REPORT OF

THE

STATE AUDITOR

Colorado Lottery
Department of Revenue

Performance Audit
November 2003

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November 14, 2003

Members of the Legislative Audit Committee:

This report contains the results of the performance audit of the Colorado Lottery at the Department of Revenue. The audit was conducted pursuant to Section 24-35-218, C.R.S., which requires the State Auditor to conduct an analysis and evaluation of the performance of the Lottery Division at least once every five years. The report presents our findings, conclusions, and recommendations, and the responses of the Colorado Lottery and the Department of Revenue.

Joanne Hill

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OFFICE OF THE STATE AUDITOR **REPORT SUMMARY**

JOANNE HILL, CPA
State Auditor

Colorado Lottery
Performance Audit, November 2003

Authority, Purpose, and Scope

This performance audit was conducted pursuant to Section 24-35-218, C.R.S., which requires the State Auditor to conduct an analysis and evaluation of the performance of the Lottery Division at least once every five years. The audit work, performed from March through October 2003, was conducted in accordance with generally accepted government auditing standards.

Our audit focused on the Colorado Lottery's operations. In addition to the Lottery's operations, we are required by Section 24-35-218, C.R.S., to report on the Lottery's effect on gambling and provide information about the Lottery's players and the public. During the audit, we reviewed the Lottery's expenses, contracts with vendors, marketing and sales efforts, and other administrative activities. In addition, the audit evaluated the implementation status of recommendations made in the October 1997 performance audit of the Colorado Lottery; please see Appendix A for a summary of these recommendations and their status.

We gratefully acknowledge the assistance and cooperation extended by management and staff at the Colorado Lottery and the Department of Revenue.

Overview

Colorado voters passed a constitutional amendment in 1980 that allowed the establishment of a state-supervised lottery. In 1982 the General Assembly approved Senate Bill 119 which created the Colorado Lottery as a division of the Department of Revenue. The Colorado Lottery currently sells three online games (Lotto, Cash 5, and Powerball) and several scratch ticket games at about 2,800 retailers statewide. Statutes require that at least 50 percent of the Lottery's sales revenues be for prizes. In Fiscal Year 2003 gross sales were $391.5 million and lottery prizes amounted to about $227 million, or 58 percent of sales.

Currently Lottery proceeds are distributed on a quarterly basis to several state entities as required by statute: the Conservation Trust Fund receives 40 percent; the Division of Parks and Outdoor Recreation receives 10 percent; and the Great Outdoors Colorado Trust Fund (GOCO) receives 50 percent. The GOCO distribution is capped at $35 million, to be adjusted each year for changes from the 1992 Consumer Price Index of Denver. Proceeds in excess of the GOCO cap currently go to the Contingency Reserve of the State Public School Fund. Since its inception in 1983 the Colorado Lottery has distributed about $1.4 billion to its beneficiaries.

For more information on this report, contact the Office of the State Auditor at 303.869.2800.

Key Findings

Lottery and Its Statewide Impact

Section 24-35-218, C.R.S., requires the State Auditor to conduct an evaluation every five years of the Colorado Lottery's operations, effect on gambling, and its players and the public. The following summarizes the results of our statutory evaluations:

- **Operations.** In general, we found that the Lottery operates in accordance with statutes and the Colorado Constitution. Since its establishment in 1983, the Colorado Lottery has generated about $5.2 billion in sales and about $1.4 billion in net proceeds, or about 27 percent of sales. Overall, while gross sales have increased from about $136.9 million in Fiscal Year 1983 to $391.5 million in Fiscal Year 2003 (186 percent), the distributions have increased from $41.7 million to $104.8 million, (151 percent). In Fiscal Year 2003 the Lottery had about $62 million in administrative and retailer compensation expenses and about $227 million in prize expenses. The Lottery currently has six major contracts for advertising services, public relations, and online and scratch game services, totaling about $19.5 million. Lottery products are sold at about 2,800 retailers.

- **Gambling**. Nothing came to our attention that indicates that the establishment of the Colorado Lottery has had any effect on organized crime and/or illegal gambling. Additionally, our review of available data indicates that the Colorado Lottery has not had an apparent negative or positive impact on the amount of wagering on the three other forms of legal gambling in the State – parimutuel racing, bingo/raffles, and limited stakes gaming.

- **Lottery players and the public.** In general, the socioeconomic profile of Lottery players reflects the State's adult population. Although the Colorado Lottery Commission holds public meetings monthly, it does not routinely ask if there are members of the public who wish to address the Commission.

Lottery Expenses

Our examination of long-term trends in Lottery revenues indicates that the rate of growth in Lottery sales has slowed in recent years. Since future revenue growth may be limited, it is important that the Lottery ensure that all expenses incurred for its operations are reasonable and necessary. Our review identified the need for an overall evaluation of these expenses and instances in which the Lottery could improve its oversight of costs:

- **Distributions to beneficiaries have not increased at the same rate as revenues.** Although the Lottery's total revenues have increased by about 185 percent since Fiscal Year 1983, the Lottery's expenses have increased by 220 percent. Additionally, the amounts distributed to beneficiaries have not kept pace with the increase in sales, growing by about 151 percent.

Distributions as a percentage of sales revenues have declined from 1983 to 2003. The decline in sales revenues paid to beneficiaries is of particular concern because the Lottery was created specifically to provide funding to benefit outdoor resources and activities.

- **Marketing expenses need to be addressed.** Almost one-third, or about $10 million, of the Lottery's administrative expenses represents marketing costs. Marketing expenses include advertising, public relations, sponsorships, promotions, event marketing, and salaries for 13 staff. Overall, we found that the Lottery's marketing plan is not comprehensive. It does not set goals and measurable objectives that target resources most likely to increase sales.

- **Lottery sales staff are not adequately monitored and most receive an incentive bonus.** Thirty-eight staff, or about 31 percent of the total Lottery staff, are involved in sales activities. Of the 38, 31 are sales representatives who are directly involved with delivering tickets to the 2,800 retailers. The Lottery has not recently performed a comprehensive review of the sales representatives' routes to identify the most cost-efficient routes. Additionally, Lottery management does not adequately monitor the sales representatives to ensure that they carry out their responsibilities and address all problems that may affect sales. Finally, we identified problems with the Lottery's current incentive pay program for the sales representatives: a majority of the sales staff receive bonuses even when sales decline, there is no apparent relationship between ticket sales and bonuses paid, and the Lottery pays staff bonuses for performing expected duties rather than for exemplary performance. Since 1983 the Lottery has paid about $3.7 million in bonuses for its sales staff.

- **Retailer base has remained constant and retailer compensation has grown.** The Lottery's retailer base has remained relatively constant for the past five years at about 2,800 retailers. The retailers are primarily gas/convenience, liquor, and grocery stores. The Lottery has not taken actions to expand to other types of outlets, such as coffee shops and recreational facilities. Additionally, compensation for Colorado Lottery retailers has increased significantly from $20.9 million in Fiscal Year 1997 to $29.5 million in Fiscal Year 2003. From Fiscal Years 2001 through 2003, almost 100 percent of eligible retailers received a bonus for meeting marketing standards; thus, it appears that the bonus goal may be set too low.

- **Administrative expenses could be reduced.** In Fiscal Year 2003 the Colorado Lottery's administrative expenses were about $32.3 million. In Fiscal Year 2002 Colorado's percentage of administrative expenses to revenues was 7.8 percent, higher than 21 of the 39 U.S. lotteries; the national average was 5.5 percent. We identified areas in which the Colorado Lottery could reduce its costs, including vehicle expenses, travel, official functions, and cell phones.

  - **Fleet.** In Fiscal Year 2003 the Lottery maintained a fleet of 55 state-owned vehicles at a cost of about $285,000 for 54 (44 percent of total staff). It appears that 24 of these vehicles were driven less than the statutorily required 12,600 miles; two vehicles assigned to sales representatives were driven less than 1,000 miles. Additionally, Lottery staff who used their state vehicles to commute to and from work did not always reimburse the State as required by statute. State employees who commute with state vehicles are required to reimburse the State $60 per month because they derive a personal benefit from using the state vehicle. We estimate that the State lost about $68,000 in reimbursement revenues over the past three fiscal years.

- **Cell phones.** In Fiscal Year 2003 the Lottery spent about $20,000 on cell phones for about half of its staff. We found the Lottery lacks basic controls over its cell phone inventory. We question whether these cell phones and the related expenses are necessary for the Lottery to conduct business.

- **Travel.** In Fiscal Year 2003 the Lottery spent about $105,000 on travel and about $122,000 in Fiscal Year 2002. We found that the Lottery had been reimbursed by two of its vendors (Scientific Games and GTECH) for 10 trips totaling about $8,100 in Fiscal Year 2002. While state statutes do not prohibit agencies from being reimbursed by vendors, we question the propriety of the Lottery receiving payments from vendors for non-investigative travel expenses. In addition, we found that the Lottery does not consistently adhere to the statewide travel price agreements. We reviewed 11 out-of-state trips for Fiscal Year 2002 and found the Lottery paid more than the State's price agreement for airfare for 8 of the 11 trips. The total in excessive payments for these eight flights was about $4,600.

- **Official functions.** In Fiscal Year 2002 the Lottery spent about $26,000 on official functions, including about $16,500 on food and meals, $5,000 on flowers and gifts, and $4,500 on miscellaneous items, such as a plaque. While some of these costs are typical of those incurred in running a business, others clearly are not and appear excessive. For example, the Lottery spent about $2,700 on employee appreciation gifts, including wallets, minifans, bags, and key holders.

- **The Lottery does not track its consumer research budget.** Over the last three fiscal years, the Lottery spent about $750,000 in consumer research as a part of its contract with Scientific Games. However, we identified about $51,000 in consumer research services that were never provided. Additionally, the Lottery does not have a comprehensive consumer research plan that sets goals and measurable objectives and that targets resources to activities most likely to increase sales.

- **Alternative ticket delivery services may not be cost-beneficial.** The Lottery plans to spend about $205,000 on a pilot test for courier ticket services to deliver initial scratch games to each Colorado retailer in Fiscal Year 2004. According to the Lottery, it would like to use courier services to deliver all scratch tickets; it estimates that courier services would cost an additional $1.9 million per year. Currently, the Lottery spends about $2.2 million on ticket delivery and sales-related activities, including salaries and benefits for 38 sales staff, vehicle leases, and merchandising at about 2,800 retailer locations. The Lottery has reported that "no hard evidence exists showing that sales will increase due to courier delivery." Without such evidence, we question the value of increasing costs by implementing a courier service for ticket delivery.

Administrative Issues

We reviewed two critical functions that the Lottery plans to move to a vendor in November 2004 as part of a system conversion. We also evaluated the Lottery's internal controls over cash and ticket reconstruction.

- **Adequate system controls are needed to ensure inventories are safeguarded and accounting transactions are accurate**. The Lottery has contracted with Scientific Games to provide both scratch and online game products and services beginning in November 2004. As a part of this contract, the Lottery will transfer several critical functions that are currently processed by its internal computer system and Lottery staff. These functions include control of scratch ticket inventories and recording, reconciling, and reporting revenue and accounts receivables for ticket sales. Scientific Games will control all parts of the scratch ticket process. This represents a significant risk to the State.

- **Petty cash funds have not been periodically checked.** The Lottery maintains two petty cash funds at its Denver office. We found that these funds are not checked on an unscheduled basis and that they can be used to cash Lottery employees' personal checks.

- **Strict controls over scratch ticket reconstruction are needed.** In Fiscal Year 2003, 162 scratch tickets were so damaged that the validation number needed to cash the ticket was illegible. When this occurs, the Lottery will attempt to graphically reconstruct the ticket. Lottery investigators can request the scratch ticket vendor to perform this process. We found that the Lottery does not compare the investigators' log for scratch ticket reconstruction with the vendor's log to ensure that all requests are legitimate and accurate. Thus, there is a risk that the vendor or a Lottery staff member could reconstruct a ticket for personal benefit.

Our recommendations and the Colorado Lottery's and the Department of Revenue's responses can be found in the Recommendation Locator on pages 7 through 10 of this report.

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	42	Increase the percentage of sales revenues paid to beneficiaries by (a) performing a comprehensive analysis of all expenses and identifying ways to decrease or eliminate expenses or use resources more efficiently, and (b) developing and implementing a plan to reduce costs and achieve specific goals for increasing the percentage of sales paid to beneficiaries.	Colorado Lottery	Agree	July 2004
2	44	Ensure marketing activities are cost-beneficial by (a) developing a comprehensive marketing plan with goals and measurable objectives that targets resources to activities most likely to increase sales, (b) evaluating all market activities to assess the impact on sales and compare actual to expected impact and identifying the most effective and cost-efficient means of increasing sales, and (c) revising the marketing plan on the basis of results achieved, including reducing expenses in areas that are not cost-beneficial.	Colorado Lottery	Agree	July 2004
3	49	Improve oversight and utilization of sales staff by (a) reviewing all sales routes and sales volumes in different areas of the State and determining how to focus more resources on areas with higher sales, (b) performing and documenting evaluations of sales representatives' activities on a regular basis, and (c) reevaluating the sales incentive plan.	Colorado Lottery	Agree	June 2005
4	52	Work to expand the retailer base and ensure commissions and bonuses paid to retailers are reasonable by (a) identifying the most effective ways to recruit new types of retailers and (b) reevaluating the retailer compensation plan.	Colorado Lottery	Agree	January 2005

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
5	55	Ensure the most cost-efficient use of state-owned vehicles by (a) identifying ways to reduce the number of vehicles, (b) implementing procedures to ensure all vehicle reports are complete and accurate, and (c) tracking staffs' specific vehicle mileage to accurately identify the need for vehicles.	Colorado Lottery	Agree	March 2004
6	57	Adhere to state statutes and State Fleet Management Rules regarding required monthly commuter reimbursements.	Colorado Lottery	Agree	December 2003
7	60	Improve controls over administrative expenses and reduce costs by (a) reevaluating the current use of all special event tickets, (b) reassessing the cell phone policy, (c) reviewing travel expenses to ensure they are reasonable and follow appropriate Statewide Travel Management guidelines, (d) amending vendor contracts to eliminate vendor reimbursement of Lottery staff costs not associated with investigative functions, and (e) establishing policies that are in accordance with State Fiscal Rules for official functions and ensuring these expenses are reasonable and benefit the State.	Colorado Lottery	Agree	July 2004
8	63	Improve consumer research by (a) developing a comprehensive plan that sets goals and measurable objectives, (b) establishing controls over consumer research projects, and (c) working with the vendor to either recover the costs of services not provided or arrange for the vendor to conduct additional research projects prior to the end of the contract period.	Colorado Lottery	Agree	July 2004

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
9	64	Perform a thorough cost-benefit analysis of using an alternative ticket delivery system.	Colorado Lottery	Agree	August 2004
10	69	Ensure that adequate controls are established over the implementation and operation of the new online and scratch system by (a) implementing controls to ensure segregation of scratch ticket inventory and validation files, (b) implementing comprehensive procedures for routinely testing reconciliations, (c) establishing milestones and deadlines for completion of the design and implementation of the new system and procedures for reporting and resolving all system problems, and (d) requiring the vendor to have an annual SAS 70 Type 2 audit.	Colorado Lottery	Agree	January 2005
11	72	Improve controls over the petty cash funds by (a) using state procurement cards or a voucher system for qualifying business purchases, (b) eliminating the cashing of employee personal checks, (c) reevaluating the need for two petty cash funds and the amounts to be maintained in the funds, and (d) performing an independent validation of the petty cash funds on a periodic, unscheduled basis.	Colorado Lottery	Agree	December 2003
12	74	Improve monitoring of ticket reconstruction requests to include routine reconciliation between the log maintained by Lottery investigators and external vendor records. Ensure the Department of Revenue internal auditor conducts routine and unannounced reviews.	Colorado Lottery Department of Revenue	Agree	January 2004

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
13	75	Ensure information is available to the public and enhance public participation in Commission meetings by (a) posting notices of all Commission meetings and taking minutes of all meetings, (b) logging, reviewing, and addressing all public correspondence requesting to address the Commission, and (c) including information about Commission on the Lottery's Web site.	Colorado Lottery	Agree	December 2003
14	77	Improve survey research methods by (a) including open-ended questions to assess consumer opinions and preferences, (b) considering having consumers complete and submit preference surveys annually as part of marketing and sales promotions, and (c) evaluating consumer preference survey data to determine best practices, weaknesses in current marketing practices, and areas for improvement.	Colorado Lottery	Agree	July 2004
15	79	Work with the General Assembly to seek statutory clarification of the basis for determining the amount of reserves to be maintained by the Lottery at the end of the fiscal year.	Colorado Lottery	Agree	July 2004

Description of the Colorado Lottery

Overview

Currently 38 states and the District of Columbia operate lotteries. Two other states (North Dakota and Tennessee) approved lotteries in their November 2002 elections. During Fiscal Year 2003, U.S. lottery sales totaled $44.2 billion. In general, lottery proceeds benefit various government programs. In many states lottery profits contribute to general fund revenues as well as to a wide range of causes such as education, the environment, health care, capital construction projects, and tax relief.

History of the Colorado Lottery

Colorado voters passed a constitutional amendment in 1980 that allowed the establishment of a state-supervised lottery. Proceeds from the lottery were to be used for parks, recreation, and other projects deemed necessary by the Legislature. In 1982 the General Assembly approved Senate Bill 119, which created the Colorado Lottery (the Lottery) as a division of the Department of Revenue. The Bill also established a Lottery Commission composed of five members, appointed by the Governor and confirmed by the State Senate. Although the Lottery is part of the Department of Revenue, it is considered a cash-funded enterprise for budget and TABOR purposes.

Section 24-35-210(9), C.R.S., requires that no less than 50 percent of the total revenue from sales of lottery tickets be for prizes. The statutes also include guidelines for distribution of net proceeds to beneficiary agencies. From 1983, the first year of operations, to 2003, the Lottery has distributed more than $1.4 billion to its beneficiaries. For Fiscal Year 2003, gross sales were about $391.5 million and lottery prizes amounted to about $227 million, or 58 percent of total gross sales.

Over the years, Colorado voters have approved several changes to the distribution formula for lottery proceeds. In November 1992, Colorado voters approved a constitutional amendment that created the Great Outdoors Colorado Trust Fund (GOCO) to preserve, protect, enhance, and manage the State's wildlife, park, river, trail and open space heritage. The amendment directed that all proceeds, net of prizes and expenses, from Lottery games be distributed to the Conservation Trust Fund, the Division of Parks and Outdoor Recreation, and GOCO but allowed payments to the

State's Capital Construction Fund for payments of debt service to continue from September 1, 1993, to November 30, 1998.

Currently Lottery proceeds are distributed on a quarterly basis to several state entities: the Conservation Trust Fund receives 40 percent; the Division of Parks and Outdoor Recreation receives 10 percent; and GOCO receives 50 percent. The GOCO distribution is capped at $35 million, to be adjusted each year for changes from the 1992 Consumer Price Index of Denver. Until Fiscal Year 2002, proceeds in excess of the GOCO cap were to be distributed to the State General Fund. As discussed below, Referendum E, passed by voters in November 2000, required that these excess proceeds instead go to the Contingency Reserve of the State Public School Fund to address public school safety hazards and health concerns. Referendum E also allowed the Colorado Lottery to participate in multistate lottery games. Multistate games combine their prize pools to create larger jackpots. The Colorado Lottery Commission determined that Powerball was the best multistate option for the State of Colorado. Powerball was introduced in August 2001.

