



REPORT OF
THE
STATE AUDITOR

Colorado Lottery
Lottery Coupons

Financial Review
October 1999

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October 4, 1999

Members of the Legislative Audit Committee:

This report contains the results of the financial review of lottery coupons and their use as promotional tools by the Colorado Lottery, along with our findings, conclusions, and recommendations, and the responses of the Colorado Lottery. The review was conducted pursuant to Section 2-3-103, C.R.S.

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State Auditor

**COLORADO LOTTERY
LOTTERY COUPONS
FINANCIAL REVIEW
October 1999**

Authority, Purpose, and Scope

This financial review of the Colorado Lottery's use of coupons, free tickets, and Lottery Bucks was conducted under the authority of Section 2-3-103, C.R.S., and in accordance with generally accepted government auditing standards. We gathered information through interviews, data analysis, and document reviews. Audit work was performed between July and October 1999.

Overview

Historically, the Lottery has given away free coupons, tickets, and Lottery Bucks as a means for increasing playership of the Lottery's various online and scratch games. In 1998 and 1999, the Lottery's use of such promotional tools increased substantially and the nature of the usage also changed. Because of the security and financial risks associated with the use of free coupons, tickets, and Lottery Bucks, we conducted a financial review of this area to determine if problems existed and if improvements could be made. This report presents our findings and recommendations.

Findings and Recommendations

The following is a summary of the findings and recommendations contained in our report:

- **The Lottery used coupons to extend its marketing budget:** Coupons or free tickets have been used by the Lottery to obtain additional advertising services at no cost. The Lottery accounted for coupon and free ticket promotional expenses under the categories of prize expense and retailer compensation rather than properly classifying such promotions as marketing expenses. By classifying expenses in this way, the Lottery was able to spend \$1.6 million in addition to the dollars appropriated in its marketing line item. **We recommend that the Lottery account for all coupon-related expenses within its marketing appropriation, beginning in Fiscal Year 2000.**
- **Overspending impacts distributions of the Lottery Fund:** The Lottery distributes the net proceeds of the Lottery Fund to several beneficiary entities (the Conservation Trust Fund, the Division of Parks and Recreation, Great Outdoors Colorado and, until recently, the

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Capital Construction Fund). Net proceeds represent the total revenues of the fund (ticket sales, earned interest, license fees, etc.) minus prizes and expenses. We believe the promotional expenses that occurred as a result of coupon and free ticket giveaways decreased the net proceeds of the Lottery fund and therefore reduced distributions. Because the Lottery spent outside of its appropriated authority, we believe that it may be necessary for the Lottery to find a method for reimbursing the Fund beneficiaries. **We recommend that the Lottery work with the General Assembly to determine whether the dollars spent outside of its appropriation authority should be paid back to the Lottery Fund beneficiaries, and if so to determine an appropriate method for reimbursement.**

- **The Lottery does not have adequate controls in place for tracking coupons distributed:** During our review of the Lottery's use of coupons, we found that the Lottery does not currently have procedures or systems in place that keep an ongoing record of the number of coupons given out for promotions. Although the Lottery's systems do track the cumulative number of coupons redeemed, the current systems do not keep ongoing or cumulative records of the number of coupons distributed. Even with special programming efforts, Lottery management was unable to provide us with a total count of coupons distributed in each of the last five fiscal years. **We recommend that the Lottery track coupons just as it would other ticket inventories, including an automated process for tracking the number of coupons distributed and redeemed for each promotion.**
- **The Lottery does not have written agreements with co-sponsors:** As part of using coupons to promote Lottery ticket sales, the Lottery will often use co-sponsors to help market Lottery tickets. Although these types of promotions may expand the Lottery's ability to market its products, these promotions also carry some level of risk to the Lottery. Without contracts, the Lottery does not have any recourse in the event that corporate sponsors do not satisfy their promotional responsibilities. State Fiscal Rules and the State Procurement code also require contracts to be used when other instruments do not protect the interests of the State, and when the cost of the purchase is more than \$25,000. **We recommend that the Lottery ensure that the State's interests are protected and that it follow both the State Fiscal Rules and Procurement Code when entering into promotions involving co-sponsors.**
- **Accounting treatment for coupons could be improved:** When the Lottery issues coupons, free tickets, or Lottery Bucks in exchange for goods or services, we believe that the Lottery is participating in a non-cash or non-monetary transaction. Generally Accepted Accounting Principles (GAAP) require that non-cash or non-monetary transactions be recorded in an entity's financial statements. In both Fiscal Years 1998 and 1999, the Lottery had many promotions that involved trading coupons for services. The Lottery has not recorded or disclosed the non-cash portion of these transactions in its financial statements, as required by GAAP. **We recommend that the Lottery work with the State Controller's Office to**

