows that the addition of these games led to much higher contributions to education than projected by the consultant with the 62 percent optimum prize payout (even allowing for the fact that the consultant used a lower profit margin because of a 13.5 percent figure for administrative expenses). In fact, the Lottery's actual annual contributions in FY 2015-16 through FY 2018-19 exceeded the consultant's annual projection of \$1.244 billion with a 62 percent prize payout between \$250 million to \$550 million per year. This far exceeds the \$110 million to \$248 million in additional prize expense cited by the CSA.

Second, the consultant's methodology for identifying the optimum prize payout was based on U. S. lottery industry data from FY 1998-99 through FY 2007-08. His analysis could not have taken into account a \$30 ticket and its effects on \$20 game sales since only 5 jurisdictions had a \$30 ticket with 3 of the 5 introducing tickets with that price point in 2007 or 2008.

- ②⑩ A report like the one provided by the consultant in 2010 is not the only way to intelligently and responsibly establish prize payouts. Prior to launching the first

## California State Lottery Response to California State Audit 2019-112

\$30 Scratchers game in August 2015, the Lottery conducted market research studies to determine consumer interest and potential purchases. Additionally, the prize payout rates used by other states for their \$30 tickets were analyzed, resulting in the Lottery adopting a payout rate near the industry average for games with that price point. After sales of the first \$30 tickets were completed, the Lottery analyzed the incremental sales and profit generated from adding this product. This study showed the \$30 game generated additional dollars for education and the Lottery decided to make this \$30 product a part of the Scratchers portfolio introducing a second \$30 ticket in January 2017.

The current and historic industry data from the same source used by the consultant is available to the Lottery. So is a wealth of knowledge and experience gleaned by other states who were granted the freedom to increase prize payouts years before California had this opportunity. These are essentially “test laboratories”, and the California Lottery has benefitted by learning from their successes and their failures.

In the future, the Lottery’s budgets will be informed by an updated report that identifies an average optimum prize payout, but the Lottery will continue to use its internal expertise and industry data to make decisions concerning individual games.

The fact that the Lottery is now zero-basing its operating expenses when developing its budget will help facilitate this requirement. Because zero-basing will result in the Lottery’s budgeted operating expenses being lower than as reflected in past budgets, this will help with the proportionality between the budgeted funding for education and the budgeted net revenues, no matter how “net revenues” are defined.

Another area where the CSA is critical of the Lottery’s current process involved the manner in which a profit goal of \$2 billion was set.

(21)

In setting this goal, the Lottery considers trend analysis on growth in profits. However, the CSA believes that the Lottery should set its strategic profit goal by a more formula-driven methodology. This is problematic for several reasons:

- (1) In a business like the Lottery, sales and profits are more difficult to accurately project from a formula three years in advance.
- (2) Lottery revenue comes from California adults electing to spend their disposable income on a discretionary product and is somewhat influenced by changing market and consumer trends that are largely outside of the Lottery’s control.
- (3) The \$2 billion profit goal was set during an initial phase of the strategic planning process when specific tactics had not yet been developed. The purpose of setting that target at that point in the process was to have the

## California State Lottery Response to California State Audit 2019-112

Lottery's Divisions develop and propose strategies and tactics to achieve the agreed upon goal.

In contrast to the strategic planning process, during the annual business planning process, specific sales and profit goals are established by product based on the specific tactics and initiatives that will be implemented during the fiscal year.

- ② These sales and profit figures are created with significantly more rigor. Additionally, during the development of the annual business plan, each major initiative is reviewed to determine if the proposed expenditure will ultimately benefit the Lottery's contribution to education.

### **Procurement Practices**

#### **The Lottery Entered Noncompetitive Agreements Without Adequate Justification**

##### **Recommendation:**

*To ensure it conducts procurements in a way that preserves all possible funding for education, by August 2020, the Lottery should develop procurement procedures that, at a minimum, do the following:*

- *Provide examples of when products are truly available from only one source and examples of when the Lottery should consider whether alternative products also fulfill its needs.*
- *Require its staff to collect and maintain documentation supporting any exception to competitive bidding and provide examples of adequate and inadequate documentation.*
- *Instruct its contracts unit to deny all procurement requests that do not demonstrate adherence to contracting requirements.*

##### **Response:**

The Lottery agrees with this finding, to the extent that it identifies appropriate opportunities to strengthen the Lottery's contracting processes. Prior to the start of the CSA's work on this audit, the Lottery likewise identified a need to strengthen contracting controls, further define requirements, and incorporate some of the procurement practices used by other state agencies, in a manner that is consistent with the Lottery's mission of maximizing supplemental funding for public education.

- ① The Lottery believes that its competitive bidding exceptions are not improperly utilized and that the information provided to the CSA demonstrated that the Lottery's use of these exceptions was generally appropriate for the sampled procurements, including the Lottery's financial system upgrade. To the extent that this finding suggests that these procurements were not permitted under

## California State Lottery Response to California State Audit 2019-112

Lottery Regulations, the Lottery disagrees. However, the Lottery agrees that its supporting documentation requirements for use of competitive bidding exceptions should be strengthened and that further guidance should be provided to staff on the use of these exceptions.

The Lottery is currently working on revising its policies, procedures, and processes relating to its procurement program; specifically, the rules and documentation requirements for sole source purchasing, use of the emergency contracting exception from competitive bidding, and determining best value when awarding a purchase.

