

CALIFORNIA LOTTERY

Audit Report

DAVID & GOLIATH, LLC CONTRACT

November 19, 2010, through March 31, 2012



JOHN CHIANG
California State Controller

April 2013



JOHN CHIANG
California State Controller

April 29, 2013

Robert T. O'Neill, Director
California Lottery
700 North Tenth Street
Sacramento, CA 95811

Dear Mr. O'Neill:

The State Controller's Office audited the California Lottery's (Lottery) advertising contract with David & Goliath, LLC, for the period of November 19, 2010, through March 31, 2012.

Our audit disclosed that the Lottery prepaid television advertising production expenses to David & Goliath, LLC without proper pre-bill backup, as required by the contract.

The Lottery prepaid production expenses totaling \$923,528.00 and received pre-bill backup supporting only \$751,396.50. The Lottery did not have the required pre-bill backup to support \$172,131.50 in prepaid production expenses.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/vb

Attachment

cc: Nathaniel Kirtman III, Commissioner
California Lottery Commission
John Smolin, Commissioner
California Lottery Commission
Phil Tagami, Commissioner
California Lottery Commission
Gregory Ahern, Commissioner
California Lottery Commission
Connie M. Perez, Commissioner
California Lottery Commission
Nicholas Buchen, Deputy Director, Finance
California Lottery
Roberto Zavala, Chief Internal Auditor
California Lottery

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Audit Report

Summary

The State Controller's Office (SCO) audited the California Lottery's (Lottery) advertising contract with David & Goliath, LLC, (David & Goliath) for the period of November 19, 2010, through March 31, 2012.

Our audit disclosed that the Lottery prepaid TV advertising production expenses to David & Goliath without proper pre-bill backup, as required by the contract.

The Lottery prepaid production expenses totaling \$923,528.00 and received pre-bill backup supporting only \$751,396.50. The Lottery did not have the required pre-bill backup to support \$172,131.50 in prepaid production expenses.

Background

By authority of the California Constitution, Government Code section 12410 states, "The Controller shall superintend the fiscal concerns of the state. The Controller shall audit all claims against the state, and may audit the disbursement of any state money, for correctness, legality, and for sufficient provision of law for payment." In addition, Government Code section 12411 stipulates that "... the Controller shall suggest plans for the improvement and management of revenues."

Proposition 37, the California State Lottery Act of 1984 (Lottery Act), amended the California Constitution to authorize the establishment of a statewide lottery, to create the California Lottery Commission, and to give the commission broad powers to oversee the operation of a statewide lottery.

Pursuant to Government Code section 8880.46.6, the SCO may conduct other special post-audits of the Lottery, as the State Controller deems necessary. The Controller or his/her agents conducting an audit under this chapter shall have access and authority to examine any and all records of the California Lottery Commission.

The Lottery entered into a contract with David & Goliath to provide General Market Advertising Services for Lottery products. The contract period is November 19, 2010, through November 18, 2015, with the option to extend up to two years. The maximum amount of the contract is \$210,000,000. The following amendments to the contract have occurred.

- Amendment No. 1 revised:
 - Fiscal Provisions of the Contract Terms and Conditions
 - Attachment 1, Staff Plan and Compensation Proposal

- Amendment No. 2 revised:
 - Exhibit B, Contract Terms and Conditions
 - Exhibit E, Cost Audit Guidelines
 - Attachment 1, Staff Plan and Compensation Proposal Worksheet
- Amendment No. 3 revised:
 - Exhibit B, Contract Terms and Conditions, and section 5.2, payment
 - Attachment 1, FY 2011/2012 Staff Plan and Compensation Proposal Worksheet

Exhibit A of the contract states that the contractor will be responsible for the following:

- Assist in overall marketing analysis, strategy development, and positioning of the California Lottery and its products;
- Share responsibility for planning, coordinating, and executing specific portions of the Lottery's annual advertising plan;
- Create and produce general market advertising for the Lottery's existing products and new products;
- Develop general market media plans and purchase general television, radio, print, outdoor, digital, and any new media vehicles that assist in marketing Lottery products;
- Assist and work with the Lottery's econometric modeling and analytics agency to optimize campaign results for the maximum media ROI;
- Assist in development of digital media strategies including a robust social media and search engine strategy, and digital media negotiation buying and placement;
- The Lottery Contract Manger may require the contractor to develop, design, and provide in-store communications;
- At the discretion of the Lottery Contract Manger, the contractor may be asked to provide an integrated PR program for specific marketing communications efforts;
- The contractor may be required to assist the Lottery with its syndication activities; and
- At the request of the Lottery Contract Manager and in compliance with the Lottery Contract Manager's instructions, the contractor may be required to conduct Lottery market research studies.

Objectives, Scope, and Methodology

The purpose of the audit was to determine whether the Lottery complied with sound financial and program management practices in the administration of the David & Goliath contract.

We conducted this performance audit in accordance with 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. We did not audit the Lottery's financial statements. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The specific objectives of the audit included, but were not limited to, determining whether the Lottery has internal controls in place to ensure that:

- The Lottery is monitoring compliance with the contract terms and conditions;
- The Lottery is complying with contract state laws, regulations, rules, and policies concerning the David & Goliath contract;
- The Lottery maintains adequate internal controls to obtain reasonable assurance with respect to the safeguarding of assets; and
- The contract payments are legal and proper.

The scope of the audit was for the period of November 19, 2010, through March 31, 2012, and included, but was not limited to, the following procedures:

- Reviewing the David & Goliath contract and subcontracts, contract law, regulations, rules, Lottery policies, and related accounting records;
- Reviewing work performed by any external audit organization or by the Lottery's internal audit unit or other units;
- Interviewing and observing individuals involved in monitoring the contract;
- Obtaining an understanding of the components of internal control sufficient to conduct the audit; and
- Performing tests of procedural compliance, as we deemed necessary.

Conclusion

Our audit disclosed that the Lottery prepaid television advertising production expenses to David & Goliath without proper pre-bill backup, as required by the contract.

The Lottery prepaid production expenses totaling \$923,528.00 and received pre-bill back-up supporting only \$751,396.50. The Lottery did not have the required pre-bill back-up to support \$172,131.50 in prepaid production expenses.

**Views of
Responsible
Official**

The SCO issued a draft report to the Lottery dated February 21, 2013. Robert T. O'Neill, Lottery Director, responded by letter dated March 18, 2013. Mr. O'Neill agreed with our conclusion.

Restricted Use

This report is intended for the information and use of the California Lottery, the California Lottery Commission, and the SCO; it is not intended to be and should not be used by anyone other than these specified parties. This restriction is not intended to limit distribution of the final report, which is a matter of public record.

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

April 29, 2013

Finding and Recommendation

**FINDING—
Lottery prepaid
television
production
expenses without
proper pre-bill
backup**

The Lottery prepaid television advertising production expenses to David & Goliath without the proper pre-bill back-up, as required by the contract. The lottery did not have pre-bill back-up to support \$172,131.50 in prepaid production expenses.

We reviewed three prepayments that totaled \$923,528.00, which represented 20% of production invoices that totaled \$4,539,362.51 for the audit period. We determined that the Lottery had proper pre-bill documentation to support \$751,396.50. The Lottery did not have the required pre-bill back-up to support \$172,131.50 of the prepaid expenses.

According to the contract's Exhibit E, page 32, Cost Audit Guidelines for Production Estimates:

Documentation shall verify that no more than 50% of a TV advertising production estimate with "pre-bill" backup, billed prior to service. Documentation shall verify that the remaining 50% was invoiced after service was performed and shall include backup for the entire job.

"Pre-bill" refers to the TV advertising production subcontractor's invoice which states the estimated cost for production and requires 50% advance payment. Agency is obligated to pay the 50% of the production estimate upon presentation of a pre-bill by the subcontractor. Agency shall retain the pre-bill as backup to its own invoice without commission for payment under this Exhibit.

Based on our review, the Lottery is not in compliance with Exhibit E, Cost Audit Guidelines for Production Estimates. The Lottery prepaid funds to David & Goliath that were not supported by pre-bills by subcontractors. The Lottery's standard practice is to prepay 50% of every production estimate upon the request of David & Goliath. The Lottery is not presented with the required pre-bill back-up support at the time of the prepayment.