Lottery Products and Sales

The Colorado Lottery began scratch game ticket sales in 1983. For the first six years of operations, the only game the Lottery offered was the scratch game. In 1988 the General Assembly passed a bill authorizing the first online game, Lotto. Lotto was launched in January 1989. This was followed by the introduction of Keno in 1991, Cash 5 in 1996 and, as noted above, Powerball in 2001. Keno was discontinued in 1998.

The Lottery's current product mix includes three online games and numerous scratch games:

- **Scratch:** A scratch player purchases a ticket from a retailer. The players "scratch" the covering in a specified area of the scratch ticket to instantly determine if the ticket has a winning combination. In Fiscal Year 2003 the Lottery offered 48 different scratch games (of which 35 were introduced in Fiscal Year 2003), which generated about $254.3 million in sales, a $2.9 million decrease from Fiscal Year 2002.

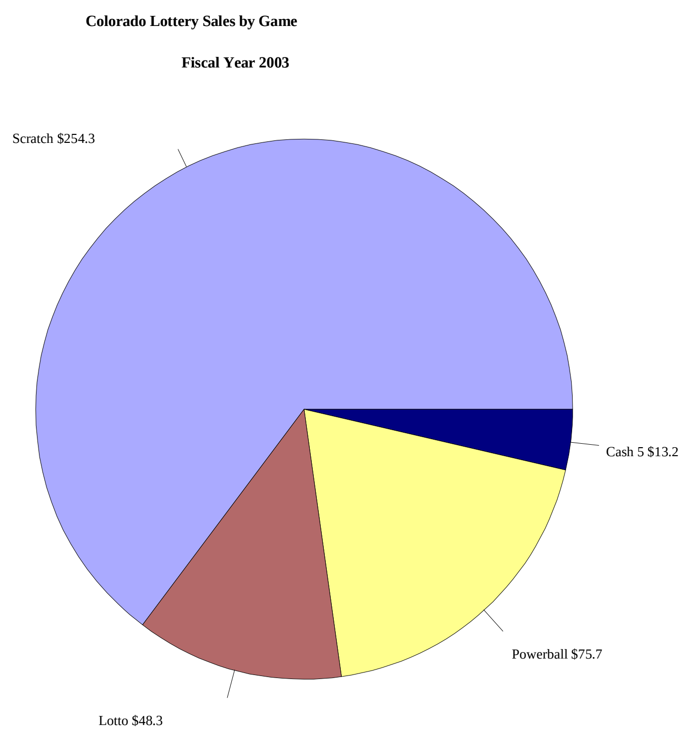
- **Lotto:** The player attempts to match 6 out of 42 numbers drawn to win the jackpot amount. Players matching three to five of the six numbers win a smaller prize. The jackpot winner has two choices to obtain the winnings, either an annuity or a cash option. The annuity option spreads the jackpot payments over 25 years; the cash prize option is a lump-sum payment equal to the present value of the annuity, around 40 percent of the jackpot prize.

Lotto drawings take place twice a week, and jackpots start around $1 million (annuity value). Lotto sales were approximately $48.3 million in 2003, a decrease of $9.3 million from Fiscal Year 2002.

- **Cash 5:** Cash 5 games are similar to Lotto. A player attempts to match 5 out of 32 numbers, with jackpots up to $20,000. These drawings take place six times a week. Cash 5 sales totaled about $13.2 million in 2003 or about the same as in Fiscal Year 2002.

- **Powerball:** Players attempt to match 5 out of 53 numbers and 1 Powerball number between 1 and 42. Jackpots for Powerball begin at $10 million, and drawings are twice a week. Winners can choose between an annuity or a cash option. In Fiscal Year 2003, Powerball accounted for about $75.7 million in sales revenues, a decrease of $4.2 million from Fiscal Year 2002.

In total, the Lottery's sales were about $391.5 million in Fiscal Year 2003 as shown in the following chart. Of this amount, online (Lotto, Cash 5, and Powerball) sales were approximately $137.2 million, or about 35 percent of total sales. The Lottery's overall sales performance for Fiscal Year 2003 reflected a $16.5 million decrease from Fiscal Year 2002.



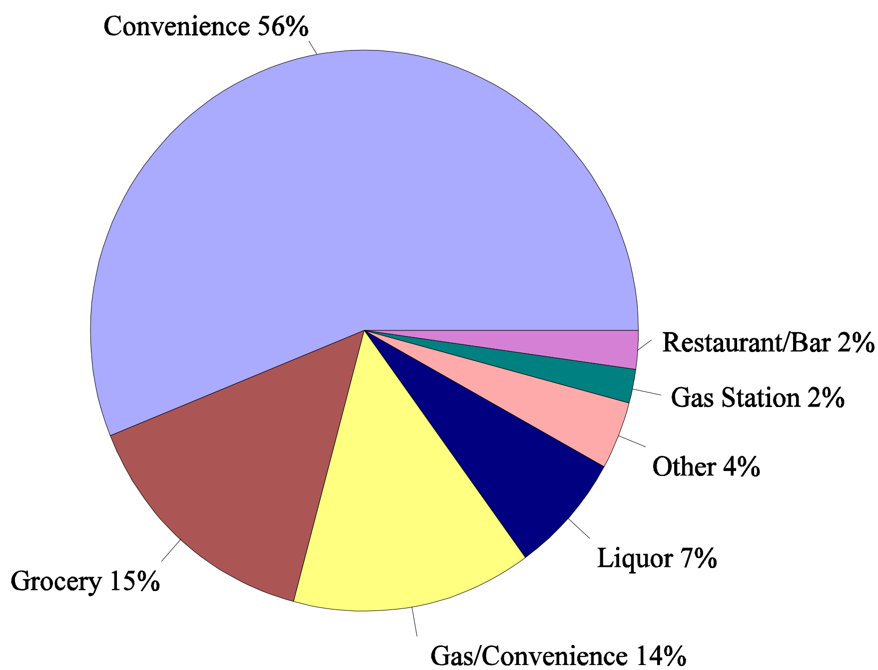
Source: Office of the State Auditor's analysis of data from the Lottery on game sales for Fiscal Year 2003.

Retailers include grocery stores, convenience stores, and various other businesses. In Fiscal Year 2003 there were about 2,800 retailers, including:

- 1,112 convenience stores.
- 459 liquor stores.
- 423 grocery stores.
- 463 gas/convenience stores.
- 55 gas stations.
- 64 restaurants and bars.
- 185 other (e.g., drugstores, bowling alleys, and hair salons).

Convenience stores account for about 40 percent of the retail outlets and have the greatest market share of sales (56 percent) as shown in the following graph.

Market Share of Sales by Retailer Type
Fiscal Year 2003



Source: Office of the State Auditor’s analysis of data from the Lottery on retailer sales and market share. The total number of retailers was 2,761 in Fiscal Year 2003.

In Fiscal Year 2003 the Lottery's expenses totaled almost $289 million and included the following:

- Prize expenses of about $227 million.

- Retailer commissions and bonuses of about $29.5 million.

- Administrative expenses of about $32.3 million, including about $10 million for the costs of tickets and vendor fees, $9.1 million for marketing and communication expenses, and $8 million for wages and benefits. Remaining administrative costs of $5.1 million included, among other things, vehicle leases, cell phones, computer operations, office and warehouse space, equipment rental, and online telecommunications.

The Lottery’s expenses are discussed in detail in Chapter 2.

Organization and Budget

The Lottery's headquarters is in Pueblo, and it also has offices in Denver, Fort Collins, and Grand Junction. For Fiscal Year 2003 the Lottery was appropriated about $359 million and 128 FTE, 4.7 of which are currently vacant. The Lottery Division is organized as follows:

- **Operations** includes accounting, budgeting, purchasing, policy and planning, and management information system (MIS) functions. Operations is primarily responsible for operating the four prize claim offices, reception, customer services, licensing, microfilming, revenue reporting, budgeting, distributing net proceeds to the beneficiary funds, developing new games, contract monitoring, and operating the Lottery's internal computer and online networks.

- **Security** conducts background investigations of all Lottery employees, vendors, and retailers. Security is also responsible for overseeing security-related controls for the Lottery's internal computer system.

- **Marketing** is responsible for product advertising, research and development, public and media relations, customer relations, delivery of scratch tickets, and research and development.

- **Administration** includes the division director, the deputy director, the marketing director, the administration director, and office support personnel.

The Role of the Lottery Commission

As mentioned earlier, the Lottery Commission governs the overall activities of the Lottery. The Commission approves lottery drawing guidelines, establishes new game rules, and reviews monthly financial statements. Section 24-35-208, C.R.S., requires the Commission to conduct public hearings and promulgate rules and regulations concerning, but not limited to:

- Types of lottery games to be conducted.

- Price of tickets.

- Frequency and methods of drawings.

- Manner of selecting winning tickets.

- Method of sales.

- Amount of retailer compensation.

The Commission consists of five members appointed by the Governor and confirmed by the State Senate. According to Section 24-35-207, C.R.S., the Commission must include at least one certified public accountant, at least one attorney, and at least one law enforcement officer; no more than three members can belong to the same political party. Members serve four-year terms with a maximum of two terms.

Lottery and Its Statewide Impact

Chapter 1

Background

Section 24-35-218, C.R.S., requires the State Auditor to conduct an audit of the Lottery Division at least once every five years. Regarding the Lottery's operations, statutes require that at a minimum the audit must include evaluations of the following:

- The amount of revenue generated by the Lottery for the Conservation Trust Fund and the percentage that such amount bears to total state revenue.

- The administrative and other expense of Lottery dollar collections as compared to revenue derived.

- An evaluation of the performance of Lottery equipment contractors and licensed sales agents.

- Whether the Lottery performs its statutory duties efficiently and effectively.

- Whether administrative or statutory changes are necessary to improve the operation of the Lottery in the best interests of the State's citizens.

Regarding the Lottery's effect on gambling, statutes require that at a minimum the audit must include evaluations of the following:

- Whether there has been an increase in organized crime related to gambling within the State.

- The competitive effect of the Lottery on other forms of legal gambling in the State, both profit and nonprofit in nature.

Regarding the Lottery's players and the public, statutes require that at a minimum the audit must include evaluations of the following:

- A socioeconomic profile of persons who play the Lottery.

- Whether the Commission encourages public participation in its decisions rather than participation only by the people it regulates.

- Whether the Lottery's complaint, investigation, and disciplinary procedures adequately protect the public.

This chapter discusses the results of our review of the statutorily required topics.

Lottery Operations

The following summarizes our evaluation of the Lottery operations required by statute.

Revenue Generated for the Beneficiary Funds

As noted above, Section 24-35-218(1)(c)(I), C.R.S., requires an analysis of the amount of revenue generated by the Lottery for its beneficiaries and the percentage that such amount bears to total state revenues.

Since its establishment in 1983, the Lottery has generated about $5.2 billion in sales and about $1.4 billion in net proceeds, or about 27 percent of sales. Net proceeds represent total revenue (ticket sales, earned interest, license fees, etc.) minus prizes and expenses. The table on the following page shows revenue distributed to the beneficiaries; for example, since 1983 about $512.9 million has been distributed to the Conservation Trust Fund and $128.1 million has been distributed to the Division of Parks and Outdoor Recreation Fund. In Fiscal Year 1999 the last statutorily required payment was made to the Capital Construction Fund to cover debt service payments on various projects, mainly prisons.

Beginning in Fiscal Year 2002, net proceeds were distributed, in general, by the following statutory formula: 40 percent to the Conservation Trust Fund, 10 percent to the Division of Parks and Outdoor Recreation, and 50 percent to GOCO. The GOCO distribution, capped at $35 million, is to be adjusted each year for changes from the 1992 Consumer Price Index of Denver. Proceeds in excess of the GOCO cap go to the Contingency Reserve of the State Public School Fund. In Fiscal Year 2003 the GOCO cap was about $48.7 million; the excess distributed to the Contingency Reserve of the State Public School Fund was about $3.7 million.

The following table shows the distributions to the beneficiaries since 1983.

Colorado Lottery Revenue Distributed to Beneficiary Funds
Fiscal Years 1983-2003
(In Thousands)

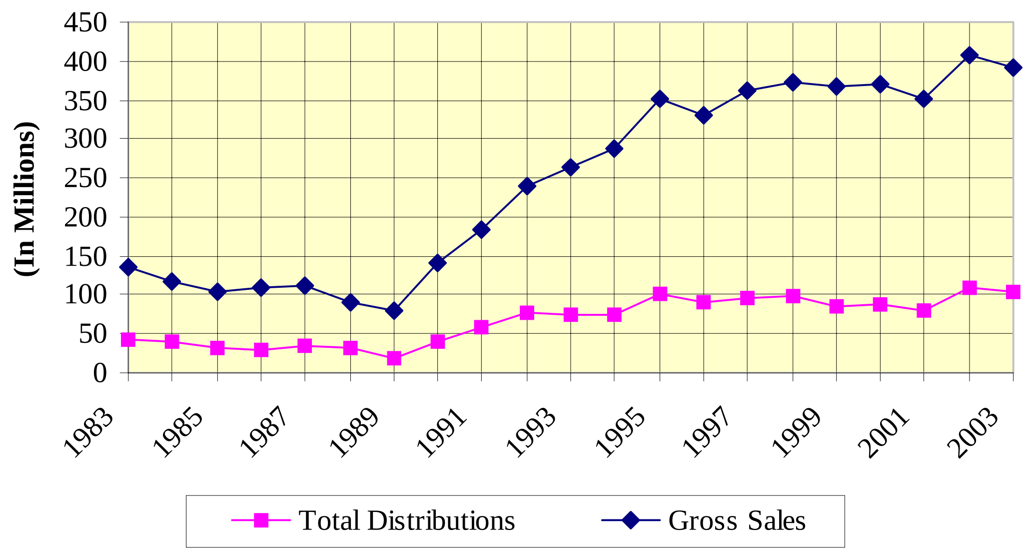
Year	Conservation Trust Fund	Capital Construction Fund	GOCO	Division of Parks and Outdoor Recreation Fund	Contingency Reserve of State Public School Fund	General Fund	Total Distributions
1983	$16,666	$20,832	-	$4,166	-	-	$41,664
1984	16,572	19,963	-	4,143	-	-	40,678
1985	12,811	16,014	-	3,203	-	-	32,028
1986	11,672	14,591	-	2,918	-	-	29,181
1987	14,000	17,500	-	3,500	-	-	35,000
1988	13,200	16,500	-	3,300	-	-	33,000
1989	7,406	9,257	-	1,851	-	-	18,514
1990	11,584	26,396	-	2,896	-	-	40,876
1991	16,192	38,681	-	4,048	-	-	58,921
1992	23,178	47,013	-	5,795	-	-	75,986
1993	21,929	35,221	$10,870	5,482	-	-	73,502
1994	22,671	34,547	11,167	5,668	-	-	74,053
1995	34,363	34,386	23,302	8,563	-	-	100,614
1996	33,190	30,661	19,257	8,264	-	-	91,372
1997	34,486	37,044	14,476	8,584	-	-	94,590
1998	35,690	30,055	22,945	8,886	-	-	97,576
1999	33,896	11,092	31,232	8,465	-	-	84,685
2000	35,791	-	43,488	8,948	-	$1,250	89,477
2001	31,714	-	39,642	7,928	-	-	79,284
2002	44,019	-	46,523	11,005	$8,500	-	110,047
2003	41,912	-	48,699	10,478	3,690	-	104,779
TOTAL	**$512,942**	**$439,753**	**$311,601**	**$128,091**	**$12,190**	**$1,250**	**$1,405,827**
% of Total Net Proceeds	**36.5%**	**31.3%**	**22.1%**	**9.1%**	**0.9%**	**0.1%**	**100.0%**

Source: Office of the State Auditor's analysis of distributions from the Colorado Lottery.

Distributions to the Conservation Trust Fund have represented less than 1 percent of total state revenue since the inception of the Lottery. Further, distributions to all the beneficiary funds have represented 1 percent, or less, of total state revenue since the inception of the Lottery. Fiscal Year 2003 distributions totaled $104.8 million, less than 1 percent compared with total state revenue of more than $14 billion.

The following chart and table compare lottery sales revenues and distributions to the beneficiaries for Fiscal Years 1983 through 2003. Overall, while gross sales have increased from about $136.9 million to $391.5 million, or by 186 percent, the distributions have increased from $41.7 million to $104.8 million, or by 151 percent. Viewed in another way, distributions as a percentage of sales have decreased since the Lottery's inception from 30 percent to 27 percent. The Lottery's lowest distributions were $18.5 million in Fiscal Year 1989, and the highest were $110 million in Fiscal Year 2002.

Gross Sales and Total Distributions
Fiscal Years 1983 - 2003



Source: Office of the State Auditor's analysis of financial data from the Colorado Lottery.

Colorado Lottery Gross Sales and Total Distributions Fiscal Years 1983-2003 (In Thousands)			
Year	**Gross Sales**	**Total Distributions**	**Distributions as a Percentage of Sales**
1983	$136,920	$41,665	30.4%
1984	117,580	40,678	34.6%
1985	105,263	32,028	30.4%
1986	108,949	29,181	26.8%
1987	113,298	35,000	30.9%
1988	90,944	33,000	36.3%
1989	78,904	18,515	23.5%
1990	139,940	40,876	29.2%
1991	185,448	58,921	31.8%
1992	239,241	75,986	31.8%
1993	263,462	73,503	27.9%
1994	286,842	74,053	25.8%
1995	351,902	100,613	28.6%
1996	331,351	91,372	27.6%
1997	360,888	94,590	26.2%
1998	374,282	97,575	26.1%
1999	368,404	84,684	23.0%
2000	370,956	89,477	24.1%
2001	350,633	79,284	22.6%
2002	407,967	110,047	27.0%
2003	391,474	104,779	26.8%
TOTAL	**$5,174,648**	**$1,405,827**	**27.2%**

Source: Office of the State Auditor’s analysis of distributions from the Colorado Lottery.

Overall, the Lottery has distributed funds to the beneficiaries in accordance with statutes and the Colorado Constitution. During our review of the Lottery's operations we identified cost savings and the potential for additional sales that could result in increased proceeds to the beneficiaries. These areas are discussed in detail in Chapter 2.

Lottery Expenses

Section 24-35-218(1)(c)(II), C.R.S., requires the State Auditor to analyze the Lottery's expenses. In Fiscal Year 2003 the Lottery had about $62 million in administrative and retailer compensation expenses. This equates to a 16.5 percent increase since our 1997 performance audit. Administrative expenses have remained at about $32 million; however, retailer compensation has increased from $20.9 million to $29.5 million, or by more than $8.6 million (41 percent). Part of the increase is attributable to an increase in both the retailer compensation rate and sales. According to U.S. lottery industry standards, administrative costs include all expenses of operating a lottery, excluding retailer compensation. Retailers typically receive commissions based on sales and might also receive bonuses for meeting individual sales goals and selling or cashing winning tickets. Section 24-35-210(9), C.R.S., requires that disbursements for Lottery prizes are no less than 50 percent of sales; therefore, prizes are not considered an administrative expense. As discussed in Chapter 2, the Lottery's Fiscal Year 2003 prize expenses were about $227 million. The following table shows the Colorado Lottery's administrative and retailer compensation expenses in Fiscal Years 1997 and 2003.

