

**The Colorado Lottery  
Department of Revenue**

**Performance Audit  
August 2013**



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*The mission of the Office of the State Auditor  
is to improve government for the people of Colorado.*



August 28, 2013

Members of the Legislative Audit Committee:

This report contains the results of a performance audit of the Colorado Lottery. The audit was conducted pursuant to Section 24-35-218(1)(b), C.R.S., which requires the Office of the State Auditor to conduct an analysis and evaluation of the performance of the Colorado Lottery at least once every 5 years. The report presents our findings, conclusions, and recommendations, and the responses of the Colorado Lottery and the Lottery Commission.



We Set the Standard for Good Government

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## *Glossary of Terms and Abbreviations*

**Awards Plan** – Sales Performance Awards Plan

**BEST** – Building Excellent Schools Today Program

**Capital Construction Fund** – Public School Capital Construction Assistance Fund

**CLASS** – Comprehensive Lottery Accounting and Support System

**Commission** – The Lottery Commission

**Department** – The Department of Revenue

**Division** – The Division of Parks and Wildlife

**DPA** – Department of Personnel & Administration

**FTE** – Full Time Equivalent

**GOCO** – The Great Outdoors Colorado Trust Fund

**Lottery** – The Colorado Lottery, a division within the Department of Revenue

**MUSL** – Multi-State Lottery Association

**(RAISE) Bonus** – Retailer Award Incentive for Sales Excellence Bonus

**RFP** – Request for Proposal

**Trust Fund** – The Colorado Conservation Trust Fund



# THE COLORADO LOTTERY

## Performance Audit, August 2013

### Report Highlights



Dianne E. Ray, CPA  
State Auditor

The Colorado Lottery  
Department of Revenue

#### PURPOSE

Conduct an analysis and evaluation of the Colorado Lottery's (the Lottery) management of sales revenue, expenses, and proceeds available to beneficiaries; the integrity and public image of its operations; and significant high-dollar contracts.

#### BACKGROUND

- The Lottery was created as a Division within the Department of Revenue by statute in 1982.
- The Lottery Commission (the Commission) is a five-member oversight entity tasked with creating rules to govern Lottery operations, conducting hearings on complaints, and reporting changes needed to improve the Lottery's effectiveness.
- The Lottery offers a variety of scratch ticket games, four in-state jackpot games, and two multistate jackpot games.
- Since its creation, the Lottery has distributed \$2.6 billion in proceeds to its beneficiary agencies, including Great Outdoors Colorado, the Conservation Trust Fund, and the Capital Construction Fund.
- In Fiscal Year 2013, the Lottery collected more than \$566 million through ticket sales, paid out more than \$345 million in prizes, and netted more than \$135 million to distribute to beneficiary agencies.

#### OUR RECOMMENDATIONS

The Lottery should improve its operations and maximize the proceeds paid to beneficiary agencies by:

- Fully implementing controls that would increase the efficiencies of the scratch ticket auto-reorder system.
- Ensuring sales staff bonuses are designed to incentivize staff performance and thereby increase sales.
- Evaluating the impact that prize payout percentages have on total sales in Colorado.
- Working with the Commission to ensure that retailer compensation properly incentivizes retailers to increase sales of Lottery products.
- Working with the Commission to ensure that communication about significant Lottery activities is optimal for both parties.
- Establishing comprehensive policies and procedures, supervisory review, and staff training processes for all types of security investigations utilized.

The Lottery and the Commission agreed with all of these recommendations.