The Lottery plans to implement the changes to its contracting program in 2020. Although the CSA recommends corrective action be completed by August 2020, the Lottery will more likely need until the end of 2020 to properly implement these changes, with assessment of their effectiveness extending into 2021. (23)

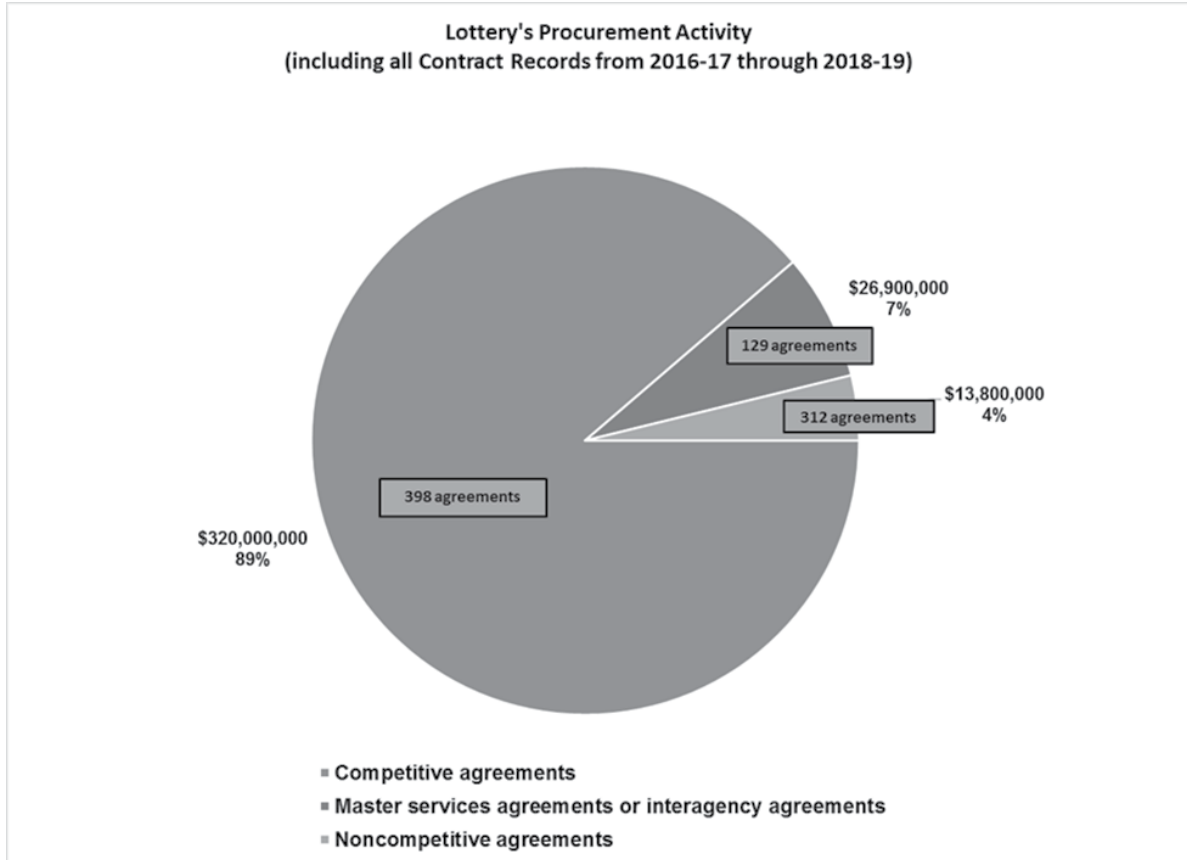
### **A. CSA's Percentages for the Lottery's Overall Procurement Activity Are Misleading**

CSA acknowledges in a footnote on page 28 of its report that one contract was excluded from CSA's analysis of overall procurement activity, because the contract amount skewed the data. The omitted procurement was the Lottery's lead advertising agency contract, which was competitively bid and valued at \$295 million. While the Lottery acknowledges that a significant portion of its procurements are not competitively bid, presenting them in this fashion is misleading. (12)

Historically, the Lottery's highest dollar value contracts, including its gaming system, Scratchers, and marketing contracts have all been competitively bid, and the vast majority of the Lottery's contract dollars are spent in connection with those contracts. As a result, excluding the Lottery's lead advertising agency contract from an analysis that is specifically based on procurement dollars is misleading at best. Including this information conveys a more accurate picture of the Lottery's overall procurement activity, both during the audit period and as a whole. (12)

When adjusted to include the lead advertising agency contract, the Lottery's actual procurement activity in dollars over the audit period is as follows: 89 percent of the Lottery's procurements are competitively bid; and 11 percent of the Lottery's procurements were not competitively bid (7 percent used leveraged procurement agreements, a noncompetitive option available to all state agencies; 4 percent were procured through another competitive bidding exception available under Lottery Regulations.) This information is depicted in the chart below.

## California State Lottery Response to California State Audit 2019-112



**The Lottery did not Minimize Retailer Trade Show expenses and Spent Excessively on Food and Beverages**

**Recommendation:**

*To ensure it conducts procurements in a way that preserves all possible funding for education, by August 2020, the Lottery should develop procurement procedures that, at a minimum, do the following:*

- *Provide examples of when products are truly available from only one source and examples of when the Lottery should consider whether alternative products also fulfill its needs.*
- *Require its staff to collect and maintain documentation supporting any exception to competitive bidding and provide examples of adequate and inadequate documentation.*
- *Instruct its contracts unit to deny all procurement requests that do not demonstrate adherence to contracting requirements.*

## California State Lottery Response to California State Audit 2019-112

### Response:

The Lottery agrees that the contracts associated with its retailer trade shows lacked sufficient documentation to support its evaluation of best value for lodging, food and catering, and event space. While pricing information was not accurately recorded, the Lottery did go through a process to evaluate best value based on available options that met the Lottery's requirements, and overall, the Lottery received significant value from retailer trade shows. (24)

A Lottery internal audit of its Sales Division's Procurement Practices (2019) had identified several issues that the Lottery immediately began to address. This corrective action plan included the hiring of a new Sales Administration Chief focused on administration and operations, enhanced review of the Sales division's procurements and travel, zero-based budgeting for Sales & Marketing division in FY 2019-2020, and adherence to the State Leadership Accountability Act for internal controls.

As CSA reported, retailer trade shows are not currently being planned by the Lottery. However, educating retailers and maintaining positive engagement with them remains a priority. Survey results from each trade show indicated that retailers found value in attending the events with workshops achieving an average of 4.8 out of 5 rating, and 95 percent indicating that they would attend future trade shows. If and when the Lottery resumes a retailer trade show program, the Lottery will continue to execute its corrective action plan, engage in a best value analysis for all contracts and retain thorough documentation to support the contract.

### **Amending the Lottery Act Would Create Greater Accountability for the Lottery's Procurement Processes**

#### **Recommendation:**

*To ensure that the Lottery is subject to oversight of its procurement practices, the Legislature should amend the Lottery Act to direct the SCO to conduct audits of the Lottery's procurement process at least once every three years.*

#### **Response:**

The Lottery provides no comment in connection with this recommendation.