Colorado Lottery Administrative and Retailer Compensation Expenses
Fiscal Years 1997 and 2003

Expense Item	**1997**	**2003**	**% Inc/(Dec)**
Marketing and Communications (advertising, sales, sponsorships, special events, and public affairs)	$10,357,620	$9,093,013	(12.2%)
Wages, Benefits, and Accrued Annual and Sick Leave	$6,700,980	$8,055,900	20.2%
Ticket Production and Vendor Fees	$10,431,794	$9,998,612	(4.2%)
Other Operating Expenses (professional services, travel, equipment, materials and supplies, equipment maintenance, and other costs)	$3,172,125	$4,056,549	27.9%
Motor Pool Leasing	$299,693	$284,947	(4.9%)
Online Telecommunications	$1,177,042	$801,383	(31.9%)
Subtotal Administrative Costs	**$32,139,254**	**$32,290,404**	**(0.5%)**
Retailer Commissions and Bonuses	$20,905,763	$29,528,971	41.2%
TOTAL	**$53,045,017**	**$61,819,375**	**16.5%**

Source: Colorado Lottery's Statements of Revenues, Expenses, and Changes in Fund Net Assets for Fiscal Years 1997 and 2003.

All U.S. lotteries provide compensation to their retailers. The Colorado Lottery pays each retailer an average commission of 6.5 percent of the retailer sales, plus another 1 percent cashing bonus for all prizes cashed from $1 to $599. Prizes in excess of $599 must be redeemed at a Lottery office. Retailer compensation is discussed in Chapter 2.

As shown in Appendix B, Colorado's ratio of administrative costs to total revenues was ranked in the upper half of U.S. lotteries in Fiscal Year 2002, while the return to the State was one of the lowest among U.S. lotteries. Specifically, 21 of the 39 U.S. lotteries had lower administrative to revenues cost ratios than Colorado, and 20 of the 34 (59 percent) U.S. lotteries that do not operate video lottery terminals had a higher return to the governmental beneficiaries than Colorado. In Fiscal Year 2002 Colorado's administrative costs were 7.8 percent of revenues, while the national average was about 5.5 percent; in Fiscal Year 2003 Colorado's administrative costs were 8.2 percent of the Lottery's gross sales and 8.2 percent of the Lottery’s total revenues (gross sales plus other revenue, e.g., interest income) of about $394 million. We also noted that the Colorado Lottery’s percentage of administrative expenses to revenue was roughly similar to other lotteries with a similar sales volume; generally, this ratio decreases with increasing sales volume.

Equipment Contractors and Licensed Sales Agents

Section 24-35-218(1)(c)(III), C.R.S., requires the State Auditor to evaluate the performance of the Lottery’s equipment contractors (game services suppliers) and licensed sales agents (retailers). The Lottery has procedures in place for monitoring its equipment contractors, other contractors, and licensed sales agents to ensure their performance is adequate. In most cases we found that the Lottery has also established controls to ensure that it receives all contractually required services and obligations.

The Lottery has six major contracts for advertising services, public relations, online and scratch game services, and a lease for scratch ticket vending machines. In Fiscal Year 2003 these contracts totaled about $19.5 million. With the addition of Powerball, annual Multi-State Lottery Association costs were about $180,000 in Fiscal Year 2003. The table below shows the Lottery's six major contracts.

Colorado Lottery's Six Largest Contracts Fiscal Year 2003		
Contractor	**Service Provided**	**Expense**
Karsh and Hagan Communications, Inc.	Advertising	$8,203,000
GTECH Corp.	Online games	$7,274,000
Scientific Games, Inc.	Scratch games	$2,083,000
Oberthur Gaming Technologies Corp.	Scratch games	$851,000
Interlott Technologies, Inc.	Lease of scratch ticket vending machines	$651,000
Peter Webb Public Relations, Inc.	Public relations	$399,000
TOTAL		**$19,461,000**
Source: Office of the State Auditor's analysis of contract data from the Lottery.		

The Lottery has two major game service suppliers: Scientific Games produces the majority of instant scratch tickets and GTECH maintains the online ticket sales system for Lotto, Cash 5, and Powerball. Karsh and Hagan provides advertising services and represents the Lottery's largest contract, more than $8 million annually. Peter Webb Public Relations, Inc., provides services such as handling media relations and press releases.

During Fiscal Year 2003 the Lottery issued a request for proposal for online ticket services because its contract with GTECH expires in October 2004. In June 2003 the Lottery awarded the contract to provide both online and scratch services and products beginning November 2004 to Scientific Games. According to the Lottery management, due to advances in the industry, Scientific Games will be able perform several functions more efficiently and effectively than the current arrangement. The primary areas where significant changes are planned include the scratch ticket validation and inventory systems, as well as the processes for recording, reconciling, and reporting accounts receivable and revenue of ticket sales. Currently the Lottery's internal computer system processes these functions. Under the new contract with Scientific Games, the total cost for the first year of operations beginning November 1, 2004 (Fiscal Year 2005), will be $6.3 million; the total maximum contract cost for goods and services will be more than $56 million over the life of the contract, through Fiscal Year 2011. Our analysis and recommendation regarding the conversion to Scientific Games are discussed in Chapter 3.

Contracts Reviewed

We reviewed four of the Lottery's contracts to determine whether they had been bid appropriately and whether the contracts included performance measures and provisions for holding the contractors accountable for their work. Nothing came to our attention that indicated issues with bidding for the contracts or evaluations of proposals. Two of these contracts (NSR and Ciber) will provide independent validation and verification project oversight services for the computer migration from the Lottery's current internal system to Scientific Games services. We reviewed these contracts because they are a critical component to the success of the new system. The third contract we reviewed (Karsh and Hagan) provides professional advertising and marketing services. This is the Lottery's most expensive contract. The final contract (Scientific Games) is for the production of the Lottery's instant scratch tickets. This contract includes $250,000 annually for consumer research. Because the Lottery is moving to Scientific Games for all of its products (scratch and online) we included this contract in our sample to ensure the Lottery's current monitoring is appropriate and any problems have been handled in accordance with the contract.

Based on our review, we found that each contract includes remedies that the Lottery may invoke if the contractor fails to perform its contractual obligations. Each contract also includes performance measures sufficient to measure the products and services provided by the contractor, including deliverables. The Lottery assigns contract monitors who develop specific procedures to monitor each contract. We reviewed these monitoring procedures and found that they are adequate for ensuring that the contractors fulfill their obligations. We also found that, for the most part, monitors follow these procedures. We noted one exception in that the Lottery has not adequately tracked the expenses related to the $250,000 available for consumer research and, as a result, has not received the full value of the contract. This issue is discussed in Chapter 2.

Licensed Sales Agents

The other area we reviewed to determine whether the Lottery has adequate controls was its monitoring of the performance of its licensed sales agents, or retailers. The Lottery is responsible for conducting criminal background and credit history checks of all new and renewing retailers. The Lottery will deny a license if the background investigation identifies problems. For example, in 2002 a background investigation determined that a retail applicant had not submitted the names of all corporate officers. The Lottery contacted the applicant for the additional information on one officer; when the applicant did not provide complete data on the corporate officer, the Lottery denied the application for a license.

Lottery sales staff also monitor the performance of the individual retailers. For example, retailers have the opportunity to earn up to a 0.5 percent bonus on total sales for implementing marketing standards (performance agreement) set by the Lottery. Standards include visibly displaying games for sale, carrying the minimum games negotiated, and having a play center or rack. The Lottery monitors the performance of its retailers by checking quarterly to determine if the marketing standards are met. In the past three fiscal years (2001 through 2003), almost all (over 99 percent) of the eligible retailers received a bonus for meeting marketing standards. Retailer compensation is discussed in Chapter 2.

Administrative and Statutory Changes

Sections 24-35-218(1)(c)(IX) through (X), C.R.S., require the State Auditor to determine whether the Lottery performs its statutory duties efficiently and effectively and if any administrative and statutory changes are needed. We found that, in general, the Lottery operates in accordance with statutes and the Colorado Constitution. However, we did find some areas where the Lottery is not following statutes, State Fiscal Rules, or its own internal policies. These areas are discussed in Chapter 2. Recommendations for improving the Lottery's operations include analyzing all expenses and identifying ways to decrease or eliminate expenses; increasing the percentage of sales paid to the beneficiaries; ensuring marketing activities are cost-beneficial; improving oversight and utilization of sales staff; expanding the retailer base and ensuring retailer compensation is reasonable; and reducing administrative expenses in the areas of vehicles, travel, official functions, and cell phones. We also recommend that the Lottery ensure adequate controls are established over the implementation of the new online and scratch system, implement internal controls over petty cash and ticket reconstruction, enhance public participation in Commission meetings, and seek statutory clarification regarding reserves.

Gambling

The following summarizes our evaluations of the statutory gambling topics.

Organized Crime and Illegal Gambling

Section 24-35-218(1)(c)(IV), C.R.S., requires the State Auditor to determine whether there has been an increase in organized crime related to gambling within Colorado. Nothing came to our attention that indicates that the establishment of the Colorado Lottery has had any effect on organized crime and/or illegal gambling. Federal, state, and local law enforcement officials told us that they do not believe that there has been an increase in organized crime or illegal gambling related to the Colorado Lottery.

Illegal gambling includes betting on sports events, dog fights, and cockfights as well as illegal slot machines typically found at fraternal organizations.

We obtained and reviewed data from the Colorado Bureau of Investigation (CBI) and the Division of Gaming on gambling-related arrests. The total number of arrests included those reported to the CBI and arrests by the Division of Gaming. As shown in the following table, gambling-related arrests have varied since 1982. It appears that the total number of gambling-related arrests began increasing starting in 1992, the first full year of limited stakes gaming in Colorado. According to Division of Gaming officials, Division investigators arrest "about a thousand persons each year for offenses associated with Colorado casino gaming" including underage gambling and cheating. The Division reported 66 gambling-related arrests in 1992, and 844 in 2002.

Gambling Arrests in Colorado
Calendar Years 1982 Through 2002

Year	Reported to the CBI (Except for Gaming)	Reported by the Division of Gaming	Total
1982	36	N/A	36
1983	119	N/A	119
1984	109	N/A	109
1985	103	N/A	103
1986	64	N/A	64
1987	114	N/A	114
1988	141	N/A	141
1989	54	N/A	54
1990	94	N/A	94
1991	102	N/A	102
1992[1]	48	66	114
1993	78	269	347
1994	19	409	428
1995	50	529	579
1996	32	504	536
1997	13	775	788
1998	52	890	942
1999	26	1,136	1,162
2000	54	1,151	1,205
2001	18	973	991
2002	12	844	856
TOTAL	**1,347**	**7,687**	**8,884**

Source: Colorado Bureau of Investigation data and Division of Gaming arrest reports, August 2003, and Colorado Lottery Performance Audit, October 1997.
[1]1992 was the first full year of limited stakes gaming in Colorado.

Effect on Legal Gambling

Section 24-35-218(1)(c)(V), C.R.S., requires the State Auditor to determine the competitive effect of the Lottery on other forms of legal gambling in the State. Our review of available data indicates that the Colorado Lottery has not had an apparent negative or positive impact on the amount of wagering on the three other forms of legal gambling in the State. In general, revenues for all types of legal gaming in Colorado increased over the past 21 years. Parimutuel and bingo/raffles wagering existed in the State for many years before the Lottery was established, and limited stakes (casino) gaming began in 1991 in Colorado.

Legal gambling has expanded significantly since the Lottery began operations in 1983. Legal wagering in the State includes parimutuel racing (dog and horse), bingo/raffles, lottery, and limited stakes gambling at casinos. In Calendar Year 2002 these types of gaming activities in Colorado resulted in more than $1.5 billion in total revenue.

- **Parimutuel racing.** Legal gambling in Colorado began with horse racing in the 1940s. Currently there are five greyhound tracks, one major horse track, and one fair circuit horse track in Colorado. All of the tracks offer simulcasting for much of the year to allow players to wager on races in other venues. In addition, there are four off-track betting (OTB) outlets in the State that offer parimutuel wagering on races held elsewhere in the United States. According to Division of Racing records, parimutuel revenues were about $219 million in Calendar Year 2002, a 2 percent increase from the 1996 revenue of $214 million that we reported in our 1997 audit. Since 1983 parimutuel wagering has varied from a low of $190 million in Calendar Year 1991 to a high of $257 million in Calendar Year 1995.

- **Bingo/Raffles.** Unregulated charitable gambling existed in Colorado for many years and was operated mostly by religious, fraternal, educational, and veterans' organizations. In 1958 voters passed an amendment to the Colorado Constitution creating a regulatory and enforcement environment within the Office of the Secretary of State to oversee bingo, pulltabs, and raffles. According to Secretary of State records, bingo and raffles sales were about $185 million in Calendar Year 2002, a 16 percent decrease from the 1996 revenue of $221 million we reported in our 1997 audit. Since 1983, bingo/raffles wagering has varied from a low of $64 million in Calendar Year 1983 to a high of $227 million in Calendar Year 1994.

- **Lottery.** As discussed in the Description section, the Colorado Lottery began with scratch games in 1983. According to the Lottery's records, Lottery sales were about $398 million in Calendar Year 2002, a 16 percent increase from the

1996 sales of $343 million we reported in our 1997 audit. Since 1983, Lottery wagering has varied from a low of $77 million in Calendar Year 1988 to a high of $398 million on Calendar Year 2002.

- **Limited stakes casinos.** In November 1990, Colorado voters approved limited stakes gambling in three mountain mining towns. In October 1991 casino operations began in Black Hawk, Central City, and Cripple Creek. Currently, 44 casinos are licensed to operate poker, blackjack, slot machines, and video games in these three towns. The maximum legal bet is $5. According to Division of Gaming records, revenue at these Colorado casinos was about $720 million in Calendar Year 2002, a 75 percent increase from the 1996 revenue of $411 million we reported in our 1997 audit. Since 1992, the first full year of limited stakes gaming in Colorado, casino wagering has grown from a low of $180 million in Calendar Year 1992 to a high of $720 million in Calendar Year 2002.

As shown in the following table, the four types of legal gambling in Colorado have produced about $19 billion in total revenue since Calendar Year 1980. The total gaming market consists of many types of legal gambling (e.g., lottery and casinos). Market share is the percentage of each type's annual revenue compared with the total gambling revenue for all types. Between 1983 and 2002, annual gaming revenue increased from $480 million to $1.5 billion. Bingo/raffle and parimutuel racing accounted for all legal gaming in the State until the Lottery began selling tickets in 1983. Parimutuel's market share was about 80 percent of the $253 million in revenue in 1981, and bingo/raffles had about a 20 percent market share. After the inception of the Lottery, revenue as expressed in total dollars for parimutuel racing has been fairly constant while revenue for bingo/raffles has grown from about $64 million in 1983 to $185 million in 2002.

Legal Gaming Total Revenues and Market Share
Calendar Years 1980 – 2002
(In Millions)

Year	Lottery[1]	Market Share	Pari-mutuel [2]	Market Share	Casino[3]	Market Share	Bingo/ Raffles	Market Share	Total – All types
1980	N/A	N/A	$182	82%	N/A	N/A	$41	18%	$223
1981	N/A	N/A	$202	80%	N/A	N/A	$51	20%	$253
1982	N/A	N/A	$213	78%	N/A	N/A	$60	22%	$273
1983	$203	42%	$213	44%	N/A	N/A	$64	13%	$480
1984	$103	27%	$198	53%	N/A	N/A	$75	20%	$376
1985	$110	27%	$210	52%	N/A	N/A	$85	21%	$405
1986	$115	26%	$221	51%	N/A	N/A	$101	23%	$437
1987	$99	23%	$214	49%	N/A	N/A	$126	29%	$439
1988	$77	17%	$221	50%	N/A	N/A	$145	33%	$443
1989	$105	22%	$206	43%	N/A	N/A	$166	35%	$477
1990	$166	29%	$208	36%	N/A	N/A	$197	35%	$571
1991	$210	33%	$190	30%	$23	4%	$221	34%	$644
1992	$246	29%	$203	24%	$180	21%	$224	26%	$853
1993	$281	29%	$210	22%	$260	27%	$222	23%	$973
1994	$323	29%	$229	21%	$326	30%	$227	21%	$1,105
1995	$344	28%	$257	21%	$384	32%	$225	19%	$1,210
1996	$343	29%	$214	18%	$412	35%	$221	19%	$1,190
1997	$365	29%	$252	20%	$431	34%	$217	17%	$1,265
1998	$386	29%	$235	18%	$479	36%	$218	17%	$1,318
1999	$368	27%	$245	18%	$551	40%	$209	15%	$1,373
2000	$349	24%	$241	17%	$632	44%	$206	14%	$1,428
2001	$397	26%	$233	16%	$676	45%	$196	13%	$1,502
2002	$398	26%	$219	14%	$720	47%	$185	12%	$1,522
TOTAL	**$4,988**		**$5,016**		**$5,074**		**$3,682**		**$18,760**

Source: Office of the State Auditor's analysis of revenue data from the Lottery, Racing, and Gaming Divisions, and the Secretary of State.

[1] Lottery revenues in this chart are based on calendar years. Revenues, profits, and distributions discussed elsewhere in this report are based on fiscal years.

[2] According to the Colorado Racing Commission's report on parimutuel wagering, the majority of growth in Colorado's parimutuel wagering between 1994 and 1995 is due to an increase in the number of out-of-state races simulcast in Colorado. However, the State does not collect parimutuel commissions on out-of-state races simulcast in Colorado.

[3] The 1991 market share for casinos was based on three months of revenue. The casinos opened on October 1, 1991. Revenue for casinos is reported net of prizes; all other gaming revenue reported in the chart includes prize expenses. These ways of reporting revenue are consistent nationwide and are the basis of computing market shares by national gaming organizations. Additionally, prize payout percentages vary among the different forms of gaming.

In addition to state-regulated casino gambling, there are two Native American casinos in the southwestern corner of Colorado. The Ute Mountain casino opened in 1992 and the Southern Ute casino opened in 1993. There is no information about the proceeds generated by these casinos, since Native American casinos are not required to report their revenue to the State.

Lottery Players and the Public

The following summarizes our evaluations on the statutory topics related to Lottery players and the public.

Socioeconomic Profile of Lottery Players

Section 24-35-218(1)(c)(VI), C.R.S., requires the State Auditor to evaluate the socioeconomic profile of people who play the Lottery. In general, the socioeconomic profile of Lottery players reflects the State's adult population. However, as shown in the following table, 55 percent of the players are men compared with 50 percent in the population; 64 percent have education beyond high school compared with 72 percent of the population; and 30 percent are minorities compared with 24 percent of the population.

Socioeconomic Profile of Lottery Players Average Percentage of Players by Category for 2002		
Demographic Category	**Population**	**Players**
Age		
18-24	7%	7%
25-34	16%	16%
35-44	23%	20%
45-54	20%	23%
55-64	22%	23%
65+	12%	11%
No Response	0%	0%
TOTAL	100%	100%
Gender		
Male	50%	55%
Female	50%	45%
TOTAL	100%	100%
Income		
<$15,000	6%	7%
$15,000-$24,999	8%	8%
$25,000-$34,999	11%	11%
$35,000-$49,999	12%	13%
$50,000-$74,999	17%	17%
$75,000+	19%	19%
No Response	27%	25%
TOTAL	100%	100%
Education		
<12 Years	5%	9%
HS Graduate	21%	26%
Some College	27%	29%
College Graduate	30%	23%
Postgraduate Degree	15%	12%
No Response	2%	1%
TOTAL	100%	100%
Ethnicity		
White/Not Hispanic	76%	70%
Hispanic/Latino	15%	22%
African/American	4%	6%
Native American	2%	1%
Asian	3%	1%
Other	0%	0%
No Response	0%	0%
TOTAL	100%	100%

Source: Office of the State Auditor's analysis of the Colorado Lottery's 2002 socioeconomic survey, including those surveyed who had played a Lottery game in the past 30 days. The Lottery's survey was conducted in April 2002 by a third-party research company (Talmey-Drake Research Strategy).