If the Lottery does not ensure the existence of proper pre-bill backup for production prepayments, the Lottery may increase its chance of overpaying the actual costs incurred.

Recommendation

The Lottery should revise the contract to reflect its current prepayment practices for television advertising production estimates or revise its prepayment practices to comply with the contract.

Lottery's Response

The Lottery agrees with the finding.

Specifically and as stated in the draft report, the contract allows the vendor to pre-bill 50 percent for its TV production services. This is 25 percent less than the Association of Independent Commercial Producers (AICP) industry standard dictates for pre-billing. Even though TV production pre-billing is allowed, the Lottery has chosen a lower pre-billing percentage than industry standards to further reduce its risk of overpayments. This practice occurs on most marketing contracts. As stated above, all services provided by the vendor for TV production were fully supported by David & Goliath prior to final payments being made, thereby eliminating the risk that any expenses were paid for services not rendered.

SCO's Comment

The Lottery concurs with the finding and recommendation.

**Attachment—
California Lottery’s
Response to Draft Report**



March 18, 2013

Mr. Andrew Finlayson, Chief
State Controller's Office
Division of Audits
State Agency Audits Bureau
P.O. Box 942850
Sacramento, CA 94250-5874

Re: David & Goliath Contract Audit

Dear Mr. Finlayson,

Thank you for the opportunity to respond to the your recently concluded audit of the David & Goliath, LLC, advertising contract. Audits are an important part of the overall administrative and cost control process and, as such, we thank you for your comprehensive report. The purpose of the audit was to determine whether the Lottery complied with sound financial and program management practices in the administration of the David & Goliath contract.

As stated in the report dated February 21, 2013 the specific objectives of the audit (for the period of November 19, 2010 through March 31, 2012) were to determine whether the Lottery has internal controls in place to ensure that:

- The Lottery is monitoring compliance with the contract terms and conditions;
- The Lottery is complying with contract state laws, regulations, rules, and policies concerning the David & Goliath contract;
- The Lottery maintains adequate internal controls to obtain reasonable assurance with respect to the safeguarding of assets; and
- The contract payments are legal and proper.

As a note, we wish to point out that the draft report did not identify any significant internal controls issues that would require immediate corrective action. Additionally, the draft report does not indicate that any unsupported or improper payments were paid to the vendor, David & Goliath, LLC. However, the audit disclosed opportunities to improve current contract prepayment practices. Please see the following response to your finding and recommendation.

Finding

The Lottery prepaid TV advertising production expenses to David & Goliath without the proper pre-bill back-up, as required by the contract. It did not have pre-bill back-up to support \$172,131.50 of prepaid production expenses.

Recommendation

The Lottery should revise the contract to reflect its current prepayment practices for advertising production estimates or revise its prepayment practices to comply with the contract.

Response

The Lottery agrees with the finding.

Specifically and as stated in the draft report, the contract allows the vendor to pre-bill 50 percent for its TV production services. This is 25 percent less than the Association of Independent Commercial Producers (AICP) industry standard dictates for pre-billing. Even though TV production pre-billing is allowed, the Lottery has chosen a lower pre-billing percentage than industry standards to further reduce its risk of overpayments. This practice occurs on most marketing contracts. As stated above, all services provided by the vendor for TV production were fully supported by David & Goliath prior to final payments being made, thereby eliminating the risk that any expenses were paid for services not rendered.

We would also like to point out that the exception identified in the draft report reflects only about three (3) percent of the approximate \$52.9 million in total expenditures during the contract period that was audited.

The Lottery recognizes the importance of complying with contract terms and has already revised its TV production prepayment practices to comply with the contract.

If you have any additional questions, please contact the Audit Chief, Roberto Zavala at (916) 822-8358.

Sincerely,


Robert T. O'Neill
Director

**State Controller's Office
Division of Audits
Post Office Box 942850
Sacramento, CA 94250-5874**

<http://www.sco.ca.gov>