### **The Lottery Does Not Know Whether the Millions It Spends on Its Fairs Program Have Been Effective.**



## California State Lottery Response to California State Audit 2019-112

**Recommendation:**

*To ensure that it receives value for the funding it spends on its fairs program, by January 2021, the Lottery should determine whether the program has increased its brand strength, customer loyalty, customer satisfaction, ticket sales, and profits. If the analysis determines that the Lottery has not achieved these benefits, it should terminate the program.*

**Response:**

- ⑬ The Lottery disagrees with CSA's underlying conclusions on the value of the fairs and festivals program. CSA's determination does not factor in the advertising value associated with these marketing events, as part of the Lottery's overall marketing program. This value is reviewed at the onset and is the main factor used to determine if the Lottery will participate in any given event. However, the Lottery concurs with CSA's recommendation to better measure the program's intangible benefits. The Lottery had previously identified opportunities for improvement in the program in its own analyses and has already developed a plan to strengthen the effectiveness of the program.
- ⑮ As part of the zero-based budget development in early 2019, the Lottery performed an in-depth post-analysis of the 2017 Fairs and Festivals program and found that the 25 events generated over \$5.5 million dollars in on-site sales. When factoring in the \$1.3 to \$3.7 million in advertising value, the total value is \$6.1 to \$9 million, with the net gain and overall value for the Fairs and Festivals program being \$1.1 – \$3.5 million in combined on-site sales and earned advertising.

A majority of the expenses (approximately \$5.4 million) were tied to product sales in the form of retailer commissions and prize costs as well as the cost of promotional tickets going to players as a "gift with purchase." These promo tickets are used to incentivize trial purchases via a spin the wheel promotion.

- ⑯ The out-of-pocket expenses incurred for the program are 1) sponsorship fees charged by event organizers and 2) travel costs for Lottery staff working the event. These costs are minimal in comparison to the benefits realized from these events. For example, the 25 events held in 2017 cost the Lottery approximately \$230,000. The advertising value alone outweighs the accrued out-of-pocket expenses associated with the Fairs and Festivals program.

The Lottery operates the Fair and Festival program based on best practices for event and experiential marketing, which is proven to be an effective marketing strategy that drives sales and significantly improves how consumers feel about and perceive brands. In an annual survey of a wide cross-section of consumers, 85 percent of consumers were likely to purchase after participating in events and experiences, and over 90 percent have more positive feelings about



## California State Lottery Response to California State Audit 2019-112

brands after attending. (*EventTrack Event & Experiential Marketing Industry Forecast & Best Practices Study, 2018*).

Additionally, numerous consumer research studies have shown that today's consumers value experiences over possessions and are much more likely to engage with brands that deliver relevant, enriching, entertaining experiences than those that solely rely on traditional advertising in any of its forms. As a result, brands are endorsing this strategy by investing more in experiential marketing with more than a third of chief marketing officers planning to allocate up to half of their budget to experiential marketing efforts over the next three to five years (*Freeman Global Brand Experience Study, 2017*). Again, using 2017 as an example, the Fairs and Festivals Program represented less than one percent of the Lottery's overall marketing budget.

The Lottery concurs with the CSA's recommended program improvements and is in the process of developing its methodology to measure the intangible elements received at fairs and festivals, including awareness, engagement, brand strength, customer loyalty, and customer satisfaction in addition to ticket sales and profits. These metrics will be used to evaluate the efforts during the upcoming festival season that begins in the Spring and continues through the Fall.

## Appendix

## Year-Over-Year Growth from FY 2016-17 to FY 2017-18

(Dollars in Millions)

	FY 2016-17 Actual	FY 2017-18 Actual	% Diff from 2016-17	FY 2017-18 Scenario	% Diff from 2016-17	\$ Diff from 2017-18 Actual
<b>Sales:</b>						
Scratchers	\$4,576.0	\$5,077.4	11.0%	\$4,811.4	5.1%	-\$266.0
Jackpot Games	1,041.1	1,234.1	18.5%	1,234.1	18.5%	0.0
Other Draw Games	616.4	654.3	6.2%	654.3	6.2%	0.0
<b>Total, Sales</b>	<b>\$6,233.5</b>	<b>\$6,965.8</b>	<b>11.7%</b>	<b>\$6,699.8</b>	<b>7.5%</b>	<b>-\$266.0</b>
<b>Administrative Expenses:</b>						
Retailer & Gaming Costs	\$550.0	\$608.1	10.6%	\$584.6	6.3%	-\$23.6
Operating Costs	\$225.8	\$225.0	-0.3%	\$225.0	-0.3%	0.0
<b>Total, Administrative Expenses</b>	<b>\$775.8</b>	<b>\$833.2</b>	<b>7.4%</b>	<b>\$809.6</b>	<b>4.4%</b>	<b>-\$23.6</b>
<b>Net Revenues</b>	<b>\$5,457.6</b>	<b>\$6,132.6</b>	<b>12.4%</b>	<b>\$5,890.2</b>	<b>7.9%</b>	<b>-\$242.4</b>
<b>Prize Expense:</b>						
Scratchers	\$3,121.1	\$3,507.3	12.4%	\$3,297.7	5.7%	-\$209.5
Other Games	842.4	969.3	15.1%	969.3	15.1%	0.0
<b>Total, Prize Expense</b>	<b>\$3,963.5</b>	<b>\$4,476.6</b>	<b>12.9%</b>	<b>\$4,267.0</b>	<b>7.7%</b>	<b>-\$209.5</b>
<b>Contribution to Education</b>						
Unclaimed Prizes	\$1,494.2	\$1,656.1	10.8%	\$1,623.2	8.6%	-\$32.9
Interest and Other Income	46.5	36.0	-22.5%	36.0	-22.5%	0.0
<b>Total Available for Education</b>	<b>\$1,545.5</b>	<b>\$1,700.9</b>	<b>10.1%</b>	<b>\$1,668.1</b>	<b>7.9%</b>	<b>-\$32.9</b>

## COMMENTS

### CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CALIFORNIA STATE LOTTERY

To provide clarity and perspective, we are commenting on the response to our audit from the Lottery. The numbers below correspond to the numbers we have placed in the margin of the Lottery's response.