Since 1991 an independent research firm has conducted an annual statewide image study of the Colorado Lottery. The primary objective of the study has been to assess the awareness and image of the Colorado Lottery as an organization and its contributions to the State of Colorado.

According to the National Council on Problem Gambling, over 70 percent of U.S. adults reported gambling at least once in the past year, and approximately 1 percent of U.S. adults (3 million) meet criteria for pathological gambling. An independent study in 1998 paid for by the Department of Revenue reported that 0.7 percent of Colorado's population is considered to be pathological gamblers. Additionally, the study estimated that approximately 250 Colorado residents will seek treatment for problem gambling each year. In response, over the past several years, the Lottery has expanded its efforts to address problem gambling in Colorado. The Lottery also has conducted various "Play Responsibly" campaigns. In addition, information about problem gambling is included in public brochures and on the Lottery's Web site. Further, players can seek assistance through a toll-free compulsive gambling hotline, funded in part by the Lottery.

Public Participation in Lottery Commission Meetings

Section 24-35-218(1)(c)(VII), C.R.S., requires the State Auditor to determine whether the Lottery Commission encourages public participation in its meetings. According to Section 24-35-207(7)(a), C.R.S., the Lottery Commission must hold at least one meeting each month. The Lottery formally advertises its Commission meetings in the Colorado Register, which is published monthly by the Office of the Secretary of State. In addition, notices are posted in the Denver and Pueblo Lottery offices and the Pueblo County Courthouse. According to the Lottery, informal communication is the most successful method of encouraging public participation. For example, the Lottery directly contacts specific groups when issues or policies are scheduled for discussion, such as the Problem Gambling Coalition of Colorado or representatives from the agencies that receive Lottery proceeds. Statutes and the Lottery Commission do not require the Commission to seek public input on decisions that the Commission makes regarding the Lottery; however, the meetings are required to be open to the public. Additionally, our review of meeting minutes indicates that the Commission does not routinely ask if there are members of the public who wish to address the Commission.

We reviewed the Lottery's notification of meeting times, agendas, and minutes, and notification on how the public should request to address the Commission. Additionally, we assessed the Lottery's procedures for routing public correspondence addressed to the Commission. Our recommendation in this area is discussed in Chapter 3.

Complaint, Investigation, and Disciplinary Procedures

Section 24-35-218(1)(c)(VIII), C.R.S., requires the State Auditor to determine whether the Lottery's complaint, investigation, and disciplinary procedures adequately protect the public. The Colorado Lottery has established complaint, investigation, and disciplinary procedures (administrative actions) that appear to be reasonable in protecting the public. The Lottery has assigned 12 staff to investigative activities and in Fiscal Year 2003 spent about $1.4 million on tasks related to complaints, investigations, and disciplinary procedures.

We reviewed a sample of 73 of the 2,432 investigative cases from Fiscal Year 1997 through February 2003 (Fiscal Year 2003). The sample included 3 criminal investigations (e.g., theft of tickets), 3 administrative cases (e.g., defective tickets), 5 internal reviews (e.g., computer tampering), and 62 background checks (52 employees, 5 retailers, and 5 vendors). Our analysis showed that the Lottery completes investigations in a timely manner and appropriate actions are taken. Most of the investigations conducted were routine.

Complaints

The Lottery receives very few complaints from the public. Our sample included two consumer complaints which occurred in Fiscal Years 2002 and 2003. Lottery investigators concluded that one complaint was unfounded. In the other case, the scratch ticket vendor involved took action to correct the complaint, which concerned defective tickets.

Investigations

Lottery security staff conduct background investigations of Lottery employees, retailers, and contractors. All Lottery staff are subject to initial comprehensive criminal and credit background checks and annual updates as a condition of employment. Retailer background checks are also updated annually. Contractor background cases are called "complex investigations" because they involve reviews of financial statements of the company and any subsidiaries, as well as the criminal backgrounds of corporate officers and directors. These checks take up to six months to complete.

Security staff also investigate lottery-related crimes, such as theft of tickets from retailers. The Lottery reported that more than 100,000 tickets were stolen between January 2002 and August 2003. According to Lottery officials, about 50 percent of these tickets are stolen by retailer staff and the other half through store break-ins. All Colorado scratch tickets are bar-coded; therefore, once the Lottery's computerized verification system identifies tickets as stolen, they cannot be cashed. Security staff also investigate reports of ticket irregularities and/or forgeries. For example, one perpetrator attempted to change the prize on a scratch ticket from $50 to $5,000.

Additionally, the Lottery investigates allegations of internal employee theft and misuse of equipment. The Lottery has procedures in place to help identify these instances, (e.g., reviewing surveillance tapes). In Fiscal Year 2002 a Lottery employee resigned after an internal investigation found that the employee had misused state software and computers.

Disciplinary Actions

The Lottery has established disciplinary procedures and may take administrative action against retailers or staff. One of the eleven non-background investigation cases we sampled resulted in such action. A Lottery employee had misused state-owned computer equipment and software. A personnel action resulted in an administrative hearing.

Lottery Expenses

Chapter 2

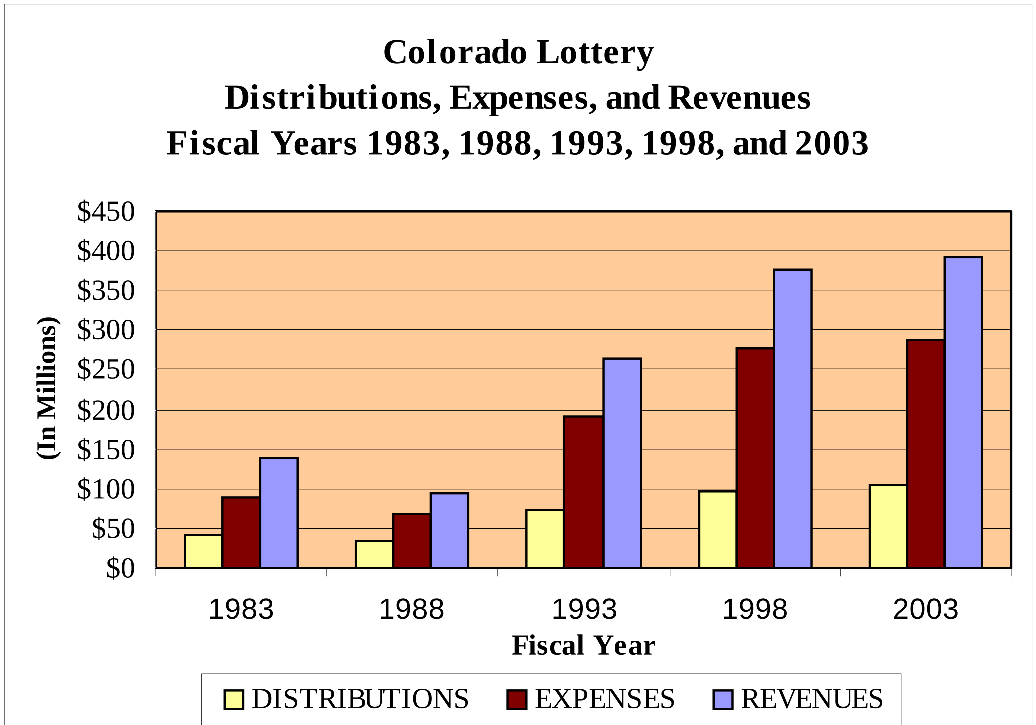
Background

As reported in Chapter 1, Colorado Lottery sales have increased dramatically since the games were first available in Fiscal Year 1983. In total, beneficiaries have received about $1.4 billion over the Lottery's 21 years of operations. While Colorado's parks, wildlife, and open space will continue to benefit from Lottery proceeds, examination of the long-term trends in Lottery revenues indicates that the rate of growth in Lottery sales has slowed in recent years (see chart page 22). Similar to other states where lotteries have been in existence for a number of years, the market for the Colorado Lottery appears to have reached maturity. This means that while sales could continue to grow, the growth would likely be modest.

Since future revenue growth may be limited, it is particularly important that the Lottery ensure all expenses incurred for its operations are reasonable and necessary. Our audit reviewed the long-term trends in the major categories of Lottery expenses and identified the need for an overall evaluation of these expenses. Additionally, we conducted detailed reviews of specific types of expenses including marketing, sales, and other administrative costs. We identified numerous instances in which the Lottery could improve its oversight of these costs to ensure funds are used effectively.

Trends in Revenues, Expenses, and Distributions

During its 21 years of operations, the Lottery has increased its revenue from $138.3 million in Fiscal Year 1983 to $393.7 million in Fiscal Year 2003, or by 185 percent; Lottery sales account for more than 99 percent of these revenues. However, the amount distributed to beneficiaries has not kept pace, growing from $41.7 million to $104.8 million, or by 151 percent. Expenses—including prize payouts and retailer commissions and bonuses, as well as administrative costs—grew from $90.1 million to $288.7 million, or by 220 percent. These changes are illustrated in the chart below.



Source: Office of the State Auditor's analysis of Colorado Lottery's Statements of Revenues, Expenses, and Changes in Net Assets.

We analyzed the Lottery's different expense categories in relation to revenues to determine which categories use the greatest share of revenue and how these relationships have changed over time. This analysis is summarized below for Fiscal Years 1983, 1993, and 2003.

Colorado Lottery
Summary of Revenue, Expenses, and Distributions
Selected Fiscal Years
(In Millions)

	1983	**% of Total Revenue**	**1993**	**% of Total Revenue**	**2003**	**% of Total Revenue**
Revenue						
Gross Ticket Sales	$136.9	99.0%	$263.4	99.2%	$391.5	99.4%
Other Revenue (e.g., interest income & license fees)	$1.4	1.0%	$2.0	0.8%	$2.2	0.6%
Total Revenue	**$138.3**	**100.0%**	**$265.4**	**100.0%**	**$393.7**	**100.0%**
Expenses						
Prizes	$70.5	51.0%	$148.0	55.8%	$226.9	57.6%
Retailer Commissions and Bonuses	$8.2	5.9%	$15.9	6.0%	$29.5	7.5%
Administration[1]	$11.4	8.2%	$28.0	10.6%	$32.3	8.2%
Total Expenses	**$90.1**	**65.1%**	**$191.9**	**72.3%**	**$288.7**	**73.3%**
Net Profit	**$48.2**	**34.9%**	**$73.5**	**27.7%**	**$105.0**	**26.7%**
Distributions to Beneficiaries[2]	$41.7	30.2%	$73.5	27.7%	$104.8	26.6%

Source: Office of the State Auditor's analysis of Colorado Lottery's Statements of Revenues, Expenses, and Changes in Net Assets.
[1]Includes ticket costs and vendor fees; marketing and communications; salaries, benefits, and professional services; and other general administrative expenses.
[2]The Lottery is statutorily required to maintain reserves, thus not all net profits are distributed to beneficiaries.

We also compared Colorado Lottery expenses with those for the 39 existing state lotteries for Fiscal Year 2002, the most recent year for which comparative data were available (this comparative information is detailed in Appendix B). Our analysis of the Lottery's expenses since inception and of national data found that:

- **Prizes**, which account for the single largest category of expenses, have grown steadily from Fiscal Year 1983 to 2003, not only in dollar amount but also in relation to revenue, rising from 51 percent to 57.6 percent. This is similar to the 58 percent the Lottery paid out in prizes in Fiscal Year 2002, which was 1.3 percent above the national average of 56.7 percent for all state lotteries in that year. Under Colorado statutes, the Lottery is required to pay out at least 50 percent of its gross ticket sales in prizes.

- **Retailer commissions and bonuses** have also risen both in amounts paid and in relation to revenue from Fiscal Year 1983 to 2003, increasing from 5.9

percent to 7.5 percent. In Fiscal Year 2002 the Lottery paid 7.4 percent for these expenses, while the national average was considerably lower at 6.0 percent in that year.

- **Administrative expenses** from Fiscal Year 1983 to 2003 appear fairly flat at about 8 percent, although in Fiscal Year 1993 administrative expenses were 10.6 percent of revenue. In Fiscal Year 2002 these expenses were 7.8 percent of revenue for the Colorado Lottery, which was about 2.3 percent above the national average of 5.5 percent for the year.

- **Distributions to beneficiaries**, although increasing in dollar amount from Fiscal Year 1983 to 2003, have dropped steadily as a percentage of revenue from 30.1 percent initially to 26.6 percent. In Fiscal Year 2002 the Lottery distributed about 27 percent of its revenue, which was 5 percent lower than the national average of 32 percent.

The decline in percentage of sales revenues paid to beneficiaries is of particular concern because the Lottery was created specifically to provide funding to benefit outdoor resources and activities. Colorado voters reaffirmed this intent in 1992 with the passage of the constitutional amendment that created Great Outdoors Colorado (GOCO). In addition to establishing GOCO, this amendment prevented the State from continuing to use lottery proceeds to fund capital construction. The Lottery's goal is to maximize revenues and profits, thereby maximizing payments to beneficiaries. To achieve this, the Lottery should perform a comprehensive evaluation of all expenses in order to identify unnecessary costs, particularly in areas where costs appear out of line with other state lotteries; ensure resources are used efficiently; and work to increase funding for distributions.

Recommendation No. 1:

The Colorado Lottery should increase the percentage of sales revenues to fund outdoor resources and activities by:

a. Performing a comprehensive analysis of all expenses and identifying ways to decrease or eliminate expenses or use resources more efficiently.

b. Developing and implementing a plan to reduce costs and achieve specific goals for increasing the percentage of sales revenues provided to beneficiaries.

Colorado Lottery Response:

Agree. Implementation date: July 2004.

a. The Lottery will perform a comprehensive analysis that will focus on evaluating all expenses and resources needed to maximize Lottery fund distributions while not causing an adverse effect on sales.

b. The Lottery will use the results from the comprehensive analysis of all expenses and resources to develop a plan including specific goals and objectives that will be incorporated into the Lottery's Business Plan.

Marketing Expenses

Out of the Lottery's total administrative expenses of $32.3 million for Fiscal Year 2003, almost one third, or about $10 million, of these expenses, including salaries, was for marketing. Of the $10 million, about $9.1 million was for a variety of marketing-related activities including a $8.2 million advertising contract with Karsh and Hagan and a $400,000 public relations contract with Peter Webb Public Relations, Inc. About $869,000 of the $10 million was for salaries of 13 marketing staff, or about 11 percent of all Lottery personnel.

Marketing activities include public relations, product management, advertisement displays that are used at retail establishments, research, Web site management, and media advertising. The Lottery conducts other activities related to marketing such as sponsorships, promotions, event marketing, and giveaways; as summarized in Appendix C, in Fiscal Year 2003 these costs totaled about $1.2 million, or 12 percent of the $10 million in marketing expenses.

Overall, we found that the Lottery's marketing plan is not comprehensive. It does not set goals and measurable objectives that target resources to activities most likely to increase sales. Specifically, the Lottery does not (1) evaluate activities to determine if they increase sales, (2) review costs associated with promotions to determine if the costs are necessary, or (3) determine how events could be more effective in increasing sales in the future. As a result, the Lottery cannot ensure that specific marketing activities increase sales and are cost-beneficial.

For example, in Fiscal Year 2003 the Lottery spent $1.2 million on numerous sponsorships, promotions, event marketing, and premium items, such as key chains, jackets, and golf items. According to management, all marketing activities of $5,000 or more are preevaluated, and those less than $5,000 are preevaluated at management's discretion. We performed a detailed review of 169 of these expenses totaling about $845,000 and found that as of May 2003, the Lottery had not pre- or postevaluated 138 of these activities, or about 82 percent. Expenses for these 138 activities totaled about $312,000. As a result, expenses for promotions and giveaways appear subjective, unsystematic, and at risk of misuse or irregularities.

Despite ongoing marketing efforts, from Fiscal Year 1998 through 2003 Lottery sales increased only by about 5 percent, and for three of those years, including Fiscal Year 2003, sales were actually less than for the prior year. As mentioned earlier, this may be an indication that the Lottery has largely saturated its market and the opportunities for further growth are limited. Also, based on Fiscal Year 2002 data, we noted that Lottery's media advertising budget as a percentage of revenue is above the national average (1.7 percent compared with 1.1 percent nationally) as shown in Appendix B. Lagging sales and relatively high costs emphasize the need for the Lottery to reevaluate its overall marketing plan and costs, ensure that activities funded are beneficial, and identify ways that expenses could be reduced or efforts redirected.

Recommendation No. 2:

The Colorado Lottery should ensure marketing activities are cost-beneficial by:

a. Developing a comprehensive marketing plan with goals and measurable objectives that targets resources to activities most likely to increase sales.

b. Evaluating all market activities to assess the impact on sales and compare actual to expected impact and identifying the most effective and cost-efficient means of increasing sales. This should include an evaluation of the activities performed under the advertising and public relations contracts.

c. Revising the marketing plan on the basis of results achieved, including reducing expenses in areas that are not cost-beneficial.

Colorado Lottery Response:

Agree. Implementation date: July 2004.

a. The Lottery will develop a more comprehensive marketing plan that will include goals and measurable objectives that targets resources with activities designed to maximize revenue for its proceeds recipients.

b. The Lottery and its advertising and public relations consultants will evaluate all marketing activity and identify the most efficient and cost-effective means to maximize revenue for its proceeds recipients.

c. The Lottery will include in its annual marketing plan an analysis of results that have been achieved. Based on the analysis, the marketing plan will incorporate changes that will maximize the effectiveness of marketing funds.

Lottery Sales Personnel

The Colorado Lottery is a sales organization; its main purpose is to sell Lottery products in order to increase revenues. About 38 sales staff, or about 31 percent of total Lottery staff, are involved in sales activities. Sales personnel include 31 sales representatives, 3 sales supervisors, 3 corporate account representatives, and 1 sales manager. We reviewed the number of sales personnel compared with other lotteries, as well as the activities performed by Colorado Lottery sales staff, and identified three areas in which improvements could be made.

Sales Routes and Lottery Sales

First, there may be opportunities to better utilize the Lottery's sales representatives. U.S. lotteries vary in how many direct sales representatives they have. In Fiscal Year 2002 U.S. lotteries had an average of 43 sales representatives; the number ranged from 139 in California to 3 in Delaware, and the nationwide median was 30. With 31 sales representatives, Colorado appears to be close to the median; however, as shown in the following table, Colorado's representatives handled fewer retailers than the national average and on average had lower sales in Fiscal Year 2002.

Comparison of Colorado Lottery Sales Representative Data With Averages for U.S. Lotteries Fiscal Year 2002

Factor	**Colorado**	**U.S. Lotteries Average**
Average number of retailers per sales staff	105	107
Average sales volume per sales staff	$15,400,000	$25,300,000

Source: Office of the State Auditor's analysis of U.S. lottery data in LaFleur's 2003 World Lottery Almanac.