#### AUDIT CONCERN

**The Lottery may be able to realize efficiencies and cost savings, and increase the amount of proceeds available for beneficiary agencies, through full use of the auto-reorder system, and analysis and modification to sales staff bonuses, retailer compensation, and prize payouts.**

#### KEY FACTS AND FINDINGS

- The Lottery has not implemented the scratch ticket auto-reorder and courier system to realize efficiencies that would result in administrative cost savings as intended. Specifically:
  - Lottery sales staff do not always allow the auto-reorder system to operate as designed for optimal sales.
  - The Lottery has made limited changes to its sales force structure to reflect efficiencies gained through the system's implementation.
  - The Lottery has not significantly reduced vehicle fleet costs.
- The Lottery has not always calculated its sales staff bonus incentives with actual sales data, as described in the approved plan.
- The Lottery has not ensured that all sales staff bonus incentives are designed specifically to reward individual sales achievements.
- The Lottery may be paying more in prize payouts than is needed to achieve optimal sales, thereby lessening the proceeds available for beneficiary agencies.
- The most recent data available in a national study showed that in Fiscal Year 2011 Colorado's prize payout percentage was 63 percent, 2 percentage points higher than the national average of 61 percent. The 2 percentage point difference equated to about \$10.4 million.
- Lottery retailers are eligible for four different types of compensation, and the rates of retailer compensation in Colorado are higher than in most other states.
- Lottery staff have not always provided the Commission with complete and timely information prior to Commission decisions on new product development.
- The Lottery did not conduct annual background rechecks for a majority of vendor employees, including those employees who have access to the Lottery's gaming systems and terminals.

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	26	The Colorado Lottery should establish controls that will allow the auto-reorder and courier system to operate as intended and to realize cost savings anticipated with the system's implementation by (a) fully implementing and providing training and accountability measures for the policies and procedures related to the auto-reorder system; (b) conducting a comprehensive evaluation of sales force needs and determining where expenses can be reduced; and (c) using the results of this evaluation to reduce expenditures as determined; revise sales representative job descriptions to reflect changes to roles; and implement a training plan for sales staff to educate them on the use of the auto-reorder system and how to maximize its benefits.	Colorado Lottery	Agree	a. December 2013 b. January 2014 c. June 2014
2	33	The Colorado Lottery (the Lottery) should ensure that any staff bonus incentives offered are designed to meet its goal of increasing sales in order to increase beneficiary proceeds. In designing and implementing the bonus incentives, the Lottery should (a) determine the method that would be most appropriate for calculating individual awards for sales staff and ensure that this method is recorded in the written plan and used to calculate awards and (b) ensure that all of the incentives included in the written plan are designed to award individual achievement for increases in sales and that incentive pay is not awarded for activities that cannot be shown to result in sales increases.	Colorado Lottery	Agree	a. July 2014 b. July 2014

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## RECOMMENDATION LOCATOR

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Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
3	40	The Colorado Lottery should ensure that prize payout structures result in the maximum proceeds for beneficiaries by (a) establishing a process for evaluating and documenting the impacts that prize payout percentages have on sales in Colorado for both scratch and state jackpot games, and report on the results of the evaluation to the Legislative Audit Committee and Interim Committee of Reference in the fall of 2014 and (b) providing documentation to the Lottery Commission when proposed prize payout percentages for scratch games differ from the annual scratch product plans and requiring that these changes be supported by data showing the projected impact that changes will have on sales and proceeds.	Colorado Lottery	Agree	a. October 2014 b. August 2013
4	45	The Colorado Lottery (the Lottery) and the Lottery Commission should work together to develop sales compensation and bonus plans that incentivize retailers and maximize proceeds for beneficiaries by (a) establishing a comprehensive ongoing process to collect, analyze, and utilize data to assist in the development of a long-term retailer compensation strategy that aligns with the Lottery's organizational goals, and report on the measures put into place to the Legislative Audit Committee and Interim Committee of Reference in the fall of 2014 and (b) amending Lottery rules for retailer compensation as needed to ensure the Lottery Commission has appropriate oversight of the retailer bonus plan.	Colorado Lottery	Agree	a. October 2014 b. March 2014
			Colorado Lottery Commission	Agree	March 2014
5	49	The Colorado Lottery (the Lottery) and the Lottery Commission should work together to ensure that communication on the Lottery's operations is optimal for both entities. This work may include establishing a standard forum to discuss information requests.	Colorado Lottery	Agree	December 2014
			Colorado Lottery Commission	Agree	December 2014

