

CALIFORNIA STATE LOTTERY

Review Report

QUARTERLY TRANSFER OF FUNDS TO PUBLIC EDUCATION

For the Quarter Ended June 30, 2019



BETTY T. YEE
California State Controller

November 2020



BETTY T. YEE
California State Controller

November 17, 2020

Alva Vernon Johnson, Director
California State Lottery
700 North Tenth Street
Sacramento, CA 95811

Dear Mr. Johnson:

The State Controller's Office reviewed the financial documentation supporting the California State Lottery's (Lottery) transfer of funds to the public education community for the quarter ended June 30, 2019. Our review found that the transfer amount of \$415,000,000 is supported by the Lottery's accounting records, and that the Lottery complied with annual revenue allocation requirements for prize payouts, funds to education, and administrative expenses as specified in the Lottery Act for the fiscal year ended June 30, 2019.

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

Sincerely,

Original signed by

JIM L. SPANO, CPA
Chief, Division of Audits

JLS/as

cc: Gregory Ahern, Chair
California State Lottery Commission
Nathaniel Kirtman III, Commissioner
California State Lottery Commission
Keetha Mills, Commissioner
California State Lottery Commission
Peter Stern, Commissioner
California State Lottery Commission
Harjinder Chima, Chief Deputy Director
California State Lottery
Nicholas Buchen, Deputy Director, Finance Division
California State Lottery
Roberto Zavala, Deputy Director, Internal Audits
California State Lottery
James Shannon, Audit Manager, Internal Audits
California State Lottery

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Review Report

Summary

The California State Lottery (Lottery) requested that the State Controller's Office (SCO) transfer \$415,000,000 to the Lottery Education Fund for disbursement to the public education community for the quarter ended June 30, 2019. Based on the work performed, we determined that the requested transfer amount was supported by the Lottery's accounting records. In addition, we determined that the Lottery complied with annual revenue allocation requirements for prize payouts, funds to education, and administrative expenses as specified in the Lottery Act for the fiscal year ended June 30, 2019.

Background

On November 6, 1984, California voters passed Proposition 37, the California State Lottery Act of 1984 (Lottery Act), which authorized the creation of a state-operated lottery. The Lottery Act is found in Title 2, Division 1, Chapter 12.5, section 8880 et seq., of Government Code.

The Lottery Act requires revenues from the Lottery to be allocated to maximize the amount of funding allocated to the public education community. The Lottery Act requires that not less than 87% of the total annual revenues from Lottery ticket sales be returned to the public in the form of prize payouts and funds to education and not more than 13% be allocated for administrative expenses. Furthermore, the Lottery Act requires that not less than 50% of the total annual Lottery revenues, in an amount to be determined by the California State Lottery Commission (Commission), be returned to the public in the form of prize payouts. In addition, the Commission must establish the percentages to be allocated to the benefit of public education.

Government Code section 8880.46.6 states that the SCO shall conduct quarterly and annual audits of all accounts and transactions of the Commission and other special audits as the State Controller deems necessary. The Controller has the authority to examine any and all records of the Commission, its distributing agencies, Lottery contractors, and lottery game retailers.

Each quarter, the Lottery requests that the SCO transfer funds to the Lottery Education Fund. The Lottery's request usually occurs eight to ten weeks after the close of each quarter. The Lottery's transfer request for the fourth quarter ended June 30, 2019, is attached (see Attachment 1).

Objectives, Scope, and Methodology

The objectives of our analysis were to determine whether:

- The requested transfer amount was supported by accounting records; and
- The Lottery complied with the annual allocation requirements specified in the Lottery Act for the fiscal year ended June 30, 2019.

We performed this analysis for the fourth quarter ended June 30, 2019. To achieve our objectives, we:

- Compared current fiscal year audited income statement balances with prior fiscal year audited income statement balances and performed analytical procedures for variances over 15%;
- Traced amounts reported in the income statement to the Lottery's accounting records;
- Traced a sample of sales and expense items to supporting documentation;¹
- Determined whether the Lottery met the annual revenue allocation requirements specified in the Lottery Act;
- Reviewed a selection of accruals and determined whether they were adequately supported, accurately calculated, and correctly recorded;
- Determined whether the requested transfer amount to the Lottery Education Fund occurred; and
- Verified that the funds were transferred from the Lottery Education Fund to the public education community for the current quarter.