Each Colorado sales representative has an assigned route of retailers to visit biweekly. According to Lottery management, most sales representatives have had the same route for about 12 years, which is also the average number of years sales staff have worked for the Lottery. Management reports that the Lottery reviews these routes at least annually and may make small adjustments. Therefore, the level of resources devoted to each route has essentially not changed for more than 12 years.

A comprehensive analysis of sales routes and the level of sales in different areas could enable Lottery to make more effective use of staff resources. The Lottery could prioritize sales activities, such as the delivery of tickets, in the areas of the State that have the greatest percentage of scratch sales. For example, by focusing efforts on the counties with the highest scratch sales, the Lottery may be able to increase sales. As part of this analysis, the Lottery should determine whether the number of sales staff is appropriate or could be reduced. The 10 counties with the highest scratch ticket sales are listed in the following table.

Counties with the Highest Lottery Scratch Sales
Fiscal Year 2003

County	Scratch Sales	% of Total Scratch Sales
El Paso	$33,900,000	13%
Denver	$32,300,000	13%
Jefferson	$24,400,000	10%
Arapahoe	$22,600,000	9%
Adams	$21,100,000	8%
Pueblo	$17,700,000	7%
Mesa	$12,600,000	5%
Larimer	$12,400,000	5%
Weld	$12,100,000	5%
Boulder	$7,700,000	3%
TOTAL	**$196,800,000**	**78%**

Source: Office of the State Auditor's analysis of county sales data for Fiscal Year 2003 from the Lottery.

Sales Staff Performance

Second, we reviewed the activities of the sales representatives and found that Lottery management does not adequately monitor the sales representatives to ensure they carry out their responsibilities and address all problems that may affect sales. For example, management does not regularly oversee the sales representatives while they are in the field delivering tickets and visiting retailers.

Both the three sales supervisors and the three corporate account representatives are responsible for monitoring the activities of the sales representatives. Supervisors are required to evaluate each of the sales representative's performance at 10 retailers each quarter, and corporate account representatives are required to accompany each sales representative once per quarter. However, we found that these reviews are not consistently documented and there is no evaluation of the sales representative's performance. Additionally, according to the Lottery, in Fiscal Year 2003 supervisors conducted only about 900 of the required 1,060 evaluations.

The performance of sales representatives is important because in addition to delivering tickets, they are the primary contacts with retailers. Lottery management should systematically and routinely monitor and track the performance of the sales representatives not only to ensure they perform their duties adequately but also to be able to address issues affecting retailers promptly.

Sales Staff Incentive Plan

Third, the Lottery needs to reassess its bonus plan for sales staff. Since 1983 the Lottery has paid almost $3.7 million in bonuses for sales staff. In our 1997 performance audit, we found that the Lottery was unable to demonstrate if the sales incentive plan was effective in increasing sales and that the Lottery had paid almost 100 percent of the total bonus amount available from Fiscal Years 1993 through 1996, indicating that the sales goals were not challenging. We recommended the Lottery review alternatives including eliminating the incentive plan or adopting a commission form of compensation that would pay a sales representative based on sales achieved.

As part of our current audit, we reviewed the Lottery's sales incentive plan for Fiscal Years 2000 through 2003. The following chart summarizes bonuses received by Lottery staff during that period.

Colorado Lottery Bonuses Received by Sales Staff Fiscal Years 2000-2003					
	2000	**2001**	**2002**	**2003**	**Four-year Average**
Sales	$371,000,000[1]	$249,000,000	$257,000,000	$254,000,000	$282,750,000
Total Bonus Available	$293,000	$310,000	$298,000	$308,000	$302,250
Total Bonus Earned	$229,000	$275,000	$265,000	$58,000	$206,750
Percent of Available Bonus Earned	78.2%	88.7%	88.9%	18.8%	68.4%
Total Sales Staff Eligible to Receive a Bonus	37	38	41	38	39
Total Staff Receiving a Bonus	32	33	39	33	34
Average Bonus Earned	$7,000	$8,000	$7,000	$2,000	$6,000
Percent of Staff Receiving a Bonus	86.5%	86.8%	95.1%	86.8%	87.2%

Source: Office of the State Auditor's analysis of the Lottery's financial and sales bonus data.
[1]In Fiscal Year 2000 bonuses were paid on both online sales of $137 million and scratch sales of $234 million. In Fiscal Years 2001 through 2003 bonuses were paid on scratch sales only.

Our review identified problems similar to those found in our 1997 performance audit, including:

- A majority of the sales staff receive bonuses, even when sales decline, such as in Fiscal Year 2003.

- No apparent relationship exists between ticket sales and bonuses paid.

We also found that the Lottery pays staff bonuses for performing expected duties rather than for exemplary performance.

Overall, the Lottery's incentive plan does not work as intended. As we reported in 1997, the majority of U.S. lotteries do not offer a bonus plan for their sales representatives. Given that the Colorado Lottery's ticket sales generally are not increasing at the high rates seen in earlier years, it may no longer be appropriate to use a bonus plan for these employees, especially since the bonus plan does not appear to have a meaningful link to sales or performance.

Recommendation No. 3:

The Colorado Lottery should improve its oversight and utilization of sales staff by:

a. Reviewing all sales routes and sales volumes in different areas of the State and determining how to focus more resources on areas with higher sales. This analysis should include assessing the number of sales staff needed to optimize sales.

b. Performing and documenting evaluations of sales representatives' activities on a regular basis and providing feedback as appropriate.

c. Reevaluating the basis for the sales incentive plan. The plan should either be linked more directly to sales or be eliminated.

Colorado Lottery Response:

Agree.

a. Implementation date: July 2004. The Lottery will analyze all sales routes, including the number of sales staff, for efficiencies and effectiveness for the purpose of maximizing revenue for its proceeds recipients.

b. Implementation date: June 2005. Using the results from the sales routes analysis, the Lottery will design a sales representative evaluation procedure. The sales representative evaluation procedure will include a requirement for documented scheduled route evaluations that include feedback as appropriate. The documentation will be incorporated into the sales representatives' performance plans.

c. Implementation date: June 2005. The Lottery will analyze the basis of its sales incentive plan and will make modifications that will link the plan more directly to sales. Additionally, the Lottery will work with the Department of Personnel and Administration to develop a plan to determine the future of sales incentives including the possibility of eliminating the incentive.

Retail Sales

As discussed previously, the Lottery sells its products through about 2,800 retailers statewide. As part of our audit, we reviewed the Lottery's oversight of its retailers and identified two issues. First, the Lottery needs to improve the development of its retailer base, and second, the Lottery needs to reevaluate its retailer compensation plan.

Development of Retail Base

The Lottery's retailer base has remained relatively constant for each of the past five years at about 2,800 retailers. In 1997 we reported that there were 2,765 retailers in Fiscal Year 1997.

In April 2003 the Lottery contracted with a company to conduct research on additional audiences for lottery products. According to the report produced for the Lottery, a younger demographic with extended purchasing power is beginning to enter the mainstream of consumers and to play scratch games. This research indicates there are opportunities for new outlets to dispense scratch tickets, beyond the current retail base, which is primarily gas/convenience, liquor, and grocery stores. According to the report, potential new outlets include large discount chain stores that carry household products, coffee shops, and recreational facilities. The Lottery should use these results to determine the benefits of expanding its retailer base to include markets consistent with the evolving demographics of Lottery players.

Retailer Compensation

As mentioned earlier in this chapter, retailer commissions and bonuses totaled $29.5 million in Fiscal Year 2003, or about 7.5 percent of revenues. This is significantly higher than the national average of about 5.6 percent of revenues. The $29.5 million in Fiscal Year 2003 is about 41 percent more than the $20.9 million paid in Fiscal Year 1997 at the time of our last audit. In January 1998 the Lottery implemented a new plan to increase retailer compensation in response to recommendations from a "Blue Ribbon" panel of Colorado retailers. The Lottery reports that it had been urged by retailers to change its compensation plan for several years prior to 1998. At the time of the change, the Lottery predicted that as "a result of these changes, Colorado will soon rank among the top three U.S. lotteries in retail commission payouts."

Under the new plan, commissions are based on the individual retailer's sales, the number of winning tickets cashed, and the retailer's compliance with a marketing sales agreement. The following table shows the Colorado Lottery's total commissions and bonuses for Fiscal Years 1997, 2002, and 2003; the breakdown by individual categories was not available from the Lottery for Fiscal Year 1997.

Colorado Lottery Retailer Commissions and Bonuses
Fiscal Years 1997, 2002, and 2003

	1997 [1]	2002	2003
Scratch Commissions (7%)	Not Available	$18,016,000	$17,774,000
Online Commissions (6%)	Not Available	$9,002,000	$8,186,000
Cashing Bonus (1% on all prizes up to $599)	Not Available	$1,797,000	$1,757,000
Marketing Standards Bonus (up to 0.50% per quarter)	Not Available	$1,930,000	$1,812,000
TOTAL	**$20,906,000**	**$30,745,000**	**$29,529,000**
AVERAGE [2]	**$7,500**	**$11,000**	**$10,500**

Source: Office of the State Auditor's analysis of Colorado Lottery data on retailer commissions and bonuses for Fiscal Years 1997, 2002 and 2003.
[1] The Colorado Lottery was unable to provide the retailer bonuses amounts per category for Fiscal Year 1997. Midway through Fiscal Year 1997 the Lottery changed its retailer compensation plan. Additionally, in Fiscal Year 1997 the scratch and online commission rate was 5.5 percent of sales.
[2] Average based upon 2,800 retailers.

We found that, in Fiscal Years 2001 through 2003, almost 100 percent of eligible retailers received a bonus for meeting marketing standards; the total amount paid for these three years was almost $5.5 million. Thus, it appears that this bonus incentive may be set too low. Similar to sales staff bonuses, retailer bonuses appear to be paid for performing standard duties as agreed upon in their performance agreement rather than for exemplary performance. Although all U.S. lotteries compensate their retailers, only 11 (28 percent) offer incentive bonuses for meeting certain marketing goals.

Other states use various methods to compensate retailers. For example, the Connecticut Lottery runs a mystery shopper program to judge display items; the Illinois Lottery pays a 1 percent selling bonus on prizes $1,000 or greater, in addition to periodic incentives; Iowa's Lottery pays bonuses based on sliding scale when a retailer increases sales beyond its sales base; and the New Jersey Lottery pays a 1.25 percent cashing commission and flat fees for selling top prizewinning tickets. The Lottery should review other retailer incentive methods to determine which has the most optimal effect on increasing sales.

Recommendation No. 4:

The Colorado Lottery should work to expand its retailer base and ensure commissions and bonuses paid to retailers are reasonable by:

a. Identifying the most effective ways to recruit new types of retailers.

b. Reevaluating the retailer compensation plan and making appropriate changes to maximize sales and ensure payments are linked to outstanding performance.

Colorado Lottery Response:

Agree. Implementation date: January 2005.

a. The Lottery will analyze the Colorado market for all types of potential Lottery retailers and its current retailer recruiting methods. Based on the analysis, the Lottery will identify potential quality and efficient retailers and also develop a cost and resource-efficient plan to recruit the new retailers.

b. The Lottery will reevaluate the retailer bonus plan to maximize the proceeds recipients' return on the retailer bonus dollar. The quest for retail space and time is highly competitive. The Lottery must compete with every product in each retail outlet to present its products prominently. Lottery staff and its marketing consultants will help develop a bonus plan that will motivate Lottery retailers to focus and sell its products. The bonus plan will be linked to performance and included in the annual marketing plan.

Administrative Expenses

In Fiscal Year 2003 the Colorado Lottery's administrative expenses were about \$32.3 million. According to U.S. lottery industry standards, administrative expenses include all costs of operating a lottery except retailer compensation and prize expenses. In our 1997 performance audit, we reported that the Colorado Lottery's administrative expenses as a percentage of total revenue (8.7 percent) was in the upper half of U.S. lotteries and higher than 20 other U.S. lotteries; the national average was 6.2 percent. Costs at the 39 U.S. lotteries vary depending on a number of factors including size of the lottery and mix of games. As shown in Appendix B, in Fiscal Year 2002, Colorado's administrative expenses as a percentage of revenue was 7.8 percent, higher than 21 of the 39 U.S. lotteries; the national average was 5.5 percent. In Fiscal Year 2003, Colorado's administrative costs were about 8.2 percent of revenue.

In 2002 the Colorado Lottery's administrative expenses as a percentage of revenue was roughly similar to other lotteries with a similar sales volume; generally, this ratio decreases with increasing sales volume. Nonetheless, our review of Lottery's administrative expenses indicates that there are a number of areas where the Lottery could reduce costs, including vehicle expenses, travel, official functions, and cell phones.

Lottery's Fleet

In Fiscal Year 2003 the Lottery maintained a fleet of 55 state-owned vehicles at a cost of about $285,000. Fifty-four of these vehicles were permanently assigned to Lottery staff members. In other words, 44 percent of Lottery's staff of 124 were assigned state-owned vehicles. The vehicles were assigned as follows:

- 38 sales staff (31 of whom deliver tickets)
- 8 investigative security staff
- 4 management and administrative staff
- 2 warehouse staff
- 1 information technology staff
- 1 marketing and communications staff
- 1 unassigned warehouse vehicle

Section 24-30-1112(1) C.R.S., states that "unless an agency can justify to the [Central Services] division the need for permanent assignment because of the unique use of a vehicle, a state-owned passenger motor vehicle shall not be permanently assigned to any state officer or employee who is likely to drive it on official business at a rate of less than twelve thousand six hundred [12,600] miles per year unless" certain requirements related to public safety can be met. Some of the vehicles in Lottery's fleet may meet the definition of unique use because they have been modified for use by the sales representatives to deliver tickets. However, we question whether there is, in fact, a need for vehicles that have significantly low mileage.

By the end of Fiscal Year 2003, the Lottery had reduced its fleet by 3 (1 management and 2 sales vehicles) to 52 vehicles. We reviewed the Lottery's documentation on vehicle mileage for Fiscal Year 2003 for all 52 current vehicles.

On the basis of documentation provided to us during the audit, it appears that 24 of these vehicles (46 percent) did not meet the 12,600 mileage requirement. While there were numerous problems with the documentation, as noted below, it appears that these 24 vehicles had an average mileage of about 7,000 miles, ranging from about 12,500 miles to as low as about 500 miles. Of these 24 vehicles, 13 were assigned to sales representatives who use them to deliver tickets to retailers; documentation for two of these sales representatives's vehicles that were assigned for the full fiscal year showed mileage of less than 1,000 miles each in Fiscal Year 2003; the lowest was under 500 miles.

The Lottery should reassess its vehicle needs to determine if it can reduce its fleet further. For example, based on Fiscal Year 2003 costs, a reduction of 24 vehicles would result in gross cost savings to the Lottery of about $124,000 per year. This cost savings would be, however, reduced if the Lottery had to reimburse its staff for driving their personal vehicles for Lottery business.

Fleet Tracking and Reporting

We also found that the Lottery should improve its vehicle reporting to ensure it is in compliance with the mileage requirements in Section 24-30-1112, C.R.S. Specifically, the Lottery does not maintain vehicle information in a manner that allows proper tracking and reporting. We reviewed the Lottery's Fiscal Year 2003 vehicle reports for a sample of 25 vehicles and found:

- **Documentation contains discrepancies.** In 3 of the 25 reports reviewed, the vehicle's mileage had been altered during the last quarter of the fiscal year to reflect higher mileages. For example, one vehicle was originally reported as having 60,608 miles; this had been crossed out and changed to 61,442 miles, an increase of 834 miles. The Lottery was unable to provide a reason for these changes. The total mileage on this vehicle was 11,203 for Fiscal Year 2003. Since the Lottery does not verify or review mileage reports, we were not able to determine if this change in mileage was intentional or an error.

- **Missing required documentation.** We found six instances where the gas receipts were not attached to monthly drivers' reports for the last two quarters of the fiscal year. Lottery policies require all receipts be attached in order to substantiate these expenses.

- **Improper procedures for tracking mileage requirements.** We found that the Lottery rotates vehicles among drivers at different times in the year. Lottery management reported that it rotates the sales staff vehicles every six months to "even-out" the mileage on its vehicles. We found, however, that vehicles with low mileage are routinely rotated at the very end of the year to staff who accumulate high mileage. As a result, the mileage on specific vehicles does not necessarily reflect individual staff members' mileage or vehicle use. For example, one sales staff drove a state-owned vehicle for eight months in Fiscal Year 2003 and averaged about 300 miles per month for a total of about 2,400 miles; this vehicle was rotated for two months to a sales staff who typically averaged 1,600 miles per month. We question this practice because it does not allow the Lottery to track the true use of state-owned vehicles on the basis of specific staff usage. This information should be accurately tracked and used by the Lottery in identifying opportunities to eliminate vehicles and achieve cost savings in this area.

The Lottery should improve the documentation and tracking of its state-owned vehicle information to ensure compliance with statute and appropriate use of state vehicles. Further, the Lottery should conduct a study to determine its actual vehicle usage by individual staff and identify which staff require a vehicle to conduct state business, with a goal of cutting its fleet in half.

Recommendation No. 5:

The Lottery should ensure the most cost-efficient use of state-owned vehicles by:

a. Analyzing its fleet to identify ways to reduce the number of vehicles, focusing on those vehicles that did not meet the mileage requirement in Fiscal Year 2003.

b. Implementing procedures to ensure that all vehicle reports are complete and accurate.

c. Tracking individual staff members' specific vehicle mileage in order to accurately identify the need for vehicles and reduce the number of vehicles used.

Colorado Lottery Response:

Agree.

a. Implementation date: January 2004. The Lottery will perform a statute compliance and needs assessment analysis of its fleet to identify and justify what vehicles are needed and that the fleet is in compliance with

Section 24-30-1112, C.R.S. Vehicles that cannot be justified or do not meet statute requirements will be returned in the most cost-efficient manner to the State.

b. Implementation date: March 2004. The Lottery will write procedures and train staff to fill out vehicle reports accurately and completely. The Lottery will also strengthen the review process to ensure forms are completed and submitted timely.

c. Implementation date: March 2004. The Lottery procedure will address maintaining accurate mileage tracking by the employee. The information gathered will be used to assess the need for vehicles and adjust the fleet accordingly.

Reimbursements to the State for Commuting Expenses

During our review of the Lottery's fleet, we found that most of the staff who use state vehicles to commute to and from work do not reimburse the State as required by statute. According to Section 24-30-1113, C.R.S., a state agency's executive director may authorize the use of state-owned vehicles for commuting between the official work station and the employee's residence. The executive director must review and authorize written applications and supporting documentation in order to make the determination. Once a state employee obtains the authorization to commute using a state vehicle, Section 24-30-1113(4), C.R.S., requires the employee reimburse the State for 20 days of use per month regardless of how many days the individual actually drove the vehicle.

Commuters are required to reimburse the State because they derive a personal benefit from using a state vehicle. According to State Fleet Management Rules, the commuting reimbursement rate is $60 per month. Also, Section 24-30-1113(4)(b), C.R.S., states that "no exceptions shall be made to the reimbursement provisions of this subsection," meaning that all commuters must pay the reimbursement.