determine the appropriate method for valuing and recording its non-monetary transactions involving coupons, free tickets, and Lottery Bucks, and begin recording and disclosing its non-monetary transactions in accordance with GAAP.

Summary of Agency Responses:

The Colorado Lottery agrees with all of the recommendations in this report and will change its procedures, policies, and accounting practices in order to comply with them.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	13	The Colorado Lottery should account for all expenses associated with the use of free tickets and coupons within its appropriated marketing line item.	Colorado Lottery	Agree	Implemented
2	13	The Lottery should work with the General Assembly to determine whether the dollars spent outside of its appropriation authority should be paid back to the Lottery Fund beneficiaries, and if so to determine an appropriate method for reimbursement.	Colorado Lottery	Agree	During the Fiscal Year 2001 budget cycle
3	14	The State Controller's Office should periodically review state agencies' spending authority and expenses to ensure that agencies are spending dollars from the proper appropriated line items.	State Controller's Office	Agree	Ongoing
4	16	The Colorado Lottery should work with the Lottery Commission to develop and set limitations on the volume and appropriate uses of coupons, Lottery Bucks, and free tickets as promotional tools.	Colorado Lottery	Agree	During Fiscal Year 2000
5	16	The Colorado Lottery should implement procedures for tracking coupons as it would any other ticket inventory, including development of databases that track the number of coupons printed, distributed, and redeemed by promotion.	Colorado Lottery	Agree	During Fiscal Year 2000

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
6	18	The Colorado Lottery should ensure that it follows both the Procurement Code and State Fiscal Rules for contracting in promotions involving co-sponsors and ensure that the interests of the State are protected.	Colorado Lottery	Agree	During Fiscal Year 2000
7	20	The Colorado Lottery should work with the State Controller's Office to determine the appropriate method for valuing and recording its non-monetary transactions involving coupons, free tickets, and Lottery Bucks.	Colorado Lottery	Agree	Implementation in Process

Lottery Overview

The Colorado Lottery was established in Fiscal Year 1983. Since inception, Lottery ticket sales have grown from about \$137 million in 1983 to over \$368 million in 1999. The Lottery's headquarters are located in Pueblo, with offices in Denver, Fort Collins, and Grand Junction. For Fiscal Year 2000 the Lottery was appropriated about \$303 million and 128 FTE. The Lottery is a Type I agency, which establishes its independence from the Department of Revenue for policy-making purposes. The Lottery Division is organized as follows:

- **Administration** includes accounting, budgeting, purchasing, policy and planning, and management information system (MIS) functions. Administration is primarily responsible for operating the prize claim offices in all four locations, reception, customer services, licensing, microfilming, reporting and budgeting revenues and expenses, distributing net revenues to the beneficiary funds, developing new games, contract monitoring, and operation of the Lottery's internal computer and on-line networks. This area employs 55 FTE.
- **Security** is responsible for conducting background investigations of all Lottery employees, vendors, and retailers, providing security oversight of games, and investigating complaints. This area employs 15.5 FTE.
- **Marketing/Sales/Communications** is responsible for product advertising, public and media relations, customer relations, delivery of scratch tickets, and point-of-sale advertising. This area employs 52.5 FTE.
- **The Director's Office** consists of 5 FTE - the Division Director, the Deputy Director, the Marketing Director, the Administration Director, and the Security Director.