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**RECOMMENDATION LOCATOR**

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<b>Rec. No.</b>	<b>Page No.</b>	<b>Recommendation Summary</b>	<b>Agency Addressed</b>	<b>Agency Response</b>	<b>Implementation Date</b>
6	54	The Colorado Lottery should improve its investigation processes by (a) establishing comprehensive, written policies and procedures for conducting all types of investigations, including which staff are responsible for which aspects of the process, and when and how follow-up actions should occur; (b) establishing a system of supervisory review that ensures cases will be closed appropriately, and all investigative activities will be clearly delegated and documented; and (c) providing ongoing training to staff as needed after comprehensive investigative processes have been implemented.	Colorado Lottery	Agree	a. January 2014 b. January 2014 c. January 2014

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# Overview of the Colorado Lottery

## Chapter 1

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The Colorado Lottery (the Lottery) is a state agency that was created after voters passed a 1980 referendum to revise the Colorado Constitution and allow for the establishment of state-supervised lottery games. Senate Bill 82-119, which was enacted on April 30, 1982, created the Lottery as a division within the Department of Revenue (the Department) and established the Lottery Commission (the Commission), which works with Lottery management to 1) protect the public interest and trust in the Lottery and 2) maximize the sales revenue generated from lottery games. The Lottery is considered a cash-funded enterprise for budget and Taxpayer's Bill of Rights (TABOR) purposes, meaning that it is self-sustaining and does not receive state general funds.

## Lottery Proceeds and Beneficiaries

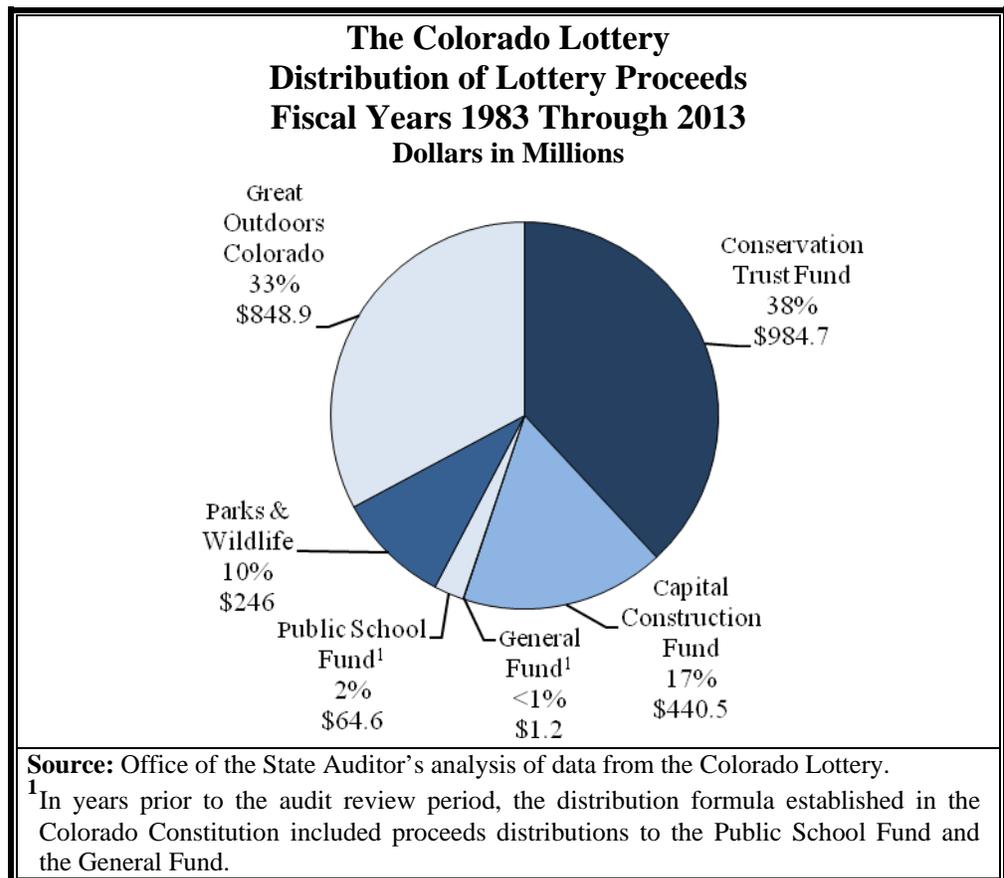
The Lottery's mission and core goal is to maximize the revenue it generates from lottery game sales in order to support its beneficiary agencies. The Lottery's net proceeds (i.e., total revenue minus operating expenses and prize payouts) are distributed to beneficiary agencies under a distribution formula established in the Colorado Constitution. Over the years, Colorado voters and the General Assembly have approved changes to the distribution formula and beneficiary agencies. In Fiscal Year 2013, the Lottery netted \$135.6 million in proceeds, which were available for distribution as follows to the state agencies listed below.