Results

Based on the work performed, we determined that the requested transfer amount of \$415,000,000 for the fourth quarter ended June 30, 2019, was supported by the Lottery's accounting records. In addition, we determined that the Lottery complied with annual revenue allocation requirements for prize payouts, funds to education, and administrative expenses as specified in the Lottery Act for the fiscal year ended June 30, 2019.

In a letter dated September 16, 2019, the Lottery requested that the SCO transfer \$415,000,000 to the Lottery Education Fund for disbursement to the public education community. On September 25, 2019, the SCO's Local Government Programs and Services Division (LGPSD) transferred \$417,803,132 from the State Lottery Fund to the Lottery Education Fund.

The remaining balance of \$2,803,132 is a year-end adjustment amount that was withheld from the fiscal year (FY) 2017-18 fourth-quarter transfer, pending completion of the financial statement audit and resolution of accounting issues.

The year-end adjustment is typically transferred to the Lottery Education Fund for disbursement to the public education community in the following year's second- or third-quarter transfer. However, the adjustment of \$2,803,132 was disbursed in the FY 2018-19 fourth-quarter transfer due to SCO mainframe computer system issues.

¹As non-statistical sampling methods were used, the results were not projected to the intended (total) population.

In our prior quarterly report, dated September 17, 2020, we disclosed the following issue, which we also disclose in this report because it remained uncorrected during the period of this review:

During the FY 2018-19 first-quarter allocation calculations, while updating the average daily attendance (ADA) figures for approximately 2,500 educational entities, LGPSD had transposed ADA numbers for some schools in two counties. LGPSD collected the overpayments from the two counties as soon as the errors were discovered. The ADA errors resulted in misallocations, with a total of \$5,196,819, to all educational entities that receive lottery funding. LGPSD reallocated the overpayments and adjustments on June 26, 2020. LGPSD staff indicated that process changes are being implemented to minimize the potential for future ADA transposition errors.

On July 1, 2020, the Lottery submitted a revision (Attachment 2) to its September 16, 2019 transfer request. The revision reported a decrease in the Lottery's operating income for the fiscal year ended June 30, 2019, but did not change the requested transfer amount of \$415,000,000. Despite the revisions, the Lottery complied with annual revenue allocation requirements specified in the Lottery Act.

For the 12 months ended June 30, 2019, of the total revenues from ticket sales:

- 63.83% was returned to the public in the form of prize payouts;
- 24.50% was transferred to the public education community; and
- 11.68% was used for administrative expenses.

The Lottery returned 88.32% of total revenues from ticket sales in the form of prize payouts and funds to education. The Lottery complied with annual allocation requirements specified in the Lottery Act. See the Schedule for a summary of Lottery revenue allocations and allocation percentages.

Views of Responsible Officials

We discussed our results with Lottery representatives via email on September 24, 2020. As there are no findings, the Lottery waived the exit conference and draft report. We agreed the report would be issued as final.

Restricted Use

This report is intended for the information and use of the Lottery, the 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 this report, which is a matter of public record, and is available on the SCO website at www.sco.ca.gov.

Original signed by

JIM L. SPANO, CPA
Chief, Division of Audits

November 17, 2020

Schedule—
FY 2018-19 and FY 2017-18
Year-to-Date Lottery Revenue Allocations

Fiscal Year 2018-2019	Three Months Ended 9/30/2018	% of Sales ¹	Six Months Ended 12/31/2018	% of Sales ¹	Nine Months Ended 3/31/2019	% of Sales ¹	Twelve Months Ended 6/30/2019	% of Sales ¹
Sales	\$ 1,632,006,024	100.00%	\$ 3,717,330,531	100.00%	\$ 5,562,239,364	100.00%	\$ 7,388,050,316	100.00%
Prizes	\$ 1,046,074,342	64.10%	\$ 2,340,130,361	62.95%	\$ 3,526,400,829	63.40%	\$ 4,715,592,673	63.83%
Operating income to education	\$ 393,824,838	24.13%	\$ 945,471,555	25.43%	\$ 1,390,758,881	25.00%	\$ 1,809,721,391	24.50%
Revenues returned to public	\$ 1,439,899,180	88.23%	\$ 3,285,601,916	88.39%	\$ 4,917,159,710	88.40%	\$ 6,525,314,064	88.32%
Administrative expenses	\$ 192,106,844	11.77%	\$ 431,728,615	11.61%	\$ 645,079,654	11.60%	\$ 862,736,252	11.68%
Miscellaneous income ²	\$ 15,409,724		\$ 30,919,170		\$ 41,508,306		\$ 61,025,893	
Adjustment	\$ -				\$ 2,803,132 ³		\$ 23,480,097 ⁶	
Allocation to Education Fund ⁵	\$ 409,234,562		\$ 976,390,725		\$ 1,435,070,319		\$ 1,894,227,381	