Lottery Coupons

Background

The Colorado Lottery uses coupons, free tickets, and Lottery Bucks as promotional tools to promote increased playship of Colorado's online and scratch games. Over the last ten years, the Colorado Lottery's use of coupons has increased substantially. According to Lottery management, coupons are used for the following reasons:

- **Growth of the player base.** Consumers are more likely to purchase unfamiliar products after they have been given an opportunity to sample the product at no charge.
- **Trial of new products.** Coupons provide incentives for consumers to purchase the new product.
- **Increased game awareness.** Coupons and free tickets can be used to increase awareness of both new and existing games.

Based on information provided by Lottery management, expenses associated with coupon use (including prize expense, commission expense, and bonus expense for those coupons redeemed) have increased by over 800 percent, from about \$92,000 in Fiscal Year 1990 to over \$889,000 in Fiscal Year 1999. In addition to increases in the volume of coupon use, the nature of coupon use has also changed. In the late 1980s and early 1990s, coupons and free tickets were primarily given directly to consumers at various events. However, Lottery now uses third parties more frequently to distribute coupons, free tickets, and Lottery Bucks. The following are examples of how the Lottery uses coupons as promotional tools:

- **Providing coupons or Lottery Bucks to a corporate sponsor in exchange for services such as advertising or research.** In Fiscal Years 1998 and 1999 the Lottery participated in several large promotions with corporate sponsors, including fast-food franchises, food vendors, and media to promote the Lottery, as well as to promote the products of the corporate sponsors. Lottery documentation shows that approximately \$536,000 and \$1.9 million in coupons were given to corporate sponsors to distribute to consumers in exchange for those sponsors providing advertising services in Fiscal Years 1998 and 1999 respectively. In addition, in Fiscal Years 1998 and 1999, Lottery paid research panelists over \$156,000 and \$143,000 in coupons respectively. These panelists would have otherwise been paid with cash.

According to Lottery staff, coupons will not be used to pay research panelists in the future.

- **Entering into a promotion with a corporate sponsor to provide coupons to consumers.** The Lottery often provides coupons to grocery store chains that are having a grand opening. The new grocery store gives coupons to consumers shopping during that grand opening.
- **Giving coupons directly to a consumer.** Lottery staff may hand out coupons to consumers at events such as the State Fair.

This report details the results of our review and recommendations for improvement of the Lottery's use of coupons.

The Lottery Used Coupons to Extend Its Marketing Budget

For the most part, the current Lottery budget is controlled through the Long Bill appropriations process. With the exception of expenditures directly related to the volume of sales (e.g. prizes and retailer compensation), all expenditures are appropriated through lump sum appropriation. In recent years, the Lottery has seen its budget tighten. The Lottery's marketing budget has increased by less than 1 percent per year over the past six years (5.9 percent since Fiscal Year 1994). For Fiscal Year 2000, the Lottery requested a significant marketing increase (over \$1.7 million), however, this request was denied.

Given the budgetary constraints, the Lottery sought ways to extend its marketing dollars. Lottery management believed that increased coupon usage was one way that it could extend its marketing efforts. As an example, the Lottery may purchase \$50,000 in radio airtime and agree to participate in an "added value" promotion. Through an "added value" promotion, the Lottery may provide \$2,000 in products (coupons or Lottery Bucks) to the radio station and receive \$20,000 in additional airtime. By participating in this type of promotion, the Lottery receives \$18,000 in added value through services that the Lottery received but did not actually pay for. From our review of Fiscal Year 1998 promotional worksheets provided by the Lottery, we identified nine promotions in which the Lottery provided a relatively small dollar amount of coupons in exchange for a much larger dollar amount of services. For these promotions, Lottery's documentation showed the face value of coupons provided was \$95,534 and the Lottery received nearly \$268,000 in added value (dollar amount by which the services received exceeded the face value of coupons given away in the promotions). In Fiscal Year 1999, the Lottery's promotional