- **The Colorado Conservation Trust Fund (the Trust Fund)** receives 40 percent of the Lottery's proceeds. Administered within the Department of Local Affairs, Trust Fund dollars are distributed to more than 460 eligible local governments, including counties, cities, towns, and Title 32 special districts that provide recreation and park services. In Fiscal Year 2013, \$54.2 million in Lottery proceeds were available for the Trust Fund.
- **The Division of Parks and Wildlife (the Division)** receives 10 percent of the Lottery's proceeds. Administered within the Department of Natural Resources, the Division uses Lottery proceeds for trail construction and maintenance, land acquisition, equipment and facility purchases, and maintenance of state parks facilities. In Fiscal Year 2013, \$13.6 million in Lottery proceeds were available for the Division.
- **The Great Outdoors Colorado Trust Fund (GOCO)** receives 50 percent of the Lottery's proceeds, up to a cap of \$35 million annually,

adjusted for inflation from the 1992 Consumer Price Index of Denver. This amount translates to a cap of \$59.2 million for Fiscal Year 2013. GOCO uses Lottery proceeds to support the State's wildlife, park, river, trail, and open space heritage. In Fiscal Year 2013, \$59.2 million in Lottery proceeds, the maximum amount allowable under the Constitutional cap, were available for GOCO.

- Beginning in Fiscal Year 2009, House Bill 08-1335 directed that any proceeds generated by Lottery sales in excess of the GOCO cap go to **the Public School Capital Construction Assistance Fund (the Capital Construction Fund)**, for the Building Excellent Schools Today (BEST) Program. The BEST Program is administered by the Department of Education and was established to assist in school construction and renovation projects. In Fiscal Year 2013, \$8.6 million in Lottery proceeds were available for the Capital Construction Fund.

Since it began selling tickets in 1983, the Lottery has distributed about \$2.6 billion to its beneficiaries. The following chart shows the breakout of how these proceeds have been distributed since that time.



## Ticket Sales and Expenses

Over Fiscal Years 2009 through 2013, the Lottery generated approximately \$2.6 billion in revenue from ticket sales for lottery games, or, an average of \$520 million per year. Of this revenue, 62 percent has been returned to players as prizes, and 15 percent has gone to operating and administrative expenses. The remaining 23 percent of the Lottery's revenue has been distributed to the state beneficiary agencies listed above.

As shown in the table below, total ticket sales have increased 14.8 percent during the 5-year period, from \$493.4 million in Fiscal Year 2009 to \$566.3 million in Fiscal Year 2013. During this same period, net proceeds to beneficiaries have increased 13.4 percent, from \$119.6 million in Fiscal Year 2009 to \$135.6 million in Fiscal Year 2013.

