

CALIFORNIA LOTTERY

Audit Report

TIME ADVERTISING CONTRACT

October 1, 2009, through September 30, 2011



JOHN CHIANG
California State Controller

November 2012



JOHN CHIANG
California State Controller

November 8, 2012

Phil Tagami, Chairperson
California Lottery Commission
700 North Tenth Street
Sacramento, CA 95811

Dear Mr. Tagami:

The State Controller's Office audited the California Lottery's (Lottery) contract with Time Advertising for the period of October 1, 2009, through September 30, 2011.

Our audit disclosed the following deficiencies:

- The California Lottery did not properly monitor the contract in relation to the insurance cancellation provision. Time Advertising's Insurance Certificates for Commercial General Liability Coverage contained a 10-day cancellation provision. However, the contract requires no less than a 30-day cancellation provision.
- The Lottery did not reconcile the contract manager's available balance log to the official accounting pay log for one of eight quarters during the audit period. The contract manager's available balance log and the official accounting pay log differed by \$883,709 for the quarter ended March 31, 2010.
- The Lottery did not properly monitor the contract to ensure compliance with respect to Exhibit E—Cost Audit Guidelines. According to Exhibit E, within 120 days of the completion of a media flight, Time Advertising shall provide to the Lottery a close-out estimate generated from the automated media system. We reviewed 13 purchase order files and 4 of the 13 files did not have a close-out estimate dated within 120 days or four months of completion of the flight, as required by the contract.
- The Lottery did not properly monitor the contract to ensure that media billings exceeding \$1,000,000 per fiscal year were charged a 7.5% mark-up rate. Our audit noted that media billings for fiscal year 2010-11 exceeded \$1,000,000, and amounts billed in excess, totaling \$315,476, were incorrectly charged a mark-up rate of 8%.

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
Chief, Division of Audits

JVB/bf

cc: Gregory Ahern, Commissioner
California Lottery Commission
Nathaniel Kirtman III, Commissioner
California Lottery Commission
Connie M. Perez, Commissioner
California Lottery Commission
John Smolin, Vice-Chairperson
California Lottery Commission
Robert T. O'Neill, Director
California Lottery
Richard Mahan, Deputy Director
Sales and Marketing Division
California Lottery
Mike Ota, Deputy Director, Finance Division
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) contract with Time Advertising for the period of October 1, 2009, through September 30, 2011.

Our audit disclosed the following deficiencies:

- The Lottery did not properly monitor the contract in relation to the insurance cancellation provision. Time Advertising's Insurance Certificates for Commercial General Liability Coverage contained a 10-day cancellation provision; however, the contract requires no less than a 30-day cancellation provision.
- The Lottery did not reconcile the contract manager's available balance log to the official accounting pay log for one of eight quarters during the audit period. The contract manager's available balance log and the official accounting pay log differed by \$883,709 for the quarter ended March 31, 2010.
- The Lottery did not properly monitor the contract to ensure compliance with respect to Exhibit E–Cost Audit Guidelines. According to Exhibit E, within 120 days of the completion of a media flight, Time Advertising shall provide to the Lottery a close-out estimate generated from the automated media system. We reviewed 13 purchase order files and 4 of the 13 files did not have a close-out estimate dated within 120 days or four months of completion of the flight, as required by the contract.
- The Lottery did not properly monitor the contract to ensure that media billings exceeding \$1,000,000 per fiscal year were charged a 7.5% mark-up rate. Our audit noted that media billings for fiscal year 2010-11 exceeded \$1,000,000, and amounts billed in excess, totaling \$315,476, were incorrectly charged a mark-up rate of 8%.

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 Time Advertising to provide "Asian Advertising for all Lottery products." The original contract period is September 8, 2009, through September 7, 2012, with the option to renew up to four years for a maximum amount of \$6,000,000. Amendment A01 reflects the new Lottery headquarters address.

Objectives, Scope, and Methodology

The purpose of the audit was to determine whether the Lottery's fiscal controls over payments and monitoring procedures are adequate to ensure that Time Advertising complies with the terms and conditions of the Time Advertising contract with the Lottery. We conducted this performance audit in accordance with generally accepted government auditing standards. We did not audit the Lottery's financial statements. 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.