worksheets show that the total amount of added value obtained was over \$345,000. The amount of added value is an estimate and represents only those promotions in which Marketing Division staff actually assessed a value to the services received in the promotion. There were 87 other promotions in Fiscal Year 1998 and 66 in Fiscal Year 1999 in which coupons were exchanged for services that were not assessed a value.

We have two major concerns with the Lottery's use of coupons. First, the Lottery accounted for coupons outside of its appropriated budget. Second, there is no evidence demonstrating that coupon usage is as effective as other marketing activities. The Lottery accounted for coupon and free ticket promotions under the category of prize expense (a continuously appropriated category), rather than properly classifying such promotions as marketing/promotional expenses (controlled by lump sum appropriation). In doing so, the Lottery exceeded its budgetary authority. Specifically, in addition to the \$9.2 million appropriated and spent on marketing activities in Fiscal Year 1999, the Lottery recorded over \$889,000 in expenses (almost 10 percent more than its appropriated marketing budget) from the Lottery Fund on promotions involving coupons or Lottery Bucks. This \$889,000 includes the cash expenses associated with prize, commission, and bonus (retailer compensation) expenses. In 1998, the Lottery recorded nearly \$694,000 in coupon related expenses (nearly 8 percent more than its appropriated marketing budget.) The Lottery's financial statements classify coupon expenses differently for budget purposes than for accounting purposes. At year-end, the Lottery reclassifies coupon expenses from the prize expense and retailer compensation categories to marketing and promotional expense.

According to Section 24-35-210(2), C.R.S., "after June 30, 1983, expenses of the division shall be paid from the lottery fund only as appropriated by the General Assembly." We believe that the Lottery's practice of charging coupon and free ticket expense to the prize expense and retailer compensation line items for budgeting purposes is in violation of this statute. Lottery should be charging any expenses associated with the use of coupons and free tickets against the appropriated marketing line item that is restricted by the appropriations process and intended for use in promotional activities. In addition, accounting for coupon expenses should be the same for financial statement purposes as it is for budgetary purposes.

Controls Over Spending Authority Need Improvement

Among controls in the system to prevent spending outside of the appropriations process is a review of expenditures by the State Controller's Office. Although the State Controller's Office is responsible for ensuring that state agencies are spending

within their appropriated authority, Controller's Office staff continued to approve Lottery's practices of spending from the prize expense and retailer compensation line items inappropriately. According to State Controller's Office staff, this treatment evolved from the way that the Lottery was originally appropriated. (Originally, the Lottery's marketing budget was continuously appropriated.)

State Controller's Office staff will no longer be approving the Lottery's use of the prize expense and retailer compensation line items to account for its promotional expenses related to coupons. The State Controller's Office is also working with the Lottery to ensure that coupon related expenses are recorded in the appropriate line items within the Lottery's budget.

Promotional Expense Impacts Distributions of the Lottery Fund

The Colorado Lottery is required to make several distributions of its net proceeds from the Lottery Fund. Net proceeds represent total revenues (ticket sales, earned interest, license fees, etc.) minus prizes and expenses. During Fiscal Year 1999 the distribution formula changed to the following: 40 percent to the Conservation Trust Fund, 10 percent to the Division of Parks and Recreation, and 50 percent (not to exceed \$35 million) to Great Outdoors Colorado (GOCO).