Fiscal Year 2017-2018	Three Months Ended 9/30/2017	% of Sales ¹	Six Months Ended 12/31/2017	% of Sales ¹	Nine Months Ended 3/31/2018	% of Sales ¹	Twelve Months Ended 6/30/2018	% of Sales ¹
Sales	\$ 1,790,096,218	100.00%	\$ 3,415,927,725	100.00%	\$ 5,217,090,830	100.00%	\$ 6,965,792,113	100.00%
Prizes	\$ 1,132,243,981	63.25%	\$ 2,180,378,533	63.83%	\$ 3,329,801,682	63.82%	\$ 4,476,580,353	64.27%
Operating income to education	\$ 444,919,295	24.85%	\$ 831,785,924	24.35%	\$ 1,284,284,601	24.62%	\$ 1,656,055,189	23.77%
Revenues returned to public	\$ 1,577,163,276	88.10%	\$ 3,012,164,457	88.18%	\$ 4,614,086,283	88.44%	\$ 6,132,635,542	88.04%
Administrative expenses	\$ 212,932,942	11.90%	\$ 403,763,268	11.82%	\$ 603,004,547	11.56%	\$ 833,156,571	11.96%
Miscellaneous income ²	\$ 5,905,268		\$ 13,561,293		\$ 30,848,873		\$ 44,881,417	
Adjustment			\$ 34,677 ⁴		\$ -		\$ (2,803,132) ³	

¹ Statutory compliance is determined on an annual basis at fiscal year-end. The percentages displayed in the first three quarters are presented to show the Lottery's year-to-date progress toward meeting annual statutory requirements.

² Miscellaneous income includes Surplus Money Investment Fund interest earned, unclaimed prizes, and other income.

³ This amount was withheld from the FY 2017-18 fourth-quarter transfer and was adjusted in the FY 2018-19 third-quarter transfer after completion of the financial statement audit and resolution of accounting issues.

⁴ This amount was withheld from the FY 2016-17 fourth-quarter transfer and was included in the FY 2017-18 second-quarter transfer after completion of the financial statement audit and resolution of accounting issues. Except in the quarter it was presented, this amount was not included in the year-to-date Lottery Education Fund allocation amounts.

⁵ The Education Fund allocation amount is sales plus miscellaneous income, plus the adjustment amount, less prizes, and less administrative expenses.

⁶ This amount was withheld from the FY 2018-19 fourth-quarter transfer and will be adjusted in a subsequent-quarter transfer after completion of the financial statement audit and resolution of accounting issues.

**Attachment 1—
California State Lottery's
Transfer Request Dated September 16, 2019**



September 16, 2019

Natalie Sidarous, Chief
 Local Government Programs and Services Division
 State Controller's Office
 3301 C Street, Suite 700
 Sacramento, CA 95816

Dear Ms. Sidarous:

The California State Lottery requests that you transfer to the Lottery Education Fund for disbursement to the education community \$415,000,000. This figure represents:

Operating income for the year ended June 30, 2019	\$ 1,811,037,466
SMIF interest earned	15,480,673
Other income	22,036
Unclaimed prizes	<u>45,523,184</u>
	<u>\$ 1,872,063,359</u>
 Less: Transfer for the nine months ended March 31, 2019	 1,432,267,187
 Amount withheld pending audit	 <u>24,796,172</u>
	 <u>\$ 415,000,000</u>

We have attached a copy of the Statement of Revenues, Expenses, and Changes in Net Position for the year ended June 30, 2019, prepared from books without audit, for your files.

Please note, as of the date of this letter, the State Controller's Office has not distributed the annual pension and other postemployment benefits reporting information needed to complete our GAAP financial statements. Once we receive the information, we will need to accrue our liability, and there may be an adjustment to our operating income. However, we anticipate that any adjustment will be funded by the amount withheld

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pending audit, and that there will be no change to the requested transfer of \$415,000,000. If that is not the case, any adjustments to the funds transferred will be made in a future quarter.

We will send an updated letter for the quarter ended June 30, 2019, once the final pension and benefits information becomes available.