The objectives of the audit were to determine whether the Lottery has controls in place to ensure that:

- The contract payments are legal and proper.
- The Lottery is abiding with state laws, rules, regulations, and policies concerning the Time contract.
- The Lottery maintains adequate internal controls to obtain reasonable assurance with respect to the safeguarding of assets.
- The Lottery is monitoring the contract for compliance.

The audit was for the period of October 1, 2009, through September 30, 2011, and included, but was not limited to, the following procedures:

- Review the Time Advertising contract and subcontracts, contract law, regulations, rules, Lottery policies, and related accounting records.
- Review work performed by any external audit organization or by any other Lottery unit.
- Interview and observe individuals involved in the development, authorization, and monitoring of the contract.
- Perform tests of procedural compliance and tests of payments, as deemed necessary.
- Obtain and understand components of internal controls sufficient to conduct the audit.

Conclusion

Our audit did not disclose any significant internal control issues or weaknesses that would be considered contrary to the Lottery's monitoring performance of the contract.

Our audit disclosed the following deficiencies:

- The Lottery did not properly monitor the contract in relation to the insurance cancellation provision. Time Advertising's Insurance Certificates for Commercial General Liability Coverage contained a 10-day cancellation provision; however, the contract requires no less than a 30-day cancellation provision.
- The Lottery did not reconcile the contract manager's available balance log to the official accounting pay log for one of eight quarters during the audit. The contract manager's available balance log and the official accounting pay log differed by \$883,709 for the quarter ended March 31, 2010.
- The Lottery did not properly monitor the contract to ensure compliance with respect to Exhibit E—Cost Audit Guidelines. According to Exhibit E, within 120 days of the completion of a media flight, Time Advertising shall provide to the Lottery a close-out estimate generated from the automated media system. We reviewed 13 purchase order files and 4 of the 13 files did not have a close-out estimate dated within 120 days or four months of completion of the flight, as required by the contract.
- The Lottery did not properly monitor the contract to ensure that media billings exceeding \$1,000,000 per fiscal year were charged a 7.5% mark-up rate. Our audit noted that media billings for fiscal year 2010-11 exceeded \$1,000,000, and amounts billed in excess, totaling \$315,476, were incorrectly charged a mark-up rate of 8%.

**Views of
Responsible
Official**

The SCO issued a draft report to the Lottery dated September 6, 2012. Robert T. O'Neill, Lottery Director, responded by letter dated September 26, 2012. Mr. O'Neill agreed with our conclusions.

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
Chief, Division of Audits

November 8, 2012

Findings and Recommendations

FINDING 1—

The Lottery did not properly monitor the contract in relation to the insurance cancellation provision

Our audit disclosed that the Lottery did not properly monitor the contract in relation to the insurance cancellation provision. Time Advertising's Insurance Certificates for Commercial General Liability Coverage contained a 10-day cancellation provision for the periods of December 1, 2008, through December 1, 2009; December 1, 2009, through December 1, 2010; and December 1, 2010, through December 1, 2011. The contract requires no less than a 30-day insurance cancellation provision.

According to the insurance policy cancellation provision, the policy could have been cancelled by deliverance of a written notice at least 10 days before the effective date of cancellation for nonpayment of premium or discovery of fraud. In addition, the policy contains a 30-day cancellation provision for any other reason listed in the cancellation provision (e.g., court judgment, gross negligence).

We reviewed documentation provided by the Lottery to determine whether it ensures that Time Advertising acquired and maintained the required insurance policy coverage for the audit period. Time Advertising acquired and maintained the proper liability coverage through insurance companies that were rated A- or better by AM Best Company for the entire audit period. However, the documentation disclosed that policies 680-283J0571-08, 680-283J0571-09, and 680-304BCO85-10 for commercial general liability coverage for the periods of December 1, 2008, through December 1, 2009; December 1, 2009, through December 1, 2010; and December 1, 2010, through December 1, 2011, respectively, could have been cancelled 10 days after a written notice was provided, which does not comply with the contract.