The promotional expenses that occur as a result of coupon and free ticket giveaways decrease the net proceeds of the Lottery Fund. As discussed previously, the Colorado Lottery has been using the prize expense and retailer compensation accounts rather than its marketing appropriation to charge these expenses against the net proceeds of the Lottery Fund. In the past two years, the Lottery has substantially increased its use of coupons and ticket giveaways, using them for major promotions. Lottery management cited changes in marketing approaches and enhanced security controls as reasons for the increase. Over the last two years the Lottery has spent almost \$1.6 million in addition to the funds that were appropriated for use in marketing activities. We believe that charging these expenses to the prize and retailer compensation line items is inappropriate, and that by doing so, the Lottery has been reducing the net proceeds available for statutory distributions to the Conservation Trust Fund, the Division of Parks and Recreation, and Great Outdoors Colorado. If the Lottery had not spent beyond the appropriation authority in its marketing line, the beneficiaries of the Lottery Fund would have received their statutory share of this \$1.6 million.

Although Lottery management maintains that the use of coupons increases sales, and therefore, increases total distributions available to Lottery Fund beneficiaries, some of the Lottery's evaluations of its largest promotions indicate that coupon distributions

cannot necessarily be linked to an increase in sales. In fact, one internal evaluation of a major promotion states that:

There is no evidence that shows free coupons created new playership or resulted in incremental sales. To the contrary, the findings support the coupons replaced sales and that sales were not necessarily generated each time a coupon was validated [redeemed].

We believe that the Lottery should work with the General Assembly to determine whether the dollars spent outside of its appropriation authority should be paid back to the Lottery Fund beneficiaries, and if so to determine an appropriate method for reimbursement. In addition, we recommend that the Lottery place restrictions on the use of coupons. Finally, beginning with Fiscal Year 2000, all expenses associated with the use of coupons should be properly charged to the Division's marketing appropriation and the volume of coupons disclosed in all reporting documents.

Recommendation No. 1:

Beginning with Fiscal Year 2000, and in all subsequent fiscal years, the Colorado Lottery should account for all expenses associated with the use of free tickets and coupons within its appropriated marketing line item. In addition, the amount of free tickets, coupons, and Lottery Bucks should be footnoted in all future budget request documents and financial reports issued by the Lottery.

Colorado Lottery Response:

Agree. Implemented.

Recommendation No. 2:

The Lottery should work with the General Assembly to determine whether the dollars spent outside of its appropriation authority should be paid back to the Lottery Fund beneficiaries, and if so to determine an appropriate method for reimbursement.

Colorado Lottery Response:

Agree. To be implemented during the Fiscal Year 2001 budget cycle.

Recommendation No. 3:

The State Controller's Office should periodically review state agencies' spending authority and expenses to ensure that agencies are spending dollars from the proper appropriated line items.

State Controller's Office Response:

Agree. By statute, the State Controller is responsible for making sure that expenditures are properly reviewed and approved and are authorized by the appropriation to which they are charged. This is accomplished through delegation to the agency controllers and by periodic review by our staff. The method used by the Lottery in accounting for promotional coupons was reviewed by the Controller's Office staff during the booking of the FY99-00 budget. A determination was made at that time to change the Lottery's process and account for the cost of the coupons against the marketing appropriation.

The Lottery Does Not Have Adequate Controls In Place for Tracking Coupons Distributed

During our review of the Lottery's use of coupons, we found that the Lottery does not currently have procedures in place that keep an ongoing record of the number of coupons given out for promotions. Even with special computer programming efforts, Lottery management was unable to provide us with a total count of coupons distributed in each of the last five fiscal years. Although the Lottery does track the cumulative number of coupons redeemed in a given year, cumulative records for the number of coupons distributed over a one-year period are not maintained. Each month the files that track the number of coupons distributed are purged. The primary concern to the Lottery is the number of coupons actually redeemed, since those coupons are the only ones for which the Lottery will be responsible for a prize expense, commission expense, and bonus expense. Although the Lottery does barcode all coupons as a security measure, these coupons are not controlled in the same way as actual scratch tickets. Because a coupon can be redeemed for an actual ticket, the same controls should be exercised over the inventory of coupons as are exercised over the inventory of actual tickets, including ongoing record keeping for the number of total coupons printed, distributed, and redeemed in each promotion.