Sincerely,



Nicholas Buchen, Deputy Director
Finance Division

Attachment
cc: Alva Johnson, Director

California State Lottery Fund
Statement of Revenues, Expenses, and Changes in Net Fund Position
For the Twelve Months Ended June 30, 2019

Operating revenues: Lottery sales	\$ 7,388,050,316
Prizes	<u>\$ 4,715,592,673</u>
Sales after prizes	<u>\$ 2,672,457,643</u>
Less game costs:	
Retailer costs	\$ 505,928,081
Gaming System costs	\$ 92,032,063
Scratchers@ game costs	<u>\$ 39,207,904</u>
Total game costs	<u>\$ 637,168,048</u>
Income before operating expenses	<u>\$ 2,035,289,595</u>
Operating expenses:	
Salaries, wages and benefits	\$ 98,340,516
Advertising	\$ 66,773,171
Promotion, public relations and point of sale	\$ 9,305,841
Other professional services	\$ 16,898,286
Depreciation and amortization	\$ 18,814,684
Other general and administrative expenses	<u>\$ 14,119,631</u>
Total operating expenses	<u>\$ 224,252,129</u>
Operating income	<u>\$ 1,811,037,466</u>
Non-operating (expenses) revenues:	
Investment earnings (Note 9)	\$ 53,177,644
Other Income	\$ 22,036
Allocation to Education Fund (Note 7)	<u>\$ (1,826,540,175)</u>
Total non-operating (expenses) revenues	<u>\$ (1,773,340,495)</u>
Changes in net position	\$ 37,696,972
Total net position - beginning of year	<u>\$ (189,412,778)</u>
Total net position - ending balance	<u><u>\$ (151,715,806)</u></u>

**Attachment 2—
California State Lottery's
Revised Transfer Request Dated July 1, 2020**

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July 1, 2020

Natalie Sidarous, Chief
 Local Government Programs and Services Division
 State Controller's Office
 3301 C Street, Suite 700
 Sacramento, CA 95816

Dear Ms. Sidarous:

On November 8, 2019, the California Lottery received pension reporting allocations from the State Controller's Office, and on February 10, 2020, we received other postemployment benefits allocations. As each of these adjustments impact the Lottery's operating income for the fiscal year ended June 30, 2019, we are submitting this revision to the letter dated September 16, 2019, previously submitted.

<u>Revised</u> Operating income for the year ended June 30, 2019	\$ 1,809,721,391
SMIF interest earned	15,480,673
Other income	22,036
Unclaimed prizes	<u>45,523,184</u>
	<u>\$ 1,870,747,284</u>
Less: Transfer for the nine months ended March 31, 2019	1,432,267,187
<u>Revised</u> Amount withheld pending audit	<u>23,480,097</u>
	<u>\$ 415,000,000</u>

We have attached a revised copy of the Statement of Revenues, Expenses, and Changes in Net Position for the year ended June 30, 2019, for your files.

Sincerely,

Nicholas Buchen, Deputy Director
 Finance Division

Attachment

cc: Alva V. Johnson, Director

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California State Lottery Fund
Statement of Revenues, Expenses, and Changes in Net Fund Position
For the Twelve Months Ended June 30, 2019

Operating revenues: Lottery sales	\$ 7,388,050,316
Prizes	<u>\$ 4,715,592,673</u>
Sales after prizes	<u>\$ 2,672,457,643</u>
Less game costs:	
Retailer costs	\$ 505,903,081
Gaming System costs	\$ 92,088,597
Scratchers® game costs	<u>\$ 39,207,904</u>
Total game costs	<u>\$ 637,199,582</u>
Income before operating expenses	<u>\$ 2,035,258,061</u>
Operating expenses:	
Salaries, wages and benefits	\$ 99,664,223
Advertising	\$ 66,773,171
Promotion, public relations and point of sale	\$ 9,305,841
Other professional services	\$ 16,898,286
Depreciation and amortization	\$ 18,814,684
Other general and administrative expenses	<u>\$ 14,080,465</u>
Total operating expenses	<u>\$ 225,536,670</u>
Operating income	<u>\$ 1,809,721,391</u>
Non-operating (expenses) revenues:	
Investment earnings (Note 9)	\$ 53,177,645
Other Income	\$ 22,036
Allocation to Education Fund (Note 7)	<u>\$ (1,825,224,100)</u>
Total non-operating (expenses) revenues	<u>\$ (1,772,024,419)</u>
Changes in net position	\$ 37,696,972
Total net position - beginning of year	<u>\$ (189,412,778)</u>
Total net position - ending balance	<u><u>\$ (151,715,806)</u></u>

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

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