Although the Lottery states our audit scope was focused on the Lottery's performance and compliance with the Lottery Act, the Audit Committee requested that we review the Lottery's expenses, its contracting practices, and whether the Lottery considers the effect on education funding when analyzing its business practices and expenses. We describe our audit objectives and methodology on pages 45 and 46 of our report.

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As we indicate on page 16, because the Lottery's budgeting process does not begin with the Lottery setting a target for education funding that meets the Lottery Act requirements, the Lottery is not ensuring that it maximizes funding for education. Further, we found the Lottery's procurement practices do not always ensure that it obtains the best value when entering into noncompetitive agreements, which also reduces the funding it provides to education.

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The Lottery's statement is inconsistent with the Lottery Act's requirements. The Lottery Act requires the Lottery to both increase funding to education in proportion to any increase in net revenue and maximize total net revenue allocated to education, as we indicate in the text box on page 9. By not meeting the proportionality requirement, the Lottery cannot demonstrate that it is maximizing funding for education.

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We disagree that the term *net revenues* is not clearly defined in state law. From our review of the Lottery Act, as we describe on page 9, we determined that the Legislature clearly intended *net revenues* to refer to total sales after deducting the Lottery's administrative and operational expenses, but before prize payments are paid out. We based our definition on a combination of the plain language in the Lottery Act, the common understanding of net revenue, and case law.

④

As we indicate on page 14, the Lottery has not used a budgeting process that is designed around meeting the Lottery Act's requirements. As we describe on pages 14 and 15, if the Lottery began its budget process by determining the optimal balance point between prize payouts and education funding, it could accurately

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determine how much it would need to provide to education in the upcoming fiscal year to satisfy the proportionality requirement. This finding led to our recommendation on page 17 that the Lottery determine the optimal amount of prize payouts that maximizes the funding for education. Therefore, if the Lottery is using this new optimal point in future budgets to meet the proportionality requirement and maximize funding for education, it should not need to artificially reduce its contributions to education or suppress sales of games. Further, if the Lottery believed that the proportionality requirement required it to suppress sales of its products and artificially lower its education contribution, it has had almost ten years to communicate that concern to the Legislature. Instead, the Lottery chose to plan its budgets without regard for the plain language meaning of a critical funding requirement in the Lottery Act.

- ⑥ The Lottery's assertion that it has complied with the Lottery Act by growing the funding contributed to education is false. Under the Lottery's approach, any amount of increased funding to education would be acceptable. However, the proportionality requirement in the Lottery Act provides a mechanism to ensure that when overall revenues increase, the funding to education increases in the same proportion. As we state on page 9, the Lottery does not know if it has maximized the funding to education because it has not determined the optimal balance between prize payouts and education funding.
- ⑦ The Lottery overstates the nature of the audit work the SCO has performed at the Lottery. Although the SCO has conducted audits of the Lottery, as we note on page 38, none of the SCO audits we reviewed from 2015 through 2018 for which the SCO published a report had findings related to the Lottery's mission to provide supplemental funding to education. As we also note on page 38, the SCO has reviewed the Lottery only for compliance with narrow sets of laws or regulations. By their nature, these types of reviews will not identify all areas for improvement or address efficiency issues.
- ⑧ Although the Lottery has provided more than 87 percent of its total annual sales revenue to prize payouts and education funding, the Lottery's sole mission is to maximize funding to education. As we indicate on page 12, the Lottery provided between 24 to 25 percent of its total annual sales revenue to education in fiscal years 2016–17 through 2018–19. Therefore, the Lottery gives the majority of this 87 percent figure to prize payouts and could not explain to us how it determined that this was the optimal percentage to provide to education, as we discuss on pages 13 through 16. As a result, the Lottery cannot demonstrate that it is fulfilling its sole mission to maximize funding for education.

The Lottery has not prioritized funding for education. As we indicate on page 14, the Lottery has not budgeted to meet the proportionality requirement because it does not budget funding for education to increase in proportion with increases from the previous fiscal year’s net revenue.

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The “outside analysis” the Lottery references was from a Lottery consultant who identified the optimal prize payout percentage in a report from 2010. However, the Lottery consultant noted that the study would lose validity as it became older and recommended the Lottery have the analysis redone with more current data. The Lottery also asserts it used certain market research data in its decision making, but it did not use this information to create budgets that complied with the requirements of the Lottery Act. Therefore, we recommend that the Lottery determine the optimal prize payout that maximizes funding for education.

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The Lottery’s belief that its exceptions to competitive bidding were appropriate is incorrect. As we indicate on page 20, we determined that in 8 of the 15 procurements we reviewed, the Lottery entered into noncompetitive agreements without adequate justification. We reached our determination based on the documentation, or lack thereof, in the Lottery’s procurement records. Moreover, the Lottery appears to agree with our finding as it notes in the same statement that it “agrees it needs to...improve supporting documentation for use of competitive bidding.”

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Our presentation of the Lottery’s procurement activity best presents the potential scope of the problem regarding the Lottery’s use of noncompetitive procurements. When conducting our review, we identified one contract that was 30 times larger in value than the next largest contract, which we excluded because it skewed the summary level data about the Lottery’s procurement activity. We clearly acknowledge excluding this contract in Figure 4 on page 23 of our report. Moreover, our presentation of the Lottery’s contract activity is not only based on the value of the contracts, but also on the number of contracts. Therefore, we believe our presentation of the Lottery’s procurement activity is appropriate.

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We describe the advertising value of \$1.3 million to \$3.7 million that the Lottery claims to have achieved from the fairs program on page 29. However, on that same page, we also note that the Lottery could not show that it had measured whether it received commensurate value for its fairs program expenditures to determine whether the fairs program is beneficial to the Lottery. Further, the Lottery only performed an analysis of advertising value after we asked whether it had received additional value from these events since it did not generate a direct profit.