Coupons, just like actual tickets, are at risk for theft, diversion, and misuse.

In Fiscal Year 1999 the Lottery performed some internal review of coupon use. Because of this review, Lottery management decided to limit expenses associated with coupon use to \$250,000 effective in Fiscal Year 1999. However, this does not limit the actual number of coupons distributed to 250,000 but rather only limits the expenses associated with those coupons that are redeemed. According to Lottery management, an average of about 60 percent of coupons are redeemed. For those coupons redeemed, coupon expense is about 66 percent for each one-dollar coupon. Also, the limit of \$250,000 is set internally by Lottery management. Although management discloses coupon use to the Commission during Commission meetings, the limit is not currently set by the Commissioners. Therefore, Lottery management can decide to extend the limits placed on coupons without Commission approval.

In October 1997 our office completed a performance audit of the Colorado Lottery. At that time we found that the Colorado Lottery's marketing costs were higher than many other U.S. lotteries. In our audit we recommended that the Lottery prioritize and implement the recommendations made in its Marketing Effectiveness Report by January 1999. We also recommended that the Lottery improve its management of official functions and marketing activities. Although Lottery management has made progress in implementing these recommendations, we do not believe that coupons, free tickets, and Lottery Bucks have been included in the Lottery's overall efforts to comply with our prior recommendations. We believe that the Lottery's use of coupons, free tickets, and Lottery bucks should be incorporated into its overall marketing plan and managed more effectively.

Prior to this review Lottery management began putting together some new procedures concerning the use of coupons and Lottery Bucks. Although these new procedures do set additional limits on the use and approval of coupons, the procedures do not set a definite limit on the volume of coupon use, address the issue of tracking total coupons distributed, or incorporate coupons into the overall marketing plan. Furthermore, the procedures governing the use of coupons are not approved by the Lottery Commission. Because the use of coupons, free tickets, and Lottery Bucks has grown so rapidly over the past several years, we believe that it is important that the Lottery Commission become involved with defining not only the appropriate uses for coupons, Lottery Bucks, and free tickets but also the volume that can be used in any given fiscal year. This volume should be appropriate in proportion to the marketing budget, and the volume should not be exceeded without prior approval from the Lottery Commission.

Recommendation No. 4:

The Colorado Lottery should work with the Lottery Commission to develop and set limitations on the volume and appropriate uses of coupons, Lottery Bucks, and free tickets as promotional tools. This limitation should be set by the Lottery Commission and incorporated into a Commission rule.

Colorado Lottery Response:

Agree. To be implemented during Fiscal Year 2000. Lottery staff will request approval of the number and value of coupons and free tickets to be given away as part of the Lottery Commission's budget approval process. Additionally, the Lottery staff will work with the Lottery Commission to identify appropriate uses for coupons and free tickets and will incorporate coupon usage in the annual IMSC (Integrated Marketing, Sales and Communications) Plan.

Recommendation No 5:

The Colorado Lottery should implement procedures for tracking coupons as it would any other ticket inventory. Procedures should include development of databases that track the number of coupons printed, distributed, and redeemed by promotion. In addition, Lottery management should ensure that coupon use is adequately reviewed and that the number of coupons given out is within the limitations set by the Lottery Commission (as discussed in Recommendation No. 4).

Colorado Lottery Response:

Agree. To be implemented during Fiscal Year 2000. The Lottery agrees that its systems do not keep a reconciled total of coupons issued during the fiscal year. The Lottery does, however, maintain records that identify how many coupons were given to individual events and the number of coupons redeemed. These records are used to record, on an accrual basis, actual redemptions and an estimate for coupons outstanding (coupons to be redeemed).