<b>The Colorado Lottery</b> <b>Ticket Sale Revenue and Net Proceeds for Beneficiaries</b> <b>Fiscal Years 2009 Through 2013</b> <b>Dollars in Millions</b>						
	2009	2010	2011	2012	2013	Percentage Change 2009-2013
Ticket Sales Revenue <sup>1</sup>	\$493.4	\$501.2	\$518.9	\$545.3	\$566.3	14.8%
Prize Payouts	(\$301.5)	(\$313.7)	(\$326.6)	(\$347.5)	(\$345.6)	14.6%
Operating/Other Expenses <sup>2</sup>	(\$ 71.7)	(\$ 74.4)	(\$ 79.7)	(\$ 76.3)	(\$ 86.7)	20.9%
Net Proceeds <sup>3</sup>	\$119.6	\$113.0	\$113.4	\$123.3	\$135.6	13.4%
<b>Source:</b> Office of the State Auditor analysis of Fiscal Years 2009 through 2012 audited and Fiscal Year 2013 unaudited financial records.						
<sup>1</sup> Other, non-ticket sales revenue, such as changes in value in assets, operating reserves, and investments, is not included. Other revenue amounted to (\$0.6) in Fiscal Year 2009, (\$0.1) in Fiscal Year 2010, \$0.8 in Fiscal Year 2011, \$1.8 in Fiscal Year 2012, and \$1.6 in Fiscal Year 2013. Because the Lottery qualifies as a cash-funded, TABOR enterprise under Article X, Section 20 of the Colorado Constitution, all revenue is TABOR exempt.						
<sup>2</sup> Operating and Other Expenses include, in part, supplemental game expenses, such as retailer compensation and gaming system costs; administrative expenses, such as marketing costs and staff wages; and prize variance fees for national jackpot lottery games.						
<sup>3</sup> The Lottery is required to distribute net proceeds to beneficiary agencies quarterly.						

As shown above, the Lottery's largest expense is for prize payouts to game winners. Statute [Section 24-35-210(9), C.R.S.] requires that the Lottery disperse "no less than fifty percent" of its total game sales revenue in prizes to game winners.

In addition to prizes, the Lottery incurs a variety of other expenses to administer lottery games. These expenses include, in part, administrative expenses such as marketing and communication costs, ticket order and delivery, state fleet leasing, and staff compensation; and game administration expenses, such as vendor fees for ticket production and gaming equipment, and compensation to retailers that sell tickets for the Lottery's games.

The Lottery sells some tickets directly at the four Lottery offices in Pueblo, Denver, Fort Collins, and Grand Junction, but the large majority of ticket sales are made through retailers licensed and trained to sell lottery products. Retailers include grocery and convenience stores, gas stations, casinos, restaurants, and various other businesses. The Lottery currently licenses and pays about 3,000 retailers to sell its products.

Prize payouts and staff and retailer compensation are discussed in more detail in chapter 2.

## Lottery Games

The Lottery's revenue is generated primarily by selling tickets for a variety of lottery games of chance, each of which offers players the possibility of winning monetary prizes. Depending on the game, ticket prices range from \$0.50 to \$20 per play, and potential prizes range from \$1 to hundreds of millions of dollars. The Lottery offers two categories of games:

- **Scratch Ticket Games.** Currently, the Lottery offers about 45 to 50 scratch ticket games for sale each year. Paper scratch tickets are sold at retailer store counters, Lottery offices, and in vending machines. Scratch games are introduced and retired continuously to ensure prize availability and maintain player interest. Scratch ticket games have the lowest profit margin of all the Lottery's games but account for more than 65 percent of the Lottery's annual sales.
- **Jackpot Games.** Currently, the Lottery offers six jackpot games that account for about 35 percent of the Lottery's annual sales. Tickets for all six jackpot games are sold through electronic, online gaming terminals at retailer store counters and the four Lottery offices. Two of the jackpot games that the Lottery offers are multistate games administered by a national lottery association, the Multi-State Lottery Association (MUSL), of which Colorado is a member state:
  - Powerball is offered by 42 state lotteries collectively, including Colorado, and offers a rolling jackpot with a minimum \$40 million prize that increases with each drawing until someone wins the jackpot.

- Mega Millions is offered by 44 state lotteries collectively, including Colorado. Mega Millions was introduced in Colorado in 2010 and offers a rolling jackpot with a minimum \$12 million prize that, in 2012, rolled over to a record high \$656 million jackpot prize.