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- ⑭ The Lottery overstates our conclusion. We did not conclude that all of the Lottery's staffing additions were adequately justified. As we describe on page 42 of the audit report, we reviewed five Lottery budget revisions in which three of the Lottery's eight divisions requested permission to add new staff positions and determined that the divisions generally provided a reasonable justification for adding these positions.
- ⑮ The Lottery's view is based on outdated case law that has been superseded by a line of cases that instead of applying a strict rule, looks to the situation presented by the type of regulation involved. In this instance, operating the Lottery does not bestow additional knowledge or expertise on its administrators regarding how to define a term as common as net revenue. Therefore, it is our view that the Lottery's interpretation of Government Code section 8880.4.5, subdivision (d), is incorrect, and that the Lottery does not have any specific knowledge or expertise that would entitle it to receive any additional weight over our office, or other outside agency reviewing its operation.
- ⑯ We shared our calculation with the Lottery of how we arrived at the \$69 million that it owed to education several times before it received our draft report. It was not until the Lottery responded to our draft report that it fully documented its rationale for why it believed the amount of \$69 million was incorrect. After carefully considering the Lottery's response, we recalculated the amount it owed education and arrived at an amount of \$36 million.
- ⑰ None of the Lottery's three reasons for its "alternative definition" are relevant in applying the meaning of net revenues for purposes of the proportionality requirement in the Lottery Act. The first reason is simply the Lottery's description of how it displays its financial statements under generally accepted accounting principles, while the other two reasons describe common cost accounting practices. Nowhere in the Lottery Act does it include consideration of these accounting principles and practices when defining net revenue in regard to the proportionality requirement.
- ⑱ The Lottery's statement is inaccurate. We acknowledge that the Lottery's operational and administrative costs are within the 13 percent limit of total annual revenue the Lottery Act allows on page 41 of our report.
- ⑲ The Lottery mischaracterizes our conclusion. We do not say that all of this money should have gone to education, rather, as we indicate on page 13, our analysis determined that the Lottery exceeded the optimal prize payout of 62 percent that the consultant had recommended in its 2010 study and it planned to pay out between \$110 million to \$248 million more than what the study suggested

was necessary for maximizing funding for education. Therefore, we recommend the Lottery determine the optimal amount of prize payouts that maximizes the funding for education.

We do not say a report like the consultant's 2010 report is the only way to determine the optimal amount of prize payouts. Our recommendation on page 17 is for the Lottery to determine the optimal amounts of prize payouts that maximize funding for education, establish a policy to annually reconsider this amount, and use this amount when setting its budgets. Moreover, we do not believe conducting market research for one scratchers game is sufficient analysis to determine the optimal amount of prize payouts that maximize funding for education.

⑳

The Lottery misunderstands our concern with the \$2 billion goal that it set for funding to education. Our concern, as stated on page 15, was that the Lottery selected the \$2 billion amount because the Lottery believed it was a "monumental" goal to inspire its sales staff to increase revenue. However, we believe the Lottery's education funding goal should be based on actual analysis.

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Although the Lottery indicates that its sales and profit figures are created with more rigor than its strategic profit goals, as we describe on page 16, the Lottery did not use this information to create a budget that met the requirements of the Lottery Act. Therefore, on page 17 we recommend the Lottery Commission require its staff to demonstrate that they have planned for education funding to be maximized and aligned with the proportionality requirement of the Lottery Act.

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Our recommendations will help ensure that the Lottery conducts procurements in a way that preserves all funding possible for education, which aligns with the Lottery's mission. We believe an implementation date of August 2020 is reasonable because, as we note on page 22, the Lottery asserts that its current executive director has made it a top priority to unify and update the Lottery's policies and procedures, and ensure staff are trained on them. Therefore, we look forward to reviewing the progress that the Lottery has made to implement our recommendations in its 60 day and six month responses to our audit.

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The Lottery's statement is unsupported by its own records. As we describe on page 24, the Lottery had no documentation showing that it accurately recorded and evaluated competing bids or determined the best value for any of the 17 hotel agreements.

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The Lottery inaccurately describes its April 2019 analysis of the fairs program. The April 2019 analysis showed the Lottery spent \$5.7 million but directly generated only \$5.5 million in sales, leading

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to a loss of \$200,000, as we indicate on page 28. Additionally, the April 2019 analysis indicated the intention of the fairs program was to increase certain intangible benefits, but the Lottery could not demonstrate that participating in the fairs program increased these intangible benefits. That April 2019 analysis never considered the advertising value that the Lottery now claims to have achieved. Rather, as we note on page 29, the Lottery calculated that advertising value in response to our inquiries during this audit.

- ②⑥ The Lottery has no basis for its assertion that its costs are minimal compared to the intangible benefits it receives from the fairs program. The Lottery believes these intangible benefits include brand strength, improved customer experience, and increased customer loyalty. As we indicate on page 29, the Lottery acknowledged that it has not measured whether it has received any commensurate value from these intangible benefits. Until it implements our recommendation to begin measuring the value of these intangible benefits, it will not know whether it receives value for the funding it spends on the fairs program.





**BETTY T. YEE**  
California State Controller

February 6, 2020

Ms. Elaine M. Howle\*  
California State Auditor  
621 Capitol Mall, Suite 1200  
Sacramento, CA 95814

**SUBJECT: JLAC 6/26/19 California State Auditor (CSA) Audit of the State Lottery**

Dear Ms. Howle:

Thank you for the opportunity to respond to your “Audit of the California State Lottery” (February 2020) and findings relating to State Controller’s Office (SCO) audit oversight. I am submitting this response to clarify and correct several statements and conclusions, which I believe will better inform the readers of your report.

The CSA report includes three principal findings leading to the conclusion SCO has not effectively overseen the State Lottery’s performance. SCO responds that the CSA report does not provide a balanced perspective of the issues, selectively choosing facts to support its arguments and drawing conclusions based on circumstance alone—an atypical audit approach. Furthermore, the CSA report ignores the reasonableness of effective legal analysis and neglects to mention or misrepresents facts made known to CSA auditors. ①

My office’s response to those findings are provided below.

