

CALIFORNIA LOTTERY

Audit Report

RETAILER AND SALES COMPENSATION AND INCENTIVES PROCESSES

July 1, 2011, through June 30, 2013



BETTY T. YEE
California State Controller

April 2016



BETTY T. YEE
California State Controller

April 15, 2016

California Lottery Commission
California Lottery
700 North Tenth Street
Sacramento, CA 95811
Attn: Nathaniel Kirtman III, Chairperson

Dear Commissioners:

The State Controller's Office audited the California Lottery's (Lottery) retailer and sales compensations and incentives processes for the period of July 1, 2011, through June 30, 2013. The purpose of the audit was to determine if the Lottery's controls over retailer compensation and incentive bonuses and district sales representative incentive bonuses are adequate to safeguard the Lottery's assets from theft, abuse, and misuse.

Based on our audit, we determined that the Lottery's retail and sales compensations and incentives processes are adequate to safeguard the Lottery's assets from theft, abuse, and misuse. However, we noted the following conditions:

- The Sacramento District Office did not maintain documentation to support the receipt and distribution of retailer incentive bonus checks for fiscal year (FY) 2011-12;
- Twelve of the 20 bonus checks selected for testing from the Sacramento District Office program check log for FY 2012-13 were not supported by a property receipt to document check delivery to the retailer;
- Five property receipts for FY 2012-13 from the Sacramento District Office were not properly documented. The receipts were in the physical file but not documented in the program check log;
- Two of the 20 checks selected for testing from the East Bay District Office check log for FY 2012-13 were not delivered in a timely manner to retailers. Checks were delivered in excess of 30 days after the check dates; and
- One property receipt from the East Bay District Office had a delivery date that was not consistent with the check cashing date.

If you have any questions, please call Andrew Finlayson, Chief, State Agency Audits Bureau, at (916) 324-6310 or email at afinlayson@sco.ca.gov.

Sincerely,

Original signed by

JEFFREY V. BROWNFIELD, CPA
Chief, Division of Audits

JVB/rg

Attachment

cc: Hugo López, Director
California Lottery
Nicholas Buchen, Deputy Director, Finance Division
California Lottery
David Cole, Deputy Director, Sales Division
California Lottery
Roberto Zavala, Deputy Director, Internal Audits
California Lottery

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Audit Report

Summary

We audited the California Lottery's (Lottery) retailer and sales compensations and incentives processes for the period of July 1, 2011, through June 30, 2013. The purpose of the audit was to determine if the Lottery's controls over retailer compensation and incentive bonuses and district sales representative (DSR) incentive bonuses, are adequate to safeguard the Lottery's assets from theft, abuse, and misuse.

Based on our audit, we determined that the Lottery's retail and sales compensations and incentives processes are adequate to safeguard the Lottery's assets from theft, abuse, and misuse. However, we noted the following conditions:

- The Sacramento District Office did not maintain documentation to support the receipt and distribution of retailer incentive bonus checks for fiscal year (FY) 2011-12;
- Twelve of the 20 bonus checks selected for testing from the Sacramento District Office program check log for FY 2012-13 were not supported by a property receipt to document check delivery to the retailer;
- Five property receipts for FY 2012-13 from the Sacramento District Office were not properly documented. The receipts were in the physical file but not documented in the program check log;
- Two of the 20 checks selected for testing from the East Bay District Office check log for FY 2012-13 were not delivered in a timely manner to retailers. Checks were delivered in excess of 30 days after the check dates; and
- One property receipt from the East Bay District Office had a delivery date that was not consistent with the check cashing date.

Audit Authority

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."

Pursuant to Government Code section 8880.46.6, the SCO may conduct 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.

Background

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.

There are over 20,000 Lottery retail locations across California. Qualifying retailers partner with the Lottery to sell Lottery products to the public. Retailers receive compensation for ticket sales based on game type and receive bonuses for the sale of winning tickets. In addition, the Lottery may pay incentive bonuses to retailers based on sales volume or other sales objectives as approved by the director. Cashing bonuses are paid to retailers for the payment of prizes less than \$600.

The Lottery Commission approved regulations which established the parameters of retailer contracts. Regulations also detail procedures for the selection and termination of retailers and the amount of compensation to be paid to retailers.

The Lottery has nine district offices throughout California that employ approximately 220 DSRs. The representatives provide sales and marketing support to the Lottery retailers. DSRs receive incentive sales bonuses, as specified by the Lottery Commission.

Objectives, Scope, and Methodology

The audit period was July 1, 2011, through June 30, 2013. The purpose of the audit was to determine if the Lottery's controls over retailer compensation and incentive bonuses and district sales representative incentive bonuses are adequate to safeguard the Lottery's assets from theft, abuse, and misuse.