The Time Advertising Contract No. 13831, section 6, states that the policies must contain a provision whereby the policies cannot be cancelled except by giving 30 days written notice to insured and certificate holders.

If the policies contain less than a 30-day written notice of cancellation, Time Advertising may not have sufficient time to obtain replacement coverage, which could expose the Lottery to potential liability.

Recommendation

The Lottery should implement controls to ensure that Time Advertising acquires and maintains insurance coverage policies that cannot be cancelled except by a 30-day written notice.

Lottery's Response

The Lottery agrees with the finding.

The SCO finding is correct that the contractor's commercial general liability insurance could have been cancelled upon 10 days written notice, in the event that the cancellation was based on non-payment or fraud. Otherwise, 30 days written notice was required.

Insurance Code section 677.2 provides pertinent part:

...The notice of cancellation shall be given at least 30 days prior to the effective date of cancellation, except that in the case of cancellation for nonpayment of premiums or for fraud the notice shall be given no less than 10 days prior to the effective date of the cancellation.

Based on changes in insurance industry practices and Insurance Code section 677.2, the Lottery previously analyzed its standard cancellation provisions and determined that a 10-day notice requirement, in the limited circumstances set forth under section 677.2, does not expose the Lottery to unreasonable risk. As such, the Lottery has modified this term to reflect the language of section 677.2 in all subsequent contracts.

With respect to the Lottery's current contracts containing the prior version of this provision, the Lottery is taking steps to identify and consider formally amending these contracts.

SCO Response

The Lottery concurs with the finding and recommendation.

**FINDING 2—
The Lottery did not
reconcile the contract
manager's available
balance log to the official
accounting pay log**

Our audit disclosed that the Lottery did not reconcile the contract manager's available balance log to the official accounting pay log for one of eight quarters during the audit period. The contract manager's available balance log and the official accounting pay log differed by an amount of \$883,709 for the quarter ended March 31, 2010. The Lottery determined that the difference was an error caused by staff changes.

If the Lottery fails to consistently reconcile the contract manager's available balance log to the official accounting pay log, inappropriate payments could occur, such as:

1. The contract payments could exceed the contract's available balance;
2. An invoice approved by the contract manager may not be paid; and/or
3. An invoice may be paid without the contract manager's approval.

The Lottery Contract Manager's Handbook, Chapter 4—Invoice Process, states the following:

The accounting office sends a contract verification memo to the contract manager the first week of every quarter. The memo must be reviewed and approved, and returned to the accounting office approximately two weeks from the date of the memo. This ensures that the available balance for the contract was the same on both the contract

manager's and accounting office's payment logs. This also ensures that the contract manager has seen all invoices paid against the contract and helps to verify that accounting has received and paid all invoices that the contract manager has approved.

Recommendation

The Lottery should implement controls to ensure that it reconciles the contract manager's available balance log and the official accounting pay log. This will ensure that the contract manager has seen all invoices paid against the contract, the accounting department has received and paid all invoices approved by the contract manager, and invoice payments do not exceed the available contract balance.

Lottery's Response

The Lottery agrees with the finding and has incorporated changes in the quarterly reconciliation process.

SCO Response

The Lottery concurs with the finding and recommendation.

FINDING 3— The Lottery did not properly monitor the contract in relation to the agency mark-up rate for media billings

Our audit disclosed that the Lottery did not properly monitor the contract to ensure that media billings exceeding \$1,000,000 per fiscal year were charged a 7.5% mark-up rate. Our audit noted that media billings for fiscal year 2010-11 exceeded \$1,000,000, and amounts billed in excess were incorrectly charged a mark-up rate of 8%. Currently, the marketing division uses a manual-pay log system to track when media billings meet and exceed \$1,000,000. However, the manual-pay log system was implemented for fiscal year 2010-11; therefore, it was not in effect for fiscal year 2009-10. The manual-pay log for fiscal year 2010-11 recorded that media billings exceeded \$1,000,000 by \$315,476.

On March 8, 2012, after we reviewed media invoices, nine months after the end of fiscal year 2010-11, the marketing division requested and received a \$1,577 ($\$315,476 \times .5\%$) credit memo to address the media invoices that were not billed the proper 7.5% mark-up rate during the audit period. Because the marketing division did not have a manual-pay log to track media billings for fiscal year 2009-10, it provided a marketing estimate summary, which stated that media billings for fiscal year 2009-10 did not exceed \$1,000,000.