1. CSA Finding: *SCO inappropriately removed a finding from an April 2019 audit report after the Lottery requested changes to the report. The finding questioned the costs of \$720,000 in hotel agreements.*

This finding appears to be based on a misinterpretation of circumstances and is unsupported by evidence to demonstrate a finding was removed without proper analysis. SCO understands the purpose of CSA’s audit is to provide recommendations on improving oversight of the State Lottery’s performance. Questioning a decision by SCO relative to a finding based on an outdated regulation appears to be an overreach by CSA staff. As stated to your staff, the SCO auditor’s decision to remove the finding came only after full consideration and internal discussion among the SCO auditors and SCO counsel concerning the relevancy of the finding when viewed from the perspective of the current regulation. CSA staff seems to take issue with the determination to pull the finding being made within 24 hours. However, the fact that this decision was made within a 24-hour period does not diminish the fact that the issue was fully vetted by this office ② ③ ④

\* California State Auditor’s comments begin on page 81.

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internally among SCO audit staff, and after considering comments from both the State Lottery and SCO counsel. Moreover, as your auditors correctly note, there was not unanimity among the SCO audit team with regard to the continual viability of the finding. In the final analysis, it was an audit management decision to remove the finding.

- Essentially, the CSA finding in this regard is based in large part upon the CSA staff determination that SCO improperly removed its finding after discovering auditors had relied upon an outdated regulation to determine whether the State Lottery followed competitive bidding procedures. In actuality, SCO auditors independently concluded there was enough of a difference between the outdated regulation and the revised regulations in effect during the time in question
- ⑤ to warrant pulling the finding from the report. While CSA auditors may take a different legal view of those regulations, the fact remains the decision was reached by SCO auditors after full
  - ⑥ discussion with SCO legal staff, independent of any outside influences. To attempt to supplant this determination now with your office's own interpretation of the regulations is unnecessary and only serves to show reasonable minds may differ as to the significance, or lack thereof, of the language of the new regulation.

#### **\$720,000 in Hotel Agreements**

- ⑦ As indicated above, CSA asserts without context that SCO erred in removing one issue related to internal controls used to ensure best value in retailer trade show hotel agreements.

SCO initially included three findings in its 2018 State Lottery report related to \$720,000 in hotel costs. Those findings pertained to room procurements inconsistent with approval authorities, inconsistent procurement of the state rate, and excess lodging rate forms not properly submitted to demonstrate the best rate was obtained. The hotel agreements issue, which ultimately was presented as a management discussion in the final report, addressed the State Lottery's interpretation of efforts to procure the best hotel vendor.

- ⑤ SCO disagrees the characterization of the hotel agreements issue as a management discussion
- ⑦ "lacked analytical rigor," as suggested in the CSA report. As described in the report, the State Lottery's legal counsel argues procurement regulations for smaller contracts "hold the Lottery to a less strict standard than the outdated requirements the SCO had relied on during its audit because the regulations stated that the Lottery would perform activities such as contracting multiple bidders and determining which bidder was best qualified, where possible-implying that it was not an absolute requirement to perform these activities in all cases." The CSA report neglects to mention the SCO chief counsel concurred with the State Lottery counsel and determined the inclusion of the words "where possible" as added to the regulation meant the Lottery should seek out additional bidders whenever it is feasible to do so. In other words, the State Lottery may discontinue contacting multiple bidders if the work hours used to obtain the best price would cost the State Lottery more money than the actual cost benefit of obtaining a better price.

As further explained to CSA auditors, hotel agreements involve many factors, including lodging room rates for a block of rooms, parking rates, function space rental costs, and food and

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beverage minimums. Since SCO already included findings regarding room rate costs, costs for hotel rooms were not presented as part of the questioned costs. Additionally, retailers attending the conference were charged a \$25 to \$30 attendance fee and this attendance fee revenue (estimated at \$170,000) offset the total costs of the events; therefore, the total cost to the Lottery is estimated at \$550,000. ⑧

During audit work, SCO already understood the State Lottery sales team undertook considerable efforts to select the appropriate hotel and event space for the retailer trade shows, evaluating factors including availability, dining options, reviews, parking availability, location, lucrativeness of dining and accommodations to the lottery sales vendor community targeted by trade shows, and at least 10,000 square feet of meeting space. The sales team then contacted hotels and negotiated the best price for the meeting location. After factoring in the time and cost associated with seeking out and negotiating rates with different hotels, the possibility that the Lottery could have achieved substantial savings by contracting with other hotels is questionable. ⑨

#### Timing of Audit Decisions

As discussed above, CSA speculates SCO should have waited longer than 24 hours before deciding to leave the hotel agreements issue as a management discussion. However, there is no audit standard imposing a wait time prior to reaching an audit determination, and suggesting the validity of an audit finding be dependent on such an arbitrary time factor is suspect, at best. Regardless, additional time would not have changed the determination. ④ ⑩

#### New Audit Procedures

CSA asserts SCO should develop and follow procedures to ensure objections to audit findings are addressed by the audit team who worked on the audit. However, SCO already has procedures to ensure objections to audit findings are addressed by the audit team, and those procedures were followed during the audit of the State Lottery. SCO had two meetings to discuss State Lottery objections to findings, and the audit manager's disagreement with removing the finding was discussed at both meetings. Based on the immateriality of the issue, SCO auditors opted to leave the issue as a discussion item. Since SCO has such procedures and took into consideration the audit team's analysis, determination, and conclusion with regard to the finding, SCO does not agree with the CSA recommendation and requests CSA remove any suggestion the SCO audit was not independent. ⑪ ⑥

#### Procurement Audits

SCO believes the CSA recommendation the Legislature amend the Lottery Act to direct SCO to audit the Lottery's procurement process is misleading and unnecessary. SCO already is conducting regular audits of the Lottery's procurement processes and will conduct these audits at least every three years. As previously reported to CSA, SCO planned these audits in the three-year audit plan developed months prior to the CSA report. The exclusion of this information from the CSA report provides an incomplete picture, suggesting SCO does not already plan and perform this work. ⑫ ①

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2. *CSA Finding: The SCO relied solely on the Lottery to prepare a report on the Lottery's performance without assessing the thoroughness of the report, and therefore the Legislature has gone without independent analysis of whether the Lottery fulfilled the purposes of the 2010 changes to the Lottery Act.*