The objectives of the audit were to determine whether the Lottery:

- Maintains adequate internal controls over the Lottery's retailer compensation and incentive bonuses process and DSR incentive bonuses process to safeguard against any theft, abuse or loss to the State; and
- Abides by state and federal laws, rules, and regulations, and the Lottery's policies and procedures, regarding retailer compensation and incentive bonuses and DSR incentive bonuses.

Audit procedures included, but were not limited to, the following:

- Reviewing the California State Lottery Act, California Lottery Regulations, California Government Code, State Administrative Manual, Lottery's policies and procedures, and any other applicable rules and regulations;
- Reviewing work performed by any external audit organization, the Lottery's Internal Audit Unit, or any other Lottery unit;

- Interviewing and observing individuals who are involved in the Lottery's processes related to retailer compensation and incentive bonuses and DSR incentive bonuses;
- Analyzing and evaluating the Lottery's policies and procedures and compliance with laws, rules, and regulations relating to retailer compensation and incentive bonuses and DSR incentive bonuses;
- Obtaining an understanding and performing tests of the Lottery's controls over retailer compensation and incentive bonuses; and
- Performing substantive tests of the Lottery's transactions for retailer compensation and incentive bonuses and DSR incentive bonuses. We judgmentally sampled and tested:
 - 40 of 198 retailer bonus checks noted in district sales office check logs; and
 - 104 of 594 incentive bonus payments paid to DSRs throughout the course of our audit period.

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 believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Conclusion

Based on our audit of the Lottery's retailer compensation, retailer incentive bonuses, and DSR incentive bonus processes for the period of July 1, 2011 through June 30, 2013, we determined that the Lottery's retailer and sales compensations and incentives processes are adequate to safeguard the Lottery's assets from theft, abuse, and misuse. However, we noted the following conditions:

- The Sacramento District Office did not maintain documentation to support the receipt and distribution of retailer incentive bonus checks for FY 2011-12;
- Twelve of the 20 bonus checks selected for testing from the Sacramento District Office program check logs for FY 2012-13 were not supported by a property receipt to document check delivery to the retailer;
- Five property receipts for FY 2012-13 from the Sacramento District Office were not properly documented. The receipts were in the physical file but not documented on the program check log;
- Two of the 20 checks selected for testing from the East Bay District Office check log for FY 2012-13 were not delivered in a timely manner to retailers. Checks were delivered in excess of 30 days after the check dates; and

- One property receipt from the East Bay District Office had a delivery date that was not consistent with the check cashing date. The property receipt for Au Energy, LLC, check #67-366954, dated June 18, 2012, states a delivery date of January 31, 2013, several months after the check date. According to the SCO, the check was cashed by the retailer on July 5, 2012, approximately three weeks after the check date.

**Views of
Responsible
Officials**

On February 10, 2016, Hugo Lopez, Director, responded to the draft report on behalf of the Lottery. The Lottery agreed with the findings. The response is included as an attachment to this report.

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 15, 2016

Finding and Recommendation

FINDING 1— Lottery district sales offices did not consistently abide by control procedures over retailer bonus checks

Of the nine Lottery district sales offices, we visited the Sacramento District Office and the East Bay District Office and reviewed their processes and documentation to determine if these district sales offices abided by control procedures for retailer bonus checks, such as the timely distribution to retailers and the maintenance property receipts. For the Sacramento District Office, we selected 20 of the 79 bonus checks noted in the check log for fiscal year (FY) 2012-13. At the East Bay District Office, we selected 20 of the 119 bonus checks noted in the check logs for FY 2011-12 and FY 2012-13. We noted the following conditions:

- The Sacramento District Office did not maintain any documentation to support the receipt and distribution of retailer incentive bonus checks for FY 2011-12;
- Twelve of the 20 bonus checks selected for testing from the Sacramento District Office program check log for FY 2012-13 were not supported by a property receipt to document check delivery to the retailer;
- Five property receipts for FY 2012-13 from the Sacramento District Office were not properly documented. The receipts were in the physical file but were not documented on the program check log;
- Two of the 20 checks selected for testing from the East Bay District Office check log for FY 2012-13 were not delivered in a timely manner to retailers. Checks were delivered in excess of 30 days of the check dates; and
- One property receipt for the East Bay District Office had a delivery date that was not consistent with the check cashing date. The property receipt for Au Energy, LLC, check #67-366954, dated June 18, 2012, states a delivery date of January 31, 2013, which is several months after the check date. We noted that, the check was cashed by the retailer on July 5, 2012, which was approximately three weeks after the check date.