The Lottery Does Not Have Written Agreements With Co-Sponsors

As part of using coupons to promote Lottery ticket sales, the Lottery will often use co-sponsors to help market Lottery tickets. These co-sponsors are usually corporations that are interested in getting media coverage to promote their products. As an example, in Fiscal Year 1999 the Lottery entered into a special promotion with a fast-food franchise. In this promotion, the Lottery provided about 896,000 coupons for free lotto tickets to the franchise for distribution with certain meals between August and September 1998. According to documentation provided by the Lottery, the franchise's contribution to the co-promotion was to provide all advertising for the promotion, including television, radio, and newsprint. According to information in the Marketing Division's evaluation of this promotion, the franchise spent over \$811,000 on advertising for this event. As a result of this promotion, Marketing staff estimate that the Lottery received a large amount of media coverage for only about half of what the coverage would have cost to purchase. The Lottery has done similar promotions involving other food vendors and various radio and television stations throughout the State.

These types of promotions carry some level of risk to the Lottery. For example, Lottery records indicate that for two of its promotions the corporate sponsors did not comply with the Lottery's guidelines for internal controls and coupon distribution. As another example, one corporate sponsor agreed to provide advertising materials in each of the stores that were distributing the corporation's product and the Lottery coupons. This corporate sponsor agreed to provide 10-second radio spots to advertise the promotion in exchange for the Lottery providing coupons for free Lottery tickets to help promote the corporation's product. According to documentation provided by Lottery management, the corporate sponsor did not provide either of these advertising items.

One reason that these problems may have occurred is that there were no contracts between the Lottery and these corporate sponsors to identify the duties, expectations, and distribution requirements for the promotion. We found that the Lottery does not use contracts with most of its co-sponsors. Without contracts, the Lottery does not have any recourse in the event that the corporate sponsors do not satisfy their responsibilities in the promotion.

State Fiscal Rule 3-1 requires that contracts be used when other instruments cannot adequately protect the interests of the State and also when the cost of a purchase is more than \$25,000. The State Procurement Code also requires state agencies to solicit bids for all purchases costing over \$25,000. At our request, Lottery

management is currently working with the State Controller's Office and the Division of Purchasing to determine whether the types of promotions involving trading coupons for services constitute a purchase of services and, if so, how those services should be valued to determine what type of purchase agreement would be needed in order to comply with the State Fiscal Rules and the State Procurement Code.

The Lottery is participating in co-sponsored promotions primarily for the purposes of obtaining added value for its marketing strategies and, therefore, should ensure that the terms and conditions of these transactions are clear and enforceable. Although Lottery management is considering the use of contracts, or some other form of agreement in the future, contracts or other agreements are not currently used for most promotions involving coupons.

Recommendation No. 6:

The Colorado Lottery should ensure that it follows both the Procurement Code and State Fiscal Rules for contracting in promotions involving co-sponsors. In addition, the Lottery should use contracts and other appropriate forms of written agreements to ensure that the interests of the State are protected when the Lottery enters into promotions with corporate sponsors.

Colorado Lottery Response:

Agree. To be implemented during Fiscal Year 2000.

Improvements Are Needed In Recording Expenses Associated With Coupons

As discussed in previous sections, the Lottery often uses coupons to receive added value in its promotions. When the Lottery issues coupons, free tickets, or Lottery Bucks in exchange for goods or services of any type, we believe that the Lottery is participating in a non-monetary or non-cash transaction. Generally Accepted Accounting Principles (GAAP) define a non-monetary transaction as "a reciprocal transfer in which each party to the transaction receives and/or gives up assets, liabilities, or services." All transactions of the Colorado Lottery are accounted for in the Lottery Fund, which is an enterprise fund. Because the Lottery Fund is an enterprise fund, the Lottery is required to adhere to GAAP for commercial entities. According to GAAP, all exchanges are to be recorded based on the fair value inherent

in the transaction, and this general rule applies to both monetary and non-monetary transactions. As a result, we believe that the Colorado Lottery should be recording the transactions in which coupons are exchanged for goods or services.