- ⑬ CSA staff somehow determined SCO acceptance of the State Lottery's draft AB 142 report is demonstrative of a failure to exercise appropriate independent oversight of the State Lottery. This conclusion finds no support in the law. To that point, AB 142 states:

*(e) At the end of the first five full fiscal years following enactment of the act adding this section, the Controller shall convene a lottery review group to consist of the Controller, the Superintendent of Public Instruction, and the chairperson of the commission. The review group shall report to the Legislature, no later than March 31 following the final fiscal year, on whether the amendments made by the act adding this section have furthered the purposes of the California State Lottery Act of 1984 as intended.*

- ⑬ Contrary to the implications of CSA auditors' conclusions, the legislation does not require the report be authored by my office. It simply requires the review group report to the Legislature. Presumably, had the Legislature intended the report be prepared by a particular member of the review group, it could have easily done so by designating that office in the language of the statute. The Impact Report was prepared as required under Government Code Section 8880.4.5(e) by the "Lottery Review Group," consisting of the Superintendent of Public Instruction, the Chairperson of the State Lottery, and the State Controller.
- ⑬ Additionally, in arguing the review group's report "contained no third-party analysis of the Lottery's performance," CSA introduces a speculative argument with no factual support. CSA did not attend the deliberations that preceded the report, nor were they present at the public meeting in which the matter was discussed.

3. *CSA Finding: To provide more effective oversight of the Lottery, the SCO will need to significantly adjust its approach to audits to focus on effectiveness and efficiency of the Lottery's operations.*

Finally, there appears to be some concern expressed by CSA staff suggesting SCO has failed to comply with the Lottery Act due, in large part, to the fact the office has not conducted performance audits of the State Lottery. It appears as though this question also may have been

- ⑭ raised by State Senator Ling Ling Chang in her request that CSA look into the matter. In addressing this point, CSA need look no further than language in the Controller's budgetary support appropriation which restricts the use of audit resources to fiscal audits that focus on claims and disbursements as provided for in Section 12410 of the Government Code<sup>1</sup>. Not only is it irresponsible to suggest my office use its appropriation in a manner which contradicts this budget act restriction, but it places my office at risk for personal liability for such expenditures pursuant to Section 32.00 of the annual Budget Control language.

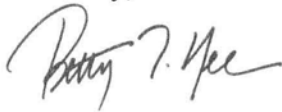


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It is unclear why CSA raises this issue when SCO has made repeated attempts to remove the budgetary support appropriation language restricting the use of audit resources to fiscal audits that only enable SCO auditors to focus on claims and disbursements. Despite numerous repeated efforts, restrictions remain. SCO would welcome the removal of this restriction to conduct expanded audits.

In summary, this audit makes assumptions and selective interpretations of fact that are inconsistent with responsible auditing practices. Over the last 35 years, SCO has conducted more than 150 audits of the State Lottery, identifying thousands of findings and many millions in erroneous and misspent funds. The assertion SCO is not providing ongoing oversight of the State Lottery – based on incomplete presentation of a procurement practice, a misleading interpretation of AB 142 not supported by statute itself, and a critique of noncompliance of an auditing function prohibited by law – is not a balanced presentation of SCO efforts.

Sincerely,



BETTY T. YEE

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<sup>i</sup> Provision 4 of the Controller's Budget Act line item (0840-001-0001) restricts SCO from expending funds appropriated for any performance reviews or performance audits, except pursuant to specific statutory authority. Accordingly, SCO has limited its scope to reviews and audits of compliance with rules and regulations.

The provision provides:

"The funds appropriated to the Controller in this act shall not be expended for any performance review or performance audit except pursuant to specific statutory authority. It is the intent of the Legislature that audits conducted by the Controller, or under the direction of the Controller, shall be fiscal audits that focus on claims and disbursements, as provided for in Section 12410 of the Government Code. Any report, audit, analysis, or evaluation issued by the Controller for the current fiscal year shall cite the specific statutory or constitutional provision authorizing the preparation and release of the report, audit, analysis, or evaluation."

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## COMMENTS

### CALIFORNIA STATE AUDITOR’S COMMENTS ON THE RESPONSE FROM THE STATE CONTROLLER’S OFFICE

To provide clarity and perspective, we are commenting on the response to our audit from the State Controller’s Office. The numbers below correspond to the numbers we have placed in the margin of SCO’s response.

We strongly disagree with the SCO’s claim that our report does not provide a balanced perspective of the issues, selectively chooses or excludes facts, and draws conclusions based on circumstances alone. We conducted our work in accordance with generally accepted government auditing standards, which require us to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions. In following these standards, we carefully considered all evidence that we gathered and performed appropriate analysis of that evidence in reaching our conclusions. Therefore, we stand by the conclusions in our report.

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We did not misinterpret the circumstances surrounding the SCO’s decision to remove the finding from its draft report. On pages 31 to 34 of our report, we describe the evidence that we analyzed in coming to the conclusion that the SCO’s decision was inappropriate and Figure 6 on page 32 provides a timeline of the events that occurred. Moreover, questioning the SCO’s decision is not an “overreach,” but rather the result of our analysis of the evidence surrounding this decision, which included reviewing the SCO’s audit records and communications between SCO and the Lottery, and analysis of the Lottery’s 17 procurements for hotel costs using both the outdated requirements and new regulations.

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The SCO misrepresents the involvement of its auditors in its decision to remove the finding. As noted on page 33, no member of the audit team communicated with the Lottery or had an opportunity to directly address the Lottery’s objections to the finding. Further, the audit manager in charge of that audit believed the Lottery had insufficient evidence to demonstrate it had obtained best value when entering into the hotel agreements, and therefore, she believed that the finding should have been included in the final SCO audit report. Given the audit team’s experience with the audit subject, SCO’s decision to remove the finding without allowing the audit team to respond directly to the Lottery’s concerns is troubling.