The Lottery's procedures state that district sales office personnel must log the receipt and distribution of retailer incentive bonus checks. The district sales representative (DSR) must deliver the check to the retailer and the retailer must sign a property receipt. The DSR must then return the receipt to the district sales office to document the delivery. District sales office personnel must log the property receipt and maintain copies of the property receipt and check. District sales office personnel must then forward the receipt to the sales support unit to Lottery Headquarters.

California Government Code section 13402 states:

Agency heads are responsible for the establishment and maintenance of a system or systems of internal control, and effective and objective ongoing monitoring of the internal controls within their state agencies. This responsibility includes documenting the system, communicating system requirements to employees, and ensuring that the system is functioning as prescribed and is modified, as appropriate, for changes in conditions.

If the Lottery's district offices do not abide by proper control procedures, retailer checks could be untimely delivered and/or improperly distributed, lost, or mishandled.

Recommendation

We recommend that the Lottery monitor and ensure that its district offices uphold proper controls over retailer incentive bonus check delivery and receipt processes and maintain the appropriate documentation.

Lottery's Response

The Lottery agrees with the findings and recommendations. Shortly after the SCO brought this to our attention in June 2015, the Lottery adopted a process change in its delivery of bonus checks to retailers. This change addresses a majority of the bonus checks in question. Specifically, the Lottery stopped issuing \$75 bonus checks to retailers and instead began processing retailer bonus payments directly into retailer bank accounts through Electronic Fund Transfers. This process change more importantly reduces the risk of untimely deliveries, no receipts and inaccurate documentation.

With respect to bonus checks greater than \$75.00, a guidance memo will be issued instructing sales staff to comply with current bonus check delivery procedures. This includes maintaining accurate documentation of bonus check delivery and receipt and reminding supervisors and managers to monitor this practice on a routine basis.

As a note, the Lottery verified that all bonus checks questioned during the audit were cashed by the retailer timely, even though documentation provided during the audit noted otherwise.

SCO's Comments

The Lottery concurs with the finding and recommendation. However, the Lottery also noted that all bonus checks questioned during the audit were cashed timely by the retailer, even though documentation provided during the audit noted otherwise.

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

700 North Tenth Street
Sacramento, CA 95811
calottery.com



February 10, 2016

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

Re: Retailer and Sales Compensation and Incentives Processes Audit

Dear Mr. Finlayson,

Thank you for the opportunity to respond to your draft audit report. We welcome the results of your audit and believe that your recommendations will add to the integrity and transparency of California Lottery (Lottery) operations.

The Lottery offers the following comments regarding the recently concluded audit of the Lottery's Retailer and Sales Compensation and Incentives Processes Audit conducted by the State Controller's Office (SCO) for the period July 1, 2011 through June 30, 2013. As stated in the audit report dated January 5, 2016, the specific objectives of the audit were to determine whether the Lottery:

1. Has adequate internal controls over the Lottery's retailer compensation and incentive bonuses process and District Sales Representative incentives bonuses process to safeguard against any theft, abuse or loss to the State; and
2. Is abiding with the state and federal laws, rules and regulations, and the Lottery's policies and procedures, regarding retailer compensation and incentive bonuses and DSR incentive bonuses.

Finding 1

Lottery district sales offices did not consistently abide by control procedures over retailer bonus checks.

Recommendation

We recommend that the Lottery monitor and ensure that its district offices uphold proper controls over retailer incentive bonus check delivery and receipt processes and maintain the appropriate documentation.

Response

The Lottery agrees with the findings and recommendations.

Shortly after the SCO brought this to our attention in June 2015, the Lottery adopted a process change in its delivery of bonus checks to retailers. This change addresses a majority of the bonus checks in question. Specifically, the Lottery stopped issuing \$75.00 bonus checks to retailers and instead began processing retailer bonus payments directly into retailer bank accounts through Electronic Fund Transfers (EFTs). This process change more importantly reduces the risk of untimely deliveries, no receipts and inaccurate documentation.

With respect to bonus checks greater than \$75.00, a guidance memo will be issued instructing Sales staff to comply with current bonus check delivery procedures. This includes maintaining accurate documentation of bonus check delivery and receipt and reminding supervisors and managers to monitor this practice on a routine basis.

As a note, the Lottery verified that all bonus checks questioned during the audit were cashed by the retailer timely, even though documentation provided during the audit noted otherwise.

If you have any additional questions, please contact the Internal Audit's Deputy Director, Roberto Zavala at (916) 822-8358.

Sincerely,

A handwritten signature in blue ink, appearing to read "Hugo López", is written over a faint, larger version of the same signature.

Hugo López
Director

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

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