In September 2002 the Lottery Director issued a policy stating "although the Lottery field sales staff perform most of their duties while traveling . . . staff are eligible to commute but are not exempt from reimbursement." Between Fiscal Years 1997 and 2003, 46 Lottery staff were authorized to use their assigned state vehicles for commuting. These staff included sales representatives, sales supervisors, corporate accounts staff, security investigators, and managers. As of

May 2003, 35 Lottery staff were commuting; however, we found that only 3 have paid the required $60 monthly reimbursement. In fact, according to Lottery staff, most commuters stopped paying the required monthly reimbursements in June 2001. We estimate that because the Lottery stopped collecting the monthly reimbursements from its staff, the State has lost about $68,000 in revenue over the past three fiscal years.

The Lottery needs to immediately comply with state statutes and require staff who are commuting using state vehicles to reimburse the State. In addition, the Lottery should collect unpaid reimbursements from Fiscal Years 2001 through 2003.

Recommendation No. 6:

The Colorado Lottery should adhere to state statutes and State Fleet Management Rules regarding required monthly commuter reimbursements by immediately collecting any amounts due from all employees who commute with state-owned vehicles.

Colorado Lottery Response:

Agree. Implementation date: December 2003. The Lottery will no longer make exceptions to the reimbursement provisions for approved commuters based on the Division of Central Services Rule 6.00, Commuting Use of State-Owned Motor Vehicles by State Officers and Employees. Accordingly, the Lottery will require reimbursement for authorized commuters.

Other Administrative Costs

We also found that the Lottery needs to improve controls over its special events, cell phones, travel, and official functions administrative costs. A discussion of needed improvements for these areas follows.

Special Events

In Fiscal Year 2003 the Lottery spent about $24,000 for special event tickets. We reviewed the Fiscal Year 2003 special event expenses and found a lack of basic controls over these costs. Special events tickets appear to be used by Lottery staff, contractors, and retailers. However, the Lottery has not systematically maintained documentation on the purpose of these expenses, approvals, attendees, and ticket use. We question the appropriateness and necessity of these costs:

- The Lottery's event system does not track who approves ticket expenses, how they were approved, or specify exactly who receives all tickets purchased. For example, two sales staff entered data indicating that they used 12 Colorado Rockies game tickets worth $1,500 to escort various retailers to a game but did not indicate who actually received the tickets.

- Lottery staff do not enter ticket information into the system in a consistent or useful manner. For example, Lottery sales staff used six tickets worth $600 ($100 per ticket) to take retailers to a Red Hot Chili Peppers concert, yet did not provide details as to the reason for this meeting or who attended.

- Some tickets are not used for marketing or sales-related purposes. For example, one Lottery manager used four tickets to a Broncos vs. Raiders game worth $220 ($55 per ticket) in order to entertain the Lottery's contractor, Scientific Games, Inc.

Cell Phones

In Fiscal Year 2003 the Lottery spent about $20,000 on cell phones. Cell phones were provided to about half of Lottery's staff (57 out of 124 staff). Each of the 57 cell phones had a basic monthly phone plan that ranged up to $46 per month. Some plans are based on a per minute charge. The Lottery believes that all staff who work outside the office more than 25 percent of the time should be provided with cell phones regardless of the actual business need for the phone or number of these staff working from their homes and not in travel status. We question whether these cell phones and the related expenses are necessary for the Lottery to conduct business, especially for such a high number of staff.

In addition, we tested a sample of 40 cell phone expenses from Fiscal Years 2001 through 2003 and identified a lack of basic controls over the phone inventory. For example, the Lottery purchased two new cell phones for about $500 in November 2001 but could not provide documentation on who received the phones and why such expensive phones were purchased.

Finally, during our testing of expenses we found that the Lottery paid about $650 for one staff member's cell phone bill; however, the Lottery could not explain the charges and had not maintained any documentation of why the charges were paid. Further, we reviewed 13 of the 40 staff reimbursements and found that 4 were miscalculated. Overall, we concluded that the Lottery has a fundamental lack of controls over cell phone inventory, billing, and use.

Travel

In Fiscal Year 2003 the Lottery's records indicate expenses of about $105,000 on travel. Of this amount, about $84,000 was reported for in-state travel and about $21,000 was reported for out-of-state travel. Over the last three fiscal years, the Lottery reported that it spent a total of about $362,000 on travel.

In Fiscal Year 2002 the Lottery reported travel expenses of about $122,000, of which about $104,000 was for in-state and about $18,000 was for out-of-state trips. Upon examination of travel expenses, it appears that the Lottery has been reimbursed by vendors and associations for numerous trips. Therefore, the costs associated with these trips were not reflected in the Lottery's Fiscal Year 2002 expenses. According to the Lottery these reimbursements were for Lottery staff to attend national conferences and scratch ticket production in Atlanta, Georgia. Section 24-35-205(8)(b), C.R.S., requires that the Lottery's vendors pay any costs associated with an investigation. We question the propriety of the Lottery receiving payments from vendors for expenses other than investigations. Such transactions could represent a conflict of interest, in appearance or in fact, as well as inappropriately understate the Lottery's expenses. Further, documentation supporting travel expenses was inadequate and not centrally maintained, making review problematic and raising concerns about whether these expenses have been fully disclosed.

In addition, we found that the Lottery does not consistently adhere to statewide travel price agreements. The Statewide Travel Management Program has established contracts and price agreements for airfare, lodging, and vehicle rentals to achieve fiscal accountability. According to State Fiscal Rules, travel charged to the State shall be for the benefit of the State and completed using the most economical means available. We evaluated a sample of 11 of the Lottery's 47 out-of-state travel itineraries for Fiscal Year 2002 and found that in 8 cases (73 percent), the amounts paid for tickets were over the state airfare price agreements; one of the eight trips was purchased less than seven days in advance. The total in excessive payments for the eight flights was about $4,600. In six instances the flights were at least $400 over the airfare price agreements; the highest was about $1,000 over the agreement.

Official Functions

In Fiscal Year 2003 the Lottery spent more than $27,000 on official functions. Over the last three years, the total expenses for official functions were more than $79,000. In Fiscal Year 2002 alone the Lottery spent about $26,000 on official functions, which included about $16,500 for food and meals, $5,000 for flowers and gifts, and $4,500 for miscellaneous items, such as rental of a meeting room. While some of these costs are typical of those incurred in running a business (e.g., plaque), others clearly are not and appear excessive. For example, the Lottery spent $2,700 in employee appreciation gifts including wallets, minifans, bags, and key holders. We also identified instances in which the reason for the official function was not adequately documented. Specifically, we found 10 instances totaling $2,900 in which the purpose of the function or the objective achieved was not documented. Additionally, we found that the Lottery's internal policies allow for payment for a spouse to attend official functions. State Fiscal Rules prior to September 1995 allowed for these types of payments. Although the current State Fiscal Rules do not prohibit payment of costs for a spouse to attend an official function, we believe that state funds should not be used for these purposes.

The Lottery needs to take immediate action to establish better controls and reduce administrative expenses.

Recommendation No. 7:

The Colorado Lottery should improve controls over administrative expenses and reduce costs by:

a. Reevaluating the current use of all special event tickets for business necessity and purpose. If the Lottery continues to use these events, it should strictly enforce documentation requirements, including the need for such expenses.

b. Reassessing its policy for providing state cell phones to staff and requiring that phones be furnished only on the basis of a significant business need; reviewing alternate service plans to utilize the most cost-effective method available; and developing internal controls over cell phones including inventory controls, maintenance of complete documentation of all charges paid, and review of all documentation for appropriateness and reasonableness.

c. Reviewing travel expenses to ensure they are reasonable and follow appropriate Statewide Travel Management guidelines.

d. Amending vendor contracts to eliminate any vendor reimbursement of Lottery staff costs not associated with investigative functions.

e. Establishing policies that are in accordance with State Fiscal Rules for official functions and ensuring these expenses are reasonable, for official state business purposes, and directly benefit the State. This should include documenting each expense, including identification of its specific purpose.

Colorado Lottery Response:

Agree.

a. Implemented. The Department of Revenue Executive Director has instructed the Lottery that event tickets are no longer to be used by employees or retailers. In the future, event tickets will only be provided to consumers for promotional purposes. The Lottery will implement documentation procedures to ensure that all relevant details related to the use of event tickets are recorded and the new policy is followed.

b. Implementation date: March 2004. The Department of Revenue has issued a cell phone policy which the Lottery will immediately adhere to. The policy requires that all cell phones be justified on the basis of business need. In addition, supervisors of all Department employees with assigned cell phones are required to review monthly billings to ensure that expenses meet the requirements of the policy. The Lottery will establish controls to ensure appropriate management of inventory, assignment of cell phones, and a review of alternative service plans.

c. Implementation date: December 2003. The Lottery will comply with State Travel Management guidelines. As required by a State Price Agreement, the Lottery travel agency now documents on the itinerary why a price agreement fare was not used. The Lottery has special travel situations that will cause the flight fare to exceed the price agreement. For example, staff who perform on-site review of ticket production are told when production starts only days before they are required to be at their destination. Airfares purchased on short notice are covered in the price agreement; however the airfare is more expensive than those book early. Also, if the traveler does not travel over a Saturday, airlines charge the more expensive price of two one way tickets as opposed to a single departure and return. There are also situations where a price agreement for a flight from Colorado Springs to specific destinations does not exist but a price agreement for an early flight may exist out of Denver International. The early flight, however, may require an overnight stay for the traveler that makes the total cost to reach the destination more than the higher cost airfare of departing from Colorado Springs.

d. Implementation date: July 2004. The Lottery will identify provisions in its existing contracts that reimburse the Lottery for travel not associated with investigative functions. Lottery staff will not make use of those provisions and will remove the provisions from the contracts when they are renewed.

e. Implemented. The Department of Revenue has issued a policy consistent with Fiscal Rule 2-7, that provides guidelines for use of Official Functions. The Lottery will immediately adhere to this policy.

Consumer Research

The Lottery spends about $250,000 annually on consumer research as part of its contract with Scientific Games. Over the last three years, the total expenses for consumer research as part of this contract were $750,000. Under this contract, consumer research includes focus groups and media research. We identified two concerns with this contract. First, the Lottery has not determined whether the benefit it receives from this expense can justify the cost of these services. We believe the Lottery should reconsider the value of such an expense. The Lottery does not have a comprehensive consumer research plan that sets goals and measurable objectives and that targets resources to activities most likely to increase sales. As a result, the Lottery cannot ensure that specific consumer activities increase sales and are cost-beneficial.

Second, the Lottery has not tracked all services received from the contractor in relation to the $750,000 paid for consumer research in Fiscal Years 2001 through 2003. We found that the Lottery paid for about $51,000 in consumer research services that were never provided. The Lottery acknowledges that it did not have controls in place to track the consumer research services received.

The Lottery should improve its oversight of consumer research project expense and reconcile its records with those of Scientific Games to determine any additional shortfalls in consumer research services under the contract. Additionally, the Lottery should work with Scientific Games to either recover the costs of services not provided or have the vendor conduct additional research projects prior to the end of the contract period (June 30, 2004).

Recommendation No. 8:

The Colorado Lottery should improve its consumer research by:

a. Developing a comprehensive plan that sets goals and measurable objectives.

b. Establishing controls over consumer research projects and ensuring it receives the full value of the consumer research component of its contract with Scientific Games.

c. Working with Scientific Games to either recover the costs of services not provided or arrange for the vendor to conduct additional research projects prior to the end of the contract period.

Colorado Lottery Response:

Agree. Implementation date: July 2004.

a. The Lottery will develop a plan to use consumer research funds available within the Scientific Games contract. The plan will include goals and measurable objectives.

b. The plan to use consumer research funds will include controls to ensure that the Lottery receives full value of the funds available within the Scientific Games contract.

c. The Lottery will work with Scientific Games to recover costs of services not provided by having Scientific Games arrange for additional research projects prior to the end of the contract period.

Ticket Delivery

The Lottery plans to spend $205,000 on a pilot test for courier services to deliver initial scratch games to each Colorado retailer in Fiscal Year 2004. The Lottery reports that it would like to use courier services to deliver all scratch tickets and estimates this would cost an additional $1.9 million per year. Currently the Lottery spends about $2.2 million on ticket delivery and sales-related activities, including salaries and benefits for 38 sales staff, vehicle leases and maintenance for 38 vehicles, and merchandising at about 2,800 retailer locations across the State.

Lottery management believes that if sales staff's delivery duties were reduced or eliminated, they would be able to spend more time on marketing efforts, including conducting in-store promotions, training retail staff, and promoting new games. However, as noted earlier in this chapter, the Lottery does not adequately monitor these activities, which are part of sales representatives' current responsibilities. Additionally, the Lottery has been unable to demonstrate how these activities increase sales.

We reviewed the Lottery's plans for using courier services for ticket delivery and found these plans lack an overall analysis of costs versus benefits. In fact, according to the Lottery "no hard evidence exists showing that sales will increase due to courier delivery because . . . there are so many variables that impact sales." Without such evidence, we question the value of increasing costs by implementing a courier service for ticket delivery.

To be cost-effective, an alternative method of ticket delivery would need to result in other cost savings (e.g., elimination of sales representatives positions through attrition) and/or increased revenue. The Lottery should not pursue an alternative ticket delivery system unless it can clearly demonstrate that an alternative delivery method would achieve an increase in net profits and distributions to beneficiaries.

Recommendation No. 9:

The Colorado Lottery should perform a thorough cost-benefit analysis of using an alternative ticket delivery system including an evaluation of specific cost savings that can be achieved, including staff reductions; how sales would be increased; and the effect on Lottery's net profits.

Colorado Lottery Response:

Agree. Implementation date: August 2004. The Lottery is currently conducting a courier delivery pilot program. The results of the pilot program will be used to update an in-progress cost-benefit analysis. The analysis will include identifying any savings including staff reductions and how sales and net profits would be affected.

Administrative Issues

Chapter 3

Background

In addition to evaluating the Colorado Lottery's expenses and marketing activities, we reviewed two critical functions (scratch inventory and accounts receivable) that the Lottery plans to move to a vendor in November 2004 as part of a system conversion. We also reviewed internal controls over cash and scratch ticket reconstruction, administrative policies regarding Commission meetings, Lottery surveys, and statutory reserve requirements.

System Controls

Currently, the Lottery has separate contracts with Scientific Games and GTECH which have averaged about $10.6 million annually (Fiscal Year 1997 through Fiscal Year 2003) for scratch and online games:

- Scientific Games produces scratch tickets for about $3.2 million annually.
- GTECH processes online product (e.g., Lotto) transactions for about $7.4 million annually.

Under the new contract that Lottery entered into in June 2003, during Fiscal Year 2005 Scientific Games will implement a new integrated system to provide services for both scratch and online games at a total cost of more than $56 million through October 31, 2010 (Fiscal Year 2011). The annual contract costs are:

- $6.3 million in Fiscal Year 2005 (November to June, or 8 months).
- $9.4 million annually for Fiscal Years 2006 through 2010.
- $3.1 million through October 31, 2010 (Fiscal Year 2011).

The Lottery has projected that actual cost savings will be about $2.6 million per year. Lottery management believes that Scientific Games "can provide the Lottery with state-of-the-art technology with a multitude of features and capabilities far beyond current capabilities for less money than is currently being paid." In other words, Scientific Games will provide additional services. Additionally, the Lottery will transfer several critical functions that are currently processed by its internal computer system and overseen by Lottery staff. These functions include:

- Control of the scratch ticket inventory and validation files.

- Recording, reconciling, and reporting revenue and accounts receivable for ticket sales.

Prior to contracting with Scientific Games for the integrated scratch and online system, the Lottery planned to replace its internal Wang computer system that processes accounting data. The General Assembly appropriated $8.2 million for this project in 2002. However, in May 2003 the Lottery reverted $6.6 million of this appropriation because it decided that the "mission critical" functions of licensing, retailer tracking, retailer billing, claims, Internal Revenue Service reporting, and internal controls would be "converted" from the Wang system to the new, integrated Scientific Games system. The Lottery retained $1.6 million of the original appropriation which it plans to use for independent validation and verification services (security and oversight) in converting the Wang system to the Scientific Games system.

At the time of our audit the Lottery was still in the design and development phase of the conversion process. Therefore, we analyzed the Lottery's plans and the impact of expected changes. We found that the Lottery needs to ensure certain processes and controls are in place prior and subsequent to implementation of the new system, specifically in the area of validating winning scratch tickets and recording, reconciling, and reporting revenue and accounts receivable.

Current Process

Because scratch game prizes are predetermined, the Lottery needs to ensure that controls are in place to mitigate the risk that vendors and/or Lottery staff could identify winning tickets. Currently, under its internal Wang system, the Lottery has appropriate controls, since neither Scientific Games nor Lottery staff have all the information needed to identify winning tickets. When manufacturing scratch tickets, Scientific Games marks the winners and produces an encrypted validation file before sending the tickets to the Lottery. The validation file identifies whether or not a ticket is a winner. After production, Scientific Games sends the tickets and the associated validation file to the Lottery. Then, the Lottery stores the tickets in its warehouse before distributing them to retailers. Additionally, the Lottery maintains a scratch ticket inventory file, which identifies the location of each ticket. Adequate segregation of duties is needed so that Scientific Games staff do not have access to the inventory file, and Lottery staff cannot decrypt the validation file.

New Contract Risks

In the future, Scientific Games will control all parts of the scratch ticket process. Under the new contract, the Lottery is planning to transfer control of the scratch ticket inventory now overseen by the Lottery to Scientific Games beginning in November 2004. Scientific Games will not only create and print tickets and the associated validation files, it will also manage the inventory file for all tickets. This inventory file will show where each ticket is located (e.g., the warehouse, a sales representative's vehicle, a retailer, etc.). Without adequate segregation of duties and system controls, Scientific Games could potentially identify the winning tickets and their exact locations. Therefore, it is important that the Lottery mitigate the risk by ensuring that the validation and inventory files remain separate.

Although the new contract between the Lottery and Scientific Games addresses controls in general terms, more needs to be done to ensure scratch ticket inventories are safeguarded.

We interviewed Lottery staff and examined documents to determine whether the Lottery has identified controls needed to ensure that the validation file and the inventory file remain separate. According to Lottery staff, to adequately segregate the validation and inventory files under the new arrangement, the Lottery would need to do one of the following:

- Hire a third party to further scramble Scientific Games' scratch validation encryption routine.

- Encrypt the ticket inventory file and only provide Lottery staff the decryption key.

- Encrypt the ticket construction file and only provide Lottery staff with the decryption key.

The Lottery should implement one or all of these controls.

Accounting Transactions

Currently the Lottery's Wang system has a daily balancing function that reconciles numerous internal and external reports and data. The balancing, or reconciliation, function is a key control in ensuring the accuracy and completeness of the Lottery's financial accounting and reporting. The Lottery's Wang system tracks retailers' accounts receivable, accounts payable, and sales, and creates journal entries for upload into the Colorado Financial Reporting System (COFRS).

The Lottery anticipates that, under the new system, Scientific Games will process the original transactions for licensing, scratch inventory, all scratch and online game processing, accounts receivable, sales, and tax reporting to retailers and prizewinners. The Lottery will receive only the summary information on all transactions, not the specific detail behind each transaction.

In Fiscal Year 2003 the Lottery's sales were about $391.5 million. Therefore, it is critical that the Lottery ensure that the risk of errors and irregularities are minimized under the new system. According to Lottery officials, under the new contract, the Lottery will not have automatic and complete access to detailed retailer accounts receivable data. Currently the Lottery plans to review summary data only. However, according to the Lottery, Scientific Games plans to contract with an independent firm, E-Success, to provide a daily reconciliation of Scientific Games transactions. According to current plans, the Lottery will have access to the reconciled data. The Lottery needs to ensure that it reviews the reconciled data on a daily basis.