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- ④ The SCO indicates that our concern with it removing the finding was based on the 24 hour period in which the SCO made this decision. However, our concerns go beyond the timing of the decision. As we show in Figure 6 on page 32, the SCO removed the finding within 24 hours after the Lottery contacted the SCO to ask for adjustments to the finding, despite the weakness of the Lottery's argument. Further, as we describe on page 34, our concerns are also based on the discussion in the e-mails exchanged between SCO and Lottery, the SCO's decision not to involve the audit team in direct conversation with the Lottery, the lack of analysis of the regulations by the SCO, and the fact that the regulations the Lottery shared with the SCO did not contradict the finding.
- ⑤ The SCO's audit records do not support its claim that "SCO auditors independently concluded there was enough of a difference between the [requirements] to warrant pulling the finding from the report." As we state on page 32, the SCO's audit records do not include documentation or any analysis that explains why SCO concluded that the regulations did not support the finding. Nor did the SCO's audit records contain any record of the SCO's analysis of the regulations. We believe the lack of any contemporaneous documentation or analysis to support the SCO's decision represent a significant lapse in analytical rigor on the part of the SCO. Moreover, when we performed our own analysis, we found little meaningful difference between the outdated requirements that the SCO originally used to support its hotel agreement finding and the new requirements.
- ⑥ As we indicate on page 34, the changes the SCO made to its report before issuing it to the public raise concerns about it strictly adhering to auditing standards, including those pertaining to its independence. Specifically, the circumstances surrounding this decision create the appearance that the SCO removed the findings because of pressure from the Lottery and not because of its own independent analysis of the evidence it had collected.
- ⑦ We discuss our analysis of the outdated requirements and new regulations—including the SCO's view of the provision "where possible"—on page 33. We found that both the outdated requirements and the regulations instruct the Lottery to seek multiple bids and keep a record of all contacts with bidders. Further, both require the Lottery to have recorded the bids submitted by potential vendors. Moreover, the SCO now asserts that the words "where possible" in the regulations allow the Lottery to discontinue contacting multiple bidders if its cost to do so was more than the benefit of obtaining a better price. However, the basis for the SCO to make this assertion is questionable as the SCO's audit records lack any indication that it considered whether Lottery performed such a cost-benefit analysis.



The SCO misses the point. The fact that Lottery charges an attendance fee is unrelated to whether the Lottery attempted to obtain the best value for the hotels where it held these events.

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The basis for the SCO's assertion that the Lottery "undertook considerable efforts" to select hotels is unclear. Rather, as we state on page 31, the SCO initially reported that it determined the Lottery had insufficient support to show it obtained best value for hotel agreements, a finding that we validated on pages 24 to 26 of our report. In fact, the SCO's draft audit report specifically questioned whether the Lottery obtained best value for the hotel agreements, indicating that the SCO had not concluded the Lottery negotiated the best price for these agreements during its audit work.

⑨

The SCO is correct that there is "no audit standard imposing a wait time prior to reaching an audit determination." However, there is an audit standard for sufficiency of evidence to support audit findings, which we found was lacking in the SCO's audit records, as noted on page 32, when we attempted to understand why the SCO believed that the regulations did not support its audit finding on the hotel agreements.

⑩

Contrary to the SCO's assertions, the SCO did not in this case ensure objections to audit findings were addressed by the audit team. As we note on page 33, no member of the audit team communicated with the Lottery or had an opportunity to directly address the Lottery's objections to the finding. Given that the audit team had a large amount of experience regarding the audit subject, SCO's decision to remove the finding without allowing the audit team to respond directly to the Lottery's concerns is troubling. Therefore, our recommendation is intended to address the gap in the SCO's procedures that allowed this situation to occur.

⑪

We stand by our recommendation that the Legislature should amend the Lottery Act to require the SCO to conduct regular audits of the Lottery's procurement practices. As noted on page 19, we found significant issues with the Lottery entering into noncompetitive agreements without adequate justification. Having the SCO regularly audit the Lottery's procurement practices will ensure that it provides the oversight that the Lottery Act intended. Moreover, SCO's assertion that it is already conducting these audits is misleading. In fact, most of the procurement audits that the SCO has conducted over the past five years are each focused on a single contract rather than an audit of the Lottery's internal controls over its procurement practices.

⑫

The SCO's statements about the review group's report are factually inaccurate and misrepresent our conclusion. We do not conclude that the Legislature required the SCO to write the review group report.

⑬

As we indicate on page 34, the SCO was required to convene the review group, but the responsibility for the review group report was the collective responsibility of the SCO, the Lottery, and the Superintendent of Public Instruction. However, this structure has the SCO as the most objective member of the review group with respect to the Lottery's performance: the Lottery cannot be an independent reviewer of its own performance and the school system, overseen by the Superintendent of Public Instruction, is the largest beneficiary of the Lottery's education funding. As we note on page 35, the Lottery's deputy director of finance confirmed to us that he authored the report that the review group submitted to the Legislature. Further, as we describe on page 35, the SCO could not demonstrate that it performed any due diligence to ensure that the report accurately reflected the Lottery's performance after the 2010 amendments to the Lottery Act or that the report's comments about the 2010 amendments aligned with the legislative intent. Therefore, we stand by our concern that the SCO would submit a report to the Legislature—stating that the review group prepared the analysis—when in fact that report contained no third-party analysis of the Lottery's performance.

⑭ The SCO's response does not address the provision in the Budget Act that allows the SCO to conduct performance audits if given express statutory authority. In the provision cited by the SCO, the Budget Act prohibits the SCO from conducting performance-related audits *unless the SCO is given express statutory authority*. As we describe on page 38, the Lottery Act allows the SCO to conduct any audits as it deems necessary in its oversight role of the Lottery, which we believe would constitute express statutory authority to conduct performance-related audits of the Lottery. Instead, the SCO has reviewed the Lottery only for compliance with narrow sets of laws or regulations. By their nature, these types of reviews will not identify all areas for improvement needed or address efficiency issues. Therefore, we stand by our recommendation that the SCO begin performing efficiency and effectiveness reviews of the Lottery.

⑮ The SCO's response overstates the audit work it performs. As we indicate on page 38, many of the audit topics that the SCO identifies are relatively small issue areas, such as individual contracts. Additionally, our review found that the SCO's audits of Lottery focused on determinations of compliance with applicable laws and regulations, rather than a broader assessment of operational effectiveness. Further, none of the audits the SCO performed related their findings to the Lottery's mission to provide supplemental funding to education. Therefore, we stand by our assertion that the SCO's current approach to auditing will not identify all shortcomings to the Lottery's performance.