The Time Advertising contract, Attachment 1-Price Sheet, states the following:

Media billings up to \$1,000,000 per fiscal year will be charged an 8% mark-up rate and media billings exceeding \$1,000,000 per fiscal year will be charged a 7.5% mark-up rate. This includes planning and placement for all media.

If the Lottery does not properly monitor media billings that exceed \$1,000,000 per fiscal year to ensure that Time Advertising charges a 7.5% mark-up rate, the Lottery may overpay for media services.

Recommendation

The Lottery should develop and implement procedures that will ensure that media billings exceeding \$1,000,000 per fiscal year are charged a 7.5% mark-up rate at the time of billing. This will ensure that the Lottery does not overpay for media services.

Lottery's Response

The Lottery agrees with the finding.

This represented the first instance during the Time Advertising contract term that media costs exceeded \$1,000,000 requiring a downward adjustment to the mark-up rate. This change in mark-up rates was not caught during invoice review; however, the Lottery requested and received a credit of \$1,577 from the vendor for this overpayment.

As of the date of this report, the contract was amended for other changes including a flat mark-up rate of 7% for all media billed. The elimination of an adjustable mark-up rate should mitigate the risk of future overpayments.

SCO Response

The Lottery concurs with the finding and recommendation.

**FINDING 4—
The Lottery did not
properly monitor the
contract in relation to
media close-out
estimate reports**

Our audit disclosed that the Lottery did not properly monitor the contract to ensure compliance with respect to Exhibit E-Cost Audit Guidelines. According to Exhibit E, within 120 days of the completion of a media flight, Time Advertising shall provide to the Lottery a close-out estimate generated from the automated media system. We reviewed 13 purchase order files and 4 of the 13 files did not have a close-out estimate dated within 120 days or four months of completion of the flight, as required by the contract. The four close-out estimates were dated six to nine months after completion of the flights.

The Time Advertising contract, Exhibit E-Cost Audit Guidelines, states that within 120 days of the completion of the flight, Time Advertising shall provide to the Lottery a close-out estimate generated from the automated media system.

If the Lottery does not receive a close-out estimate from Time Advertising in a timely manner, they may not be able to perform proper reconciliation and close-out procedures to monitor payments.

Recommendation

The Lottery should develop and implement procedures that will ensure that it receives a close-out estimate within 120 days of the completion of media flights.

Lottery's Response

The Lottery agrees with the finding and will improve monitoring of the closeout reports.

To ensure the Lottery receives closeout reports within the required 120 days, the Lottery's Marketing Division has established a process in place to verify that closeout reports are received as required. This will ensure that reconciliation and closeout procedures to monitor payments are completed timely.

SCO Response

The Lottery concurs with the finding and recommendation.

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

700 North Tenth Street
Sacramento, CA 95811
calottery.com



September 26, 2012

Mr. Jeffrey V. Brownfield, Chief
Division of Audits
State Controller's Office
P.O. Box 942850
Sacramento, CA 94250-5874

Re: Time Advertising Contract Audit

Dear Mr. Brownfield,

The California Lottery (Lottery) offers the following comments regarding the recently concluded audit of the Lottery's contract with Time Advertising conducted by the State Controller's Office (SCO) for the period October 1, 2009 through September 30, 2011. As stated in the audit report dated September 6, 2012, the specific objectives of the audit were to determine if the Lottery has controls in place to ensure that:

1. The contract payments are legal and proper.
2. The Lottery is abiding with state laws, rules, regulations, and policies concerning the Time Advertising contract.
3. The Lottery maintains adequate internal controls to obtain reasonable assurance with respect to the safeguarding of assets.
4. The Lottery is monitoring the contract for compliance.

Thank you for the opportunity to respond to the draft audit report. We are pleased with the results of the audit. Although no significant internal control issues were identified, the audit identified opportunities to clarify the insurance cancellation policy, monitor the media mark-up rate, improve the quarterly reconciliation process and ensure the timely receipt of the media close-out receipts. The Lottery's Finance and Marketing Divisions have implemented changes to address these issues. Please see the following responses to your findings and recommendations.