We contacted three other states that have contracted with Scientific Games for online, scratch, and accounting services. One of these states reported problems with the Scientific Games software for the accounting functions, such as difficulty in obtaining accurate data reports. According to Scientific Games staff, the issue was not inaccurate reports but rather a breakdown in communication regarding changes that were being requested to reports and/or software. Scientific Games staff said they are doing a better job to ensure they know exactly what is needed before changes are made. All three states indicated that they have implemented additional control measures, including daily balancing of files and thorough testing of the Scientific Games software.

In order to mitigate the risks associated with the conversion, the Lottery should have procedures in place to routinely conduct its own independent review of the processes under the new system. The review should include periodic testing of a sample of transactions as well as reconciliation procedures to ensure that all transactions are accurately and completely recorded.

It is important that the Lottery establish appropriate controls during the design phase. The Lottery should have procedures to ensure that problems occurring during and after system implementation are promptly reported and corrected by Scientific Games.

Tests of Operating Effectiveness

Because many of the functions that will be performed by Scientific Games under the new contract will affect the Lottery's and the State's financial statements, the Lottery should ensure that an independent review of the controls in place over the system and its operation is performed on an annual basis. Such reviews are required under the American Institute of Certified Public Accountants Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations*. Under the Standard, there are two types of SAS 70 audits, Type 1 and Type 2. In a Type 1 engagement, the auditor issues a report on a description of controls that is prepared by the service organization. The purpose of a Type 2 review is to determine if the external service provider has adequate controls in place to meet control objectives and to test the operating effectiveness of the controls.

The Lottery's contract with Scientific Games requires an annual SAS 70 audit to be conducted by an independent third party selected by the State. However, it does not specify the audit type. We believe that due to the significant changes that will occur with the new system, the Lottery should specifically require a SAS 70 Type 2 audit annually.

Recommendation No. 10:

The Colorado Lottery should ensure that adequate controls are established over the implementation and operation of the new online and scratch system by:

a. Implementing controls to ensure the segregation of scratch ticket inventory and validation files.

b. Implementing comprehensive procedures for routinely testing reconciliation procedures and a sample of transactions to ensure amounts are recorded accurately and completely on all systems (internal and external), including COFRS.

c. Establishing milestones and deadlines for completion of the design and implementation of the new system and procedures for reporting and resolving all system problems.

d. Requiring that Scientific Games have an annual SAS 70 Type 2 audit of its system.

Colorado Lottery Response:

Agree.

a. Implementation date: November 2004. The Lottery will implement controls that will ensure segregation of scratch ticket inventory and validation files.

b. Implementation date: November 2004. The Lottery will write and implement a comprehensive procedure for testing reconciliation procedures and sampling transactions throughout the entire system (internal and external) including COFRS.

c. Implementation date: February 2004. The Lottery will ensure that milestones and deadlines for the completion of the design and implementation of the new system, and procedures for reporting and resolving all system problems, are established.

d. Implementation date: January 2005. The Lottery will work with the State Auditor's Office to require an independent SAS 70 Type 2 audit of the online service provider.

Cash Controls

We reviewed the Lottery's controls over petty cash funds at the Denver office, including how the funds are used. We found that the Lottery does not periodically spot-check the petty cash funds on an unscheduled basis. In addition, the Lottery uses the petty cash funds to reimburse employees for Lottery expenses and to cash employees' personal checks.

Prior to Fiscal Year 2002, the Denver office had a cash drawer for cashing winning scratch and online tickets. However, the cash drawer was often out of balance. Beginning in Fiscal Year 2002, the Lottery discontinued using the cash drawer and established two petty cash funds.

The two petty cash funds each have up to $400 at a time. One fund is used to (1) pay prizes to customers for damaged or previously validated tickets less than $20 or less than $50 with a Lottery investigator's approval, and (2) to cash Lottery employees' personal checks. The limit is one check per employee per day with a $20 maximum per check. The second cash fund is used to reimburse employees for certain business expenses, such as parking, office supplies, and film development. The following table summarizes the use of the petty cash funds in Fiscal Year 2003.

Petty Cash Fund Expenses Fiscal Year 2003		
	Total Reimbursed	**Number of Transactions**
Petty Cash Fund #1		
Damaged or Previously Validated Tickets	$1,139	136
Personal Checks Cashed	$1,560	78
Petty Cash Fund #2		
Office Supplies, Postage, Parking, and Travel	$2,153	222
TOTAL	**$4,852**	**436**
Source: Office of the State Auditor's analysis of the Lottery's petty cash fund data.		

We are concerned with the Lottery's use of petty cash funds because according to State Fiscal Rules, petty cash funds should only be used for payment of incidental expenses of a nominal amount, such as postage, parking, or expenses not otherwise billed by invoice and paid by voucher or warrant. Instead of petty cash reimbursements for office supplies and travel, the Lottery should use state procurement cards or a voucher system for these purchases.

Additionally, State Fiscal Rules require that all expenses be for official state business and be reasonable and necessary under the circumstances. Cashing personal checks is not an official state business purpose. The Lottery should discontinue the practice of cashing personal checks.

Finally, State Fiscal Rules require that state agencies implement internal accounting and administrative controls to reasonably ensure that financial transactions are accurate, and reliable, and adhere to State Fiscal Rules. The petty cash funds are reconciled on a monthly basis by the custodian of the funds. However, a physical check of the petty cash funds is only conducted once at the end of the fiscal year, and the custodian of the funds is notified in advance when the check will occur. In order to protect the State's assets, the Lottery should conduct random, unannounced checks of the petty cash funds.

Recommendation No. 11:

The Colorado Lottery should improve controls over the petty cash funds by:

a. Using state procurement cards or a voucher system for qualifying business purchases.

b. Eliminating the cashing of employee personal checks.

c. Reevaluating the need for two petty cash funds and the amounts to be maintained in the funds.

d. Performing an independent validation of the petty cash funds on a periodic, unscheduled basis.

Colorado Lottery Response:

Agree.

a. Implementation date: December 2003. The Lottery agrees that it will use state procurement cards or the voucher system for qualifying business purchases if it is the most cost efficient method for payment. Small value (less than $20) infrequent business expenses may be reimbursed to the employee more cost effectively by using a controlled petty cash fund. With the assistance of the State Controller, the Lottery will establish a list of qualified business expenses which may be reimbursed through its petty cash fund.

b. Implemented. The Lottery stopped cashing employee personal checks in November 2003.

c. Implemented. The Lottery has reevaluated all petty cash funds and their balances. Two petty cash funds have been eliminated and the remaining cash fund balances have been reduced to a substantiated need.

d. Implementation date: December 2003. Petty cash funds will be audited on a periodic and unscheduled basis.

Ticket Reconstruction

In Fiscal Year 2003, 162 scratch tickets were so damaged that the validation number needed to cash the ticket was illegible. For example, a customer may have accidentally washed his or her ticket. If enough of the validation number is legible, the Lottery will attempt to graphically reconstruct the ticket to obtain the full validation number and determine if it is a winner. Only the Lottery's investigators are allowed to request a ticket reconstruction from the scratch ticket vendor. The Lottery's procedure for reconstructing a ticket requires that the customer complete two forms, including a contact form and ticket information.

The forms, along with the damaged ticket, are sent to a Lottery investigator, who obtains a "log number" for auditing and tracking purposes from the investigation office manager, who maintains the log numbers. Once a number is obtained, the investigator faxes the Lottery's scratch ticket vendor requesting a ticket reconstruction. The vendor will determine if the ticket is a winner and provide the full validation number to the Lottery.

As part of our audit, we reviewed the processes for reconciling and approving ticket reconstruction requests. We found that the Lottery does not compare the investigators’ log with the vendor’s log to ensure all requests are legitimate, and accurate, and are handled in accordance with both the Lottery's and the vendor’s procedures. Additionally, the form that is used in the process of ticket reconstruction is not pre-numbered. Pre-numbering is a useful tool for reconciling records to ensure completeness and validity. We also found that the Department of Revenue internal auditor does not routinely review and independently test the ticket reconstructions. At the time of our review, the Department had not reviewed the ticket reconstructions in at least two years.

The Lottery should implement strict controls over ticket reconstruction. Typically, cashing a ticket requires that the retailer manually enter the validation number from the actual ticket into the Lottery's ticket validation system, and the system then notifies the retailer the amount to pay. However, with ticket reconstruction, the validation information is obtained from a secondary source, i.e., the vendor. The Lottery's investigators are the only staff allowed to access vendor information; however, there is no reconciliation between the vendors' records or additional oversight and review to ensure that the integrity of the system is not compromised.

Recommendation No. 12:

The Colorado Lottery should improve its monitoring of ticket reconstruction requests to include routine reconciliation between the log maintained by its investigators and external vendor records. In addition, the Department of Revenue internal auditor should conduct routine and unannounced reviews.

Colorado Lottery Response:

Agree. Implementation date: January 2004. The Lottery will begin using a matching log number on the contact form and ticket information form. To facilitate tracking Lottery requests, the Lottery and vendor will use this log number. The Lottery investigators will periodically compare the logs to ensure all requests are legitimate, accurate, and handled in accordance with both the Lottery's and the vendor's procedures.

Department of Revenue Response:

Implementation date: January 2004. The Department of Revenue Internal Auditor will conduct routine and unannounced reviews.

Commission Meetings

The Colorado Lottery provides information about its marketing activities and sales through its monthly public Lottery Commission meetings. The Lottery publishes notices about the Commission meetings as required by Section 24-6-402(b), C.R.S. (Open Meetings Law). Meeting notices are published in the Colorado Register with the Office of the Secretary of State and posted in the Denver and Pueblo Lottery Offices, as well as the Pueblo County Courthouse. Section 24-6-402(b), C.R.S., also requires that the "minutes of any [public] meeting . . . shall be taken and promptly recorded, and such records shall be open to public inspection."

We reviewed the Lottery Commission's minutes and notices to the public for 86 meetings held from January 1997 through January 2003 and identified the following concerns:

- **Inaccurate information and lack of notices**. Two notices listed a different date from the date the meeting was held, and one meeting was held, but no notice was provided.

- **Lack of minutes.** Minutes were not taken at three Commission meetings. Additionally, the Commission has an annual retreat where Lottery staff provide informal presentations regarding the Lottery's business plan, approaches for products and new games, and its budget. We found that although the Lottery provides notice to the public of the annual retreats, no meeting minutes were taken.

- **Limited public participation**. We reviewed the meeting minutes to determine whether the Commission encourages public participation and identify the Lottery's procedures for handling correspondence from the public requesting to address the Commission. Our review showed that there has been little public presence or participation at Commission meetings. Over the past six years (1997-2003), two letters from the public were discussed, two members of the public addressed the Commission, and the media were present on another occasion but did not address the Commission. Topics brought to the Commission by the public included the publication of the odds of winning, an advertisement perceived to be offensive, issues regarding ending scratch games after the top prizes have been won, and the appropriateness of a marketing study used by the Lottery.

Additionally, we found that the Lottery does not have a method for handling correspondence or phone calls from the public requesting to address the Commission. According to Lottery staff, letters from the public are not kept in a central location and are usually thrown out after a few months. The Lottery should ensure logs of all correspondence are maintained and reviewed to ensure issues are addressed appropriately and timely. The Lottery should also ensure that notices of all meetings are posted and minutes are taken. For example, the Lottery could use its Web site to post Commission meeting times, agenda, minutes, and information on how the public can communicate with the Commission. The Web site appears to be popular with the public; it attracted almost 1.5 million unique visitors in the 12-month period of April 2002 through March 2003.

Recommendation No. 13:

The Colorado Lottery should ensure information is available to the public and enhance public participation in its Commission meetings by:

a. Posting notices of all Commission meetings and taking minutes of all meetings.

b. Logging, reviewing, and addressing all public correspondence requesting to address the Commission.

c. Including Commission meeting times, agendas, minutes, and information on addressing the Commission on the Lottery's Web site.

Colorado Lottery Response:

Agree. Implementation date: December 2003.

a. The Lottery will post notices in all four Lottery offices and on its Web site and take minutes of all Commission meetings.

b. All correspondence, regardless of source, requesting to address the Lottery Commission will be logged and processed by the Lottery Commission Secretary. The Lottery Commission Secretary will also log the disposition of each request and note the disposition in the Commission minutes when appropriate.

c. The Lottery will post notices of all Commission meetings, agendas, and minutes required by Section 24-6-402(b), C.R.S., on the Lottery's Web site. The Web site will also be upgraded to include a Lottery Commission section. The new Commission section will include easy to find instructions on how to contact and address the Commission.

Lottery Survey

As discussed in Chapter 1, the Colorado Lottery conducts an annual image study to assess the awareness and image of the Colorado Lottery and its contributions to the State over time. In addition, the Lottery conducts various socioeconomic research projects and focus groups to get feedback on advertising, outreach awareness, and the games it develops.

We conducted a review of other states and found that Oregon, Washington, and California conduct consumer preference surveys. For example, Washington tracks general shifts in attitudes, leisure behavior, and lottery play behavior. The state asks questions about specific games and has open-ended questions to determine preferences, such as how large the jackpot must be before consumers are willing to play. Colorado could follow this example to better assess public opinion and consumer predispositions throughout the State.

We found that the Lottery could enhance its survey research to better manage marketing, promotions, and sales. For example:

- **Survey research should routinely determine preferences and identify weaknesses in current practices.** Consumer feedback could provide valuable information for use in improving sales, marketing, and public relations. Information obtained from a survey should help determine which marketing methods work best and which do not work. However, the current survey is limited to socioeconomic and image-related information. As a result, this information cannot be used to fully identify weaknesses in current marketing and advertising methods, or areas for improvement

- **Surveys should include open-ended questions so that the results can be used in better determining consumers' opinions.** The Lottery's image study generally contains the same questions each year, yet does not include open-ended questions regarding what appeals to Lottery players, such as hobbies and interests, how often individuals play the Lottery, the convenience of purchasing tickets, the helpfulness of retailers, or ways to encourage sales. In addition, no open-ended questions are included; therefore, the Lottery is less apt to accurately capture the more complete attitudes and opinions of consumers. These types of questions would provide the Lottery with more qualitative research results.

The Lottery could assess consumer opinions with a consumer preference survey by requiring consumers to complete and submit surveys as part of annual promotions. This survey could be administered on the Colorado Lottery's Web site or at various events throughout the year. Survey results should be analyzed and distributed to all marketing and sales staff in order that they may use this information as a tool for improving sales and marketing each year.

Recommendation No. 14:

The Colorado Lottery should improve survey research methods by:

a. Instituting a consumer preference survey that includes open-ended questions that assess consumer opinions and preferences.

b. Considering having consumers complete and submit preference surveys annually as part of marketing and sales promotions.

c. Evaluating consumer preference survey data to determine best practices, weaknesses in current marketing practices, and areas for improvement. These survey results should be analyzed and distributed to marketing and sales staff.

Colorado Lottery Response:

Agree. Implementation date: July 2004. The Lottery will work with its advertising, public relations, scratch ticket vendor and the online vendor marketing consultants to develop and implement a preference survey that will assess consumer opinions and preferences. The survey results will be incorporated into the marketing plan that is distributed to all marketing staff.

Statutory Reserve Requirement

Currently Section 24-35-210(4.1)(a), C.R.S., requires that the Lottery reserve sufficient monies to "ensure the operation of the Lottery for the ensuing fiscal year." In 1989 the Lottery Commission established a reserve of $1 million, and until Fiscal Year 2002, the Lottery reported this reserve by including a footnote disclosing this designation in its annual financial statements. In Fiscal Year 2002 the State implemented a new reporting model for its financial statements as required by the Governmental Accounting Standards Board (GASB) under Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*.

With the implementation of GASB No. 34 in Fiscal Year 2002, the Commission changed its policy regarding the reserve requirement. Under the new reporting model, entities are required to identify the portion of net assets, or equity, that is invested in capital assets net of any related debt. The Commission's new policy is to designate the amount related to capital assets as the statutorily required reserve. This amount varies from year to year due to capital purchases or deletions or changes in depreciation and related debt. For example, capital assets net of related debt were $1.6 million and $1.4 million at the end of Fiscal Years 2002 and 2003, respectively.

Statutes provide the Commission with the authority to set the reserve amount. However, the fluctuations in this capital asset account would appear to be unrelated to the amount of reserves that should be maintained by the Lottery as operating reserves under statutes. Therefore, the Lottery should seek statutory clarification to establish an appropriate basis for determining the reserve amount. For example, the reserve amount could be based on average expenses for some portion of the year.

Recommendation No. 15:

The Colorado Lottery should work with the General Assembly to seek statutory clarification of the basis for determining the amount of reserves to be maintained by the Lottery at the end of the fiscal year.

Colorado Lottery Response:

Agree. Implementation date: July 2004. The Department of Revenue will present the request to the Joint Budget Committee or the appropriate Legislative oversight committee to pursue statute clarification.

Appendices

Appendix A

Disposition of 1997 Performance Audit Recommendations

Our 1997 statutory performance audit of the Colorado Lottery had nine recommendations for improvement. As part of the current audit, we evaluated the implementation status of the recommendations and found they were either fully or partially implemented. In addition, as part of our current audit, we identified actions needed to fully implement all recommendations.

<table>
<tr><th colspan="2">COLORADO LOTTERY
OCTOBER 1997</th></tr>
<tr><td colspan="2">No. 1: The Colorado Lottery should prioritize the recommendations in the "Marketing Effectiveness Report." It should present the report findings to the Lottery Commission and implement the recommendations by January 1, 1999.

Department of Revenue Response: Agree
Implementation Date: December 31, 1997</td></tr>
<tr><th>Agency Update</th><th>Office of the State Auditor Evaluation</th></tr>
<tr><td>The Colorado Lottery continually monitors the effectiveness of its marketing programs, and has issued three reports on marketing effectiveness in the last ten years. Of the five recommendations listed in the August 1997 Marketing Effectiveness report, all have either been implemented, or have been implemented on a continuous basis. These recommendations, however, are never finalized. They will take continuous monitoring and adjustments in the future.</td><td>Partially Implemented. The Lottery presented the report findings to the Commission in May 1998. However, we found problems continue to exist with applying more stringent criteria to improve evaluations of promotions, sponsorships, and special events. This area is discussed in more detail in the current Recommendation No. 2.</td></tr>
</table>

COLORADO LOTTERY OCTOBER 1997	
No. 2: The Colorado Lottery should improve its oversight and management of sponsorships, promotions, and special events by: (a) ensuring all requests for participation and funds are systematically reviewed by the sponsorships, promotions, and special events manager before approval; and (b) evaluating the marketing effectiveness of sponsorships, promotions, and special events, and eliminating those activities that are not cost-effective. **Department of Revenue Response: Agree** **Implementation Date: December 31, 1997**	
Agency Update	**Office of the State Auditor Evaluation**
In Fiscal Year 1998, the Colorado Lottery implemented an evaluation process of all sponsorship type activities. All major sponsorships, promotions, and special events proposals are being reviewed by the sponsorships and promotions manager. Proposals with potential receive a second review in conjunction with the Lottery's advertising agency. The manager then sets objectives for evaluation.	**Partially Implemented.** The Lottery has created a procedure for management review of all major sponsorships, promotions, and special events, including a checklist for evaluating promotions. However, the Lottery is not consistently assessing the value added by these activities and comparing this with actual costs. This area is discussed in more detail in the current Recommendation No. 2.