As discussed in previous sections, the Lottery in both Fiscal Years 1998 and 1999 had many promotions that involved exchanging coupons for services. For Fiscal Years 1998 and 1999 the Marketing Division estimates that the Lottery received a total of \$268,000 and \$345,000 in added value, respectively, for its regular promotions. For some promotions, the Marketing Division estimates that the value of the services received was more than 25 times the face value of coupons provided. The Lottery also paid panelists \$156,800 and \$143,300 in Fiscal Years 1998 and 1999 respectively; a service for which the Lottery would have had to pay cash. According to documentation provided by the Marketing Division, the assessed value of the advertising services received is based on what the Lottery's actual costs would be to purchase the same media.

However, determining the assessed value of the services received in exchange for coupons is fairly difficult because the purchase price of advertising services may be discounted for various reasons. According to GAAP, when the value of the asset received (advertising services) cannot be determined, the value of the asset given in exchange (coupons) should be used. Because the value of the coupons given away is easier to determine (each \$1 coupon can be redeemed to receive a \$1 lottery ticket), we believe that this value should be used to record the non-cash transactions.

The Lottery Does Not Currently Record the Non-Cash Portion of Coupon Transactions

The Lottery has been tracking the actual cash expenses related to the use of coupons (prize expense, commission expense, and bonus expense for those coupons redeemed); however, the non-cash portion of the coupon transactions has not been tracked or disclosed in the Lottery's financial statements. Given the changes in the nature of coupon use, the volume of coupons distributed, and the Lottery's more restrictive appropriations, we do not believe that the Lottery's current accounting treatment of coupons continues to be reasonable.

The Lottery has been accounting for coupons by reducing sales and accounts receivable from vendors for the coupons redeemed, and reclassifying the prize, commission, and bonus expense as "promotional expense." While coupons redeemed should continue to be recorded as a decrease to accounts receivable from vendors, sales should no longer be reduced for the number of coupons redeemed. In order to comply with GAAP, the Lottery must record a value for the advertising services

received in exchange for the coupons given and redeemed as part of a promotion. Therefore, the Lottery should record advertising expense instead of reducing sales for the dollar value of coupons redeemed. In Fiscal Years 1998 and 1999, respectively, about \$1 million and \$840,000 in coupons were redeemed.

In addition, GAAP requires that non-monetary transactions be disclosed in the financial statements for the period in which the transactions occur. Included in this disclosure should be the nature of the non-monetary transaction, the basis of accounting for assets transferred, and gains or losses recognized.

We believe that Lottery staff are using coupons in exchange for services, and therefore, the Lottery should be disclosing these transactions in its financial statements. The Lottery's current treatment of coupons, free tickets, and Lottery Bucks does not reflect the true cost of doing business, because the exchanges of coupons for advertising are not reflected in the financial statements. A determination needs to be made by the Lottery in conjunction with the State Controller's Office on how coupons should be valued for the purposes of exchanging them for goods or services. Once a determination is made, the Lottery should begin recording and disclosing its non-monetary transactions in accordance with GAAP.

Recommendation No. 7:

The Colorado Lottery should work with the State Controller's Office to determine the appropriate method for valuing and recording its non-monetary transactions involving coupons, free tickets, and Lottery Bucks. Once a determination is made on how these transactions should be valued, the Lottery should record and disclose all transactions in accordance with GAAP.

Colorado Lottery Response:

Agree. Implementation in process. In order to comply and remain consistent with the GAAP reporting requirements, the Lottery will work with State Controller's Office, the State Auditor's Office, and the technical support staff of the Governmental Accounting Standards Board (GASB) to identify the proper valuation and accounting entries for coupons and free tickets.

Distribution

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Department of Personnel
d.b.a. General Support Services
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