Finding 1

The Lottery did not properly monitor the contract in relation to the insurance cancellation provision.

Recommendation

The Lottery should implement controls to ensure that Time Advertising acquires and maintains insurance coverage policies that cannot be cancelled except by a 30-day written notice.

Response

The Lottery agrees with the finding.

The SCO finding is correct that the contractor's commercial general liability insurance could have been cancelled upon 10 days written notice, in the event that the cancellation was based on non-payment or fraud. Otherwise, 30 days written notice was required.

Insurance Code section 677.2 provides, in pertinent part:

“...The notice of cancellation shall be given at least 30 days prior to the effective date of cancellation, except that in the case of cancellation for nonpayment of premiums or for fraud the notice shall be given no less than 10 days prior to the effective date of the cancellation.”

Based on changes in insurance industry practices and Insurance Code section 677.2, the Lottery previously analyzed its standard cancellation provisions and determined that a 10 day notice requirement, in the limited circumstances set forth under section 677.2, does not expose the Lottery to unreasonable risk. As such, the Lottery has modified this term to reflect the language of section 677.2 in all subsequent contracts.

With respect to the Lottery's current contracts containing the prior version of this provision, the Lottery is taking steps to identify and consider formally amending these contracts.

Finding 2

The Lottery did not reconcile the contract manager's available balance log to the official accounting log.

Recommendation

The Lottery should implement controls to ensure that it reconciles the contract manager's available balance log and the official accounting pay log.

Response

The Lottery agrees with the finding and has incorporated changes in the quarterly reconciliation process.

During the quarter in question, a staffing change occurred and its associated training had yet to be completed. While the figures between the contract manager's available balance log and the official accounting pay log did not match in this one instance, Time Advertising invoices were processed for payment in accordance with the California Prompt Payment Act. Moreover, all invoices during this time period were properly approved and supported.

During the period in question, the contract manager's staff continued to review, verify and log invoices against a quarterly budget balance. As noted, the contract manager also reviewed and approved each invoice for completeness and accuracy. Before and after the quarter ending March 31, 2010, the contract manager's payment logs were reconciled with the official accounting records.

To mitigate the risk of exceeding contract balances, not paying invoices, and/or not properly approving invoices, the Lottery's Finance Division has established a process in place to ensure payment reconciliations are consistently completed every quarter.

Finding 3

The Lottery did not properly monitor the contract in relation to the agency mark-up rate for the media billings.

Recommendation

The Lottery should develop and implement procedures that will ensure that media billings exceeding \$1,000,000 per fiscal year are charged a 7.5% mark-up rate at the time of billing.

Response

The Lottery agrees with the finding.

This represented the first instance during the Time Advertising contract term that media costs exceeded \$1,000,000 requiring a downward adjustment to the mark-up rate. This change in mark-up rates was not caught during invoice review; however the Lottery requested and received a credit of \$1,577 from the vendor for this overpayment.

As of the date of this report, the contract was amended for other changes including a flat mark-up rate of 7% for all media billed. The elimination of an adjustable mark-up rate should mitigate the risk of future overpayments.

Finding 4

The Lottery did not properly monitor the contract in relation to media close-out estimate reports.

Jeffrey V. Brownfield
September 26, 2012
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Recommendation

The Lottery should develop and implement procedures that will ensure that it receives a close-out estimate within 120 days of the completion of media flights.

Response

The Lottery agrees with the finding and will improve monitoring of the close-out reports.

To ensure the Lottery receives close-out reports within the required 120 days, the Lottery's Marketing Division has established a process in place to verify that closeout reports are received as required. This will ensure that reconciliation and close-out procedures to monitor payments are completed timely.

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

Sincerely,

A handwritten signature in black ink, appearing to read "R. T. O'Neill". The signature is fluid and cursive, with the first name "R. T." and the last name "O'Neill" clearly distinguishable.

Robert T. O'Neill
Director

**State Controller's Office
Division of Audits
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<http://www.sco.ca.gov>