COLORADO LOTTERY OCTOBER 1997	
No. 3: The Colorado Lottery should improve its management of official functions and other marketing activities by: (a) evaluating the Millionaires' Club Event activities, including cost and appropriateness; (b) analyzing the cost for the quarterly sales meetings and choosing locations that are appropriate for state business; (c) developing procedures to ensure alcohol at official functions is not paid for by or billed to the Division; and (d) evaluating golf-related activities for appropriateness and cost-effectiveness. **Department of Revenue Response: Agree** **Implementation Date: December 31, 1997**	
Agency Update	**Office of the State Auditor Evaluation**
In response to this recommendation, the Lottery has added two policies, and examined its procedures to improve management of official functions. Specifically, expensive fees incurred with the previous Millionaire events were not incurred; the Lottery developed Policy 48 in response to the State Auditor's report which emphasizes that charges for purchase of alcoholic beverages will not be paid for by the Lottery and reimbursement is prohibited; the Lottery has analyzed the cost and appropriateness of its quarterly sales meetings; and the Lottery has imposed a new policy, as well as procedures, for evaluating the appropriateness and cost-effectiveness of golf-related activities.	**a) Implemented.** **b) Partially Implemented.** Although the Lottery analyzed the costs for the quarterly meetings to choose locations appropriate for state business, we found that problems still exist with the costs associated with official functions. Our current audit evaluated these costs and found that some appear to be excessive and not adequately documented. Additionally, we question whether expenses are reasonable and for the benefit of the State. This area is discussed in more detail in the current Recommendation No. 7. **c) Implemented.** **d) Partially Implemented**. The Lottery implemented a policy concerning participation in special events, such as golf events, and the benefits of attending. However, we found that not all event expenses are evaluated to ensure they are cost-effective and that expected outcomes were achieved. Current Recommendations No. 2 and No. 7 address the problems that continue to exist.

COLORADO LOTTERY OCTOBER 1997	
No. 4: Evaluate effectiveness of the sales staff incentive plan by using the Alternative Ticket Delivery Project to identify key sales-related activities. The evaluation should also include: (a) assessments of the way sales goals are set, including how challenging they are and if they should be based on both scratch and online game sales; (b) review of each position to determine if it should be included in the plan; and (c) identification and evaluation of alternatives, including elimination of the sales incentive program. **Department of Revenue Response: Agree** **Implementation Date: June 30, 1998**	
Agency Update	**Office of the State Auditor Evaluation**
The Lottery completed an intensive review of the sales incentive plan in June 1998. In its review, an evaluation of the Alternative Ticket Delivery Test System was also completed in October 1998. Results of sales representatives' job duties were analyzed from this test as well as the Lottery identifying five potential alternatives for its sales incentive program and listed the analyzed positive and negative aspects of each. The conclusion of the Alternative Ticket Delivery Test was that the Lottery might be able to contract for the delivery of tickets to retailers, thus freeing up its marketing staff to work more closely with retailers on more productive tasks such as increasing ticket sales.	**Partially Implemented.** Although the Lottery evaluated the sales incentive plan and the ability to use an alternative ticket delivery method, we found problems continue to exist in these areas. Specifically, the sales incentive plan is not structured to maximize sales (see current Recommendation No. 3). Additionally, the Lottery should conduct an additional cost-benefit analysis and establish a long-term approach to utilizing courier services for delivering tickets as discussed in our current Recommendation No. 9.

COLORADO LOTTERY OCTOBER 1997	
No. 5: The Lottery should use the *Scratch Game Prize Structure Analysis* as a basis of testing higher prize payout percentages and evaluating the associated effect on sales. **Department of Revenue Response: Agree** **Implementation Date: November 1997**	
Agency Update	**Office of the State Auditor Evaluation**
An evaluation of the higher prize payout effectiveness was completed in December 1998. The evaluation concluded that the higher price point games with higher percentage payouts appear to sell moderately better than their lower payout counterparts. This is not surprising because most of the additional payout is applied to the lower tier "churn" prizes that are typically played back.	**Implemented.**

COLORADO LOTTERY OCTOBER 1997	
No. 6: The Lottery should use unclaimed prizes to increase proceeds to the beneficiaries except when total prizes paid are below 50 percent of sales. The Lottery should also propose a change to its Commission Rules that requires 50 percent of total sales to be paid in prizes. **Department of Revenue Response: Agree** **Implementation Date: Implemented in 1997.**	
Agency Update	**Office of the State Auditor Evaluation**
The Lottery Commission approved rule changes at the September 1997 commission meeting that allowed the Lottery to reduce prize expense regardless of the individual game prize expense levels, as long as the Lottery pays an aggregate of 50 percent in prizes for all games. These rules were implemented on October 1, 1997. The new rule changes also give the Lottery Director the discretion of using unclaimed prizes to enhance a game prize structure through increased or additional prizes.	**Implemented.**
No. 7: The Colorado Lottery Commission should continue to work with the General Assembly to establish an instant bingo scratch game. **Department of Revenue Response: Agree** **Implementation Date: As needed.**	
Agency Update	**Office of the State Auditor Evaluation**
The Colorado Lottery Commission and staff agree that the bingo game is an instant scratch game and offers great sales and additional net income potential. In Fiscal Years 1998 and 1999, the issue was again presented to the legislature and was again defeated.	**Implemented.** House Bill 99-1010 allowed the State Lottery Division to conduct Instant Scratch Lotteries based upon the game of chance, commonly known as bingo.

COLORADO LOTTERY
OCTOBER 1997

No. 8: The Lottery should request a formal opinion from the Attorney General on the consumer price index calculations affecting the distributions to the beneficiaries.

Department of Revenue Response: Agree
Implementation Date: March 31, 1998

Agency Update	Office of the State Auditor Evaluation
A request for a formal opinion was sent to the Attorney General's Office on April 8, 1998. A response was received on January 15, 1999. The formal opinion from the Attorney General's Office supports the Lottery's interpretation, which is that the consumer price index (CPI) for a calendar year is released approximately 45 days after the end of the calendar year, on or about February 15 of the following year. This CPI index figure is to be used to calculate the distribution to Great Outdoors Colorado (GOCO) for the following fiscal year.	**Implemented.**

No. 9: The Lottery should ensure that the distributions to the beneficiary funds are complete and accurate by providing supervisory review of the calculations before transfers are made. It should also work with the affected funds to adjust the previous errors.

Department of Revenue Response: Agree
Implementation Date: November 1, 1997

Agency Update	Office of the State Auditor Evaluation
The Lottery prepared a recalculation of the Fiscal Years 1992 and 1994 proceeds distributions in September 1997 and corrected the distribution errors in these fiscal years. The net effect was an increase to the Conservation Trust Fund distribution of $12,761, and increase to the State Parks distribution of $3,190 and a decrease to the Capital Construction Fund distribution of $15,951. In addition, the Lottery implemented a new procedure whereby the distribution calculation is recalculated independently by a second accountant and compared with the normal distribution calculation.	**Implemented.**

U.S. Lotteries
Ticket Sales, Revenue, Expenses, and Government Return
Fiscal Year 2002

Rank Based on Expenses as % of Revenue	Jurisdiction	Ticket Sales [2] (In Millions)	Total Revenue [2] (In Millions)	Expenses (In Millions)	Prizes (In Millions)	Retailer Compensation (In Millions)	Media Ad Budgets [3] (In Millions)	Expenses as % of Total Revenue	Prizes as % of Total Revenue	Retailer Comp. as % of Total Revenue	Media Ad Budgets as % of Total Revenue	Gov't Return as % of Total Sales [4]
1	Massachusetts	$4,193.83	$4,213.22	$73.66	$3,000.90	$239.45	$0.14	1.7%	71.2%	5.7%	0.0%	21.4%
2	Rhode Island	$235.65	$237.62	$7.35	$139.42	$25.76	$1.41	3.1%	58.7%	10.8%	0.6%	NA [5]
3	New Jersey	$2,068.51	$2,101.46	$67.75	$1,144.74	$113.44	$12.16	3.2%	54.5%	5.4%	0.6%	36.5%
4	Maryland	$1,306.54	$1,307.54	$49.35	$733.20	$85.36	$13.34	3.8%	56.1%	6.5%	1.0%	33.9%
5	Connecticut	$907.90	$908.91	$38.75	$546.10	$51.68	$5.86	4.3%	60.1%	5.7%	0.6%	29.9%
6	New York	$4,753.62	$4,753.99	$225.92	$2,664.14	$284.34	$71.64	4.8%	56.0%	6.0%	1.5%	33.2%
7	Pennsylvania	$1,934.16	$1,946.95	$95.26	$1,002.46	$100.05	$18.91	4.9%	51.5%	5.1%	1.0%	38.7%
8	Ohio	$1,983.10	$2,017.86	$103.32	$1,148.13	$126.60	$21.70	5.1%	56.9%	6.3%	1.1%	32.0%
9	Florida	$2,330.37	$2,392.35	$121.96	$1,165.84	$132.35	$33.00	5.1%	48.7%	5.5%	1.4%	39.8%
10	Illinois	$1,566.67	$1,599.63	$87.46	$866.66	$79.34	N/A	5.5%	54.2%	5.0%	N/A	35.3%
11	Texas	$2,966.26	$2,967.55	$166.75	$1,715.36	$148.36	$30.04	5.6%	57.8%	5.0%	1.0%	31.3%
12	Georgia	$2,321.95	$2,335.26	$132.40	$1,308.24	$163.63	N/A	5.7%	56.0%	7.0%	N/A	31.3%
13	California	$2,896.37	$2,966.27	$184.83	$1,502.97	$198.06	$40.79	6.2%	50.7%	6.7%	1.4%	35.5%
14	Virginia	$1,108.07	$1,118.37	$74.71	$613.73	$62.24	$12.57	6.7%	54.9%	5.6%	1.1%	33.2%
15	New Hampshire	$212.83	$215.92	$15.04	$123.28	$11.47	$2.75	7.0%	57.1%	5.3%	1.3%	31.1%
16	Michigan	$1,688.06	$1,787.83	$126.27	$894.95	$120.72	$18.37	7.1%	50.1%	6.8%	1.0%	38.3%
17	Missouri	$585.19	$593.34	$43.12	$353.08	$31.21	N/A	7.3%	59.5%	5.3%	N/A	27.3%
18	Kentucky	$638.73	$647.23	$48.18	$384.23	$39.84	$10.33	7.4%	59.4%	6.2%	1.6%	27.0%
19	Indiana	$626.31	$630.63	$46.76	$371.21	$43.31	$8.75	7.4%	58.9%	6.9%	1.4%	27.0%
20	Washington	$438.60	$457.87	$34.23	$282.25	$27.13	$6.26	7.5%	61.6%	5.9%	1.4%	21.4%
21	South Carolina[1]	$335.49	$336.86	$25.34	$200.31	$23.49	$6.99	7.5%	59.5%	7.0%	2.1%	24.2%
22	**Colorado**	**$407.97**	**$414.36**	**$32.37**	**$240.32**	**$30.74**	**$6.98**	**7.8%**	**58.0%**	**7.4%**	**1.7%**	**27.0%**
23	Wisconsin	$427.55	$432.29	$33.65	$242.06	$30.12	$4.60	7.8%	56.0%	7.0%	1.1%	27.8%
24	Oregon	$336.86	$337.66	$27.90	$223.50	$29.58	$6.02	8.3%	66.2%	8.8%	1.8%	NA [5]
25	Arizona	$294.82	$295.60	$27.82	$162.12	$19.99	$6.85	9.4%	54.8%	6.8%	2.3%	28.8%
26	Louisiana	$311.62	$314.34	$30.75	$155.56	$15.88	$7.85	9.8%	49.5%	5.1%	2.5%	35.6%
27	Vermont	$81.98	$82.31	$8.58	$52.32	$4.73	$1.48	10.4%	63.6%	5.7%	1.8%	20.3%
28	West Virginia	$206.90	$223.80	$23.60	$120.18	$12.94	$6.11	10.5%	53.7%	5.8%	2.7%	NA [5]
29	Maine	$157.91	$159.94	$17.29	$91.17	$10.99	$2.61	10.8%	57.0%	6.9%	1.6%	25.6%
30	Kansas	$190.08	$191.06	$22.35	$98.96	$10.97	$2.50	11.7%	51.8%	5.7%	1.3%	29.0%
31	District of Columbia	$211.15	$211.78	$25.12	$110.74	$12.81	$4.00	11.9%	52.3%	6.0%	1.9%	29.8%
32	Delaware	$117.22	$117.25	$15.35	$59.18	$7.44	$2.48	13.1%	50.5%	6.3%	2.1%	NA [5]
33	Minnesota	$377.13	$378.66	$50.01	$223.03	$23.95	N/A	13.2%	58.9%	6.3%	N/A	21.7%
34	New Mexico	$133.97	$129.48	$17.75	$72.89	$9.24	N/A	13.7%	56.3%	7.1%	N/A	22.1%
35	Idaho	$92.67	$95.77	$13.40	$53.10	$5.35	$1.65	14.0%	55.4%	5.6%	1.7%	16.2%
36	Iowa	$181.31	$186.23	$26.18	$100.00	$11.68	N/A	14.1%	53.7%	6.3%	N/A	26.6%
37	Nebraska	$73.96	$74.60	$12.41	$39.45	$4.27	$2.00	16.6%	52.9%	5.7%	2.7%	25.0%
38	South Dakota	$26.28	$26.64	$4.79	$14.14	$1.45	$0.80	18.0%	53.1%	5.4%	3.0%	NA [5]
39	Montana	$33.63	$33.68	$7.36	$17.10	$1.98	$0.75	21.9%	50.8%	5.9%	2.2%	22.2%
	MEDIAN	**$407.97**	**$414.36**	**$33.65**	**$240.32**	**$29.58**	**$6.26**	**7.5%**	**56.0%**	**6.0%**	**1.4%**	**28.9%**
	TOTAL	**$38,761.23**	**$39,242.11**	**$2,165.09**	**$22,237.02**	**$2,351.94**	**$371.69**	**5.5%**	**56.7%**	**6.0%**	**1.1%**	**32.0%**

Source: LaFleur's 2003 World Lottery Almanac.

[1] South Carolina began its lottery in 2002. Government return data not available.

[2]

offer video lottery terminals as part of their games.

[3] Media Ad Budget data only available for 33 out of the 39 U.S. lotteries.

[4] Gov't Return (Distributions) is reported based on percentage of sales as required by Section 24-35-210(9), C.R.S.

[5] Gov't Return as a percent of ticket sales is not avalable fo Delaware, Oregon, Rhode Island, South Carolona, and West Virgina lotteries as these states have video lottery terminals.

Appendix C

Sponsorship, Promotion, Event Marketing, and Other Premium Item Expenses
Fiscal Year 2003

Sponsorships	Expenses
Pepsi Center	$110,640
KOA Broncos	86,820
Colorado Rockies	66,500
Taste of Colorado	55,000
House of Blues	35,000
Colorado State University	32,660
Colorado State Fair	25,000
KOA/Broncos	21,471
Country Jam USA	20,840
Bandimere Speedway	20,000
Cherry Creek Arts Festival	15,000
Sky Sox	13,500
Spring Spree	10,000
University of Southern Colorado	6,300
YMCA of Pueblo Corporate Cup	4,000
Pueblo Chamber of Commerce, 8th Annual Chile & Frijole Fest	3,500
City of Aurora PumpkinFest 2002	3,500
Adams State College	3,143
Town of Olathe, Olathe Sweet Corn Festival	3,000
Newsed Community Development Corp Cinco De Mayo 2003	3,000
Greenway & Nature Center of Pueblo Bluegrass on the River	3,000
Town of Frisco, Barbecue Challenge	2,500
Summit County Rotary Foundation, BBQ Challenge	2,500
PPIR Investments LLC, NASCAR Race	2,500
New West Fest, Downtown Business Association	2,500
Greeley/Weld Chamber of Commerce Golf Tournament	2,000
Colorado Festivals & Events Assoc. 2003 Conference	2,000
Denver Black Arts Festival, Inc.	1,500
City of Delta Council Tree Pow Wow 2002 Event	1,500
Westminster 7:10 Rotary Club Foundation Golf Tournament	1,250
Executive Women International Golf Tournament	1,000
Pueblo Chamber of Commerce, Colorado Municipal League	1,000
El Paso County Fair & Events Complex	1,000
Runyon Sports Complex Comm Inc	800
Powerball Balloon, Rocky Mountain Balloon Festival LLC	800
Adams/Arapahoe Golf Tournament	750
YWCA of Pueblo, Tribute to Women	500
Isabell Realty & Investment Inc, Stoney Creek Golf Tournament	500
Crowley County Days	500
Town of Mancos, Mancos Colorado Day Assoc.	250
Missouri Day Association, Fireworks Show	250
TOTAL	**$567,474**

Consumer Promotions	**Expenses**
Television Advertising	$89,955
Radio Advertising	68,866
AOL Special Events Team	39,079
State Fair, Truck Giveaway including Taxes	23,174
Road Trip (Scratch Game) Chevy Avalanche Promotion	22,203
Catch the Lotto Bug (Scratch Game) Promotional Items	16,861
Outdoor/On-Line	12,000
Bruce Springsteen Promotion	11,057
Radio Ad for the Road Trip (Scratch Game)	8,955
Bingo (Scratch Game) Car Wraps	7,379
Premium Items, T-shirts for 20th Anniversary	7,068
Van Wrap with Lottery Logo	3,700
Sky Sox Rubber Balls	3,048
Misc. (Telephone, Printing, Messenger, Etc.)	1,191
Artwork Requests	247
2002 Bandimere Ad	162
TOTAL	**$314,944**

Event Marketing	**Expenses**
America Online (AOL) Special Events Team	$143,944
Misc. - Misc. NT - Cherry Creek Arts Festival	15,000
Great American Beer Festival Event Costs	13,399
State Fair Event Costs and Promotional Items	13,190
Newspaper Advertising - Greeley Stampede	12,500
Misc. (Rentals, Telephone, Printing, Storage, etc.)	7,365
Bingo T-shirts	3,085
Country Jam Event Costs	2,770
20th Anniversary Denver Pavilions, Balloons & Flowers	2,430
Fiddler's Art 1	1,008
Concert Connection Ad	882
Adelphia Channel Guide Back Cover	852
2003 Cherry Creek Arts Festival Ad	380
Pueblo Chamber Of Commerce Parade Float/Entry	205
Catch the Lotto Bug (Scratch Game) Display Items and Signs	203
YMCA Statesman Ad	190
Balloon Nets	148
Revised Rockies Program Ad	145
Cash 5 Decal	100
Colorado Barbecue Challenge Ad	70
Artwork Requests	29
TOTAL	**$217,895**

Other Premium Items	**Expenses**
T-shirts, Wheel-Spin Promotional Items, Key Chains, Etc.	**$93,267**

GRAND TOTAL	**$1,193,580**

Source: Office of the State Auditor's analysis of the Lottery's marketing expense data.

The electronic version of this report is available on the Web site of the
Office of the State Auditor
www.state.co.us/auditor

A bound report may be obtained by calling the
Office of the State Auditor
303.869.2800

Please refer to the Report Control Number below when requesting this report.

Report Control Number 1527