In addition to the two multistate jackpot games administered by MUSL that Colorado participates in, the Lottery offers four state-administered jackpot games:

- Lotto, which is Colorado's oldest jackpot game, offers a rolling jackpot with a minimum \$1 million prize.
- Cash 5 is a fixed-jackpot game that offers a \$20,000 jackpot prize for each drawing.
- Holiday Raffle is a seasonal raffle drawing game introduced in 2012 that offers a top prize of \$500,000. A limited number of raffle tickets are sold until the game sells out or the drawing date is reached.
- Pick 3, which was first introduced for sale in April 2013, is a matrix game in which players select three numbers between zero and nine. Pick 3 offers a top prize of \$500.

The table below shows the sales revenue and ultimate proceeds generated from each of the Lottery's games in Fiscal Year 2013.

<b>The Colorado Lottery Revenue and Proceeds for Beneficiaries by Game Fiscal Year 2013 Dollars in Millions</b>			
	<b>Gross Sales</b>	<b>Proceeds to Beneficiaries</b>	<b>Percentage of Sales as Proceeds</b>
Scratch	\$368.6	\$ 60.8	16.5%
Powerball	116.7	46.4	39.8
Mega Millions	23.2	8.3	35.8
Lotto	32.6	12.0	36.8
Cash 5	21.3	7.1	33.3
Holiday Raffle	2.0	0.3	15.0
Pick 3 <sup>1</sup>	1.9	(0.9) <sup>2</sup>	(52.6) <sup>2</sup>
Other <sup>3</sup>	n/a	1.6 <sup>3</sup>	n/a
<b>Total</b>	<b>\$566.3</b>	<b>\$135.6</b>	<b>23.9%</b>
<b>Source:</b> Game sales and proceeds breakouts reported by the Colorado Lottery.			
<sup>1</sup> Pick 3 was available for one quarter in Fiscal Year 2013.			
<sup>2</sup> Due to start up costs, including marketing, Pick 3 had a net loss in its first quarter of play.			
<sup>3</sup> In Fiscal Year 2013, the Lottery distributed \$1.6 million in proceeds that derived from investment interest and other revenue not directly tied to annual individual game sales.			

The Lottery also used to offer the Colorado jackpot game MatchPlay, from 2010 to June 2012. The decision was made to discontinue this game in 2012 because of poor sales and a high prize payout percentage that resulted in lower proceeds available for beneficiaries.

## The Lottery Commission

The Commission was established as an oversight entity that is responsible for working with Lottery management to protect the Lottery's integrity and ensure effective operations. The Commission is composed of five members appointed by the Governor and confirmed by the State Senate. The Commission is statutorily authorized to govern certain aspects of the Lottery's operations, including, in part, promulgating rules regarding the Lottery's administration, conducting hearings on Lottery-related complaints, and reporting any changes needed to improve the Lottery's effectiveness [Section 24-35-208(1), C.R.S.].

The Commission must include at least one certified public accountant, an attorney, and a law enforcement officer. Members serve 4-year terms with a maximum of two terms, and no more than three members can belong to the same political party. The Commission is required to hold meetings that are open to the public at least monthly. We discuss the Commission in more detail in chapter 2.

## Lottery Administration and Organization

The Lottery is headquartered in Pueblo, with satellite offices in Denver, Fort Collins, and Grand Junction. The Lottery has 126 full-time-equivalent (FTE) staff, organized into multiple sections, as described below.

- **Administration (13 FTE).** Includes the Lottery’s executive leadership, senior management, and administrative assistant staff. The Lottery Director, who is housed in Pueblo, and the Deputy Director, who is housed in Denver, are responsible for overseeing the Lottery’s day-to-day operations and ensuring the Lottery’s fiscal success and integrity. Additionally, a Project Management Officer—who oversees large projects including major software conversions and the implementation of new games (such as the recent Pick 3 jackpot game) and who reports directly to the Department—works alongside the Lottery’s executive leadership.
- **Sales and Marketing (53 FTE).** A two-branch section that consists of:
  - 44 sales staff members responsible for working directly with the Lottery’s retailers on an ongoing basis. These responsibilities include providing retailer training, monitoring, and customer service, and recruiting new retailers. Most sales staff are assigned a sales route that includes about 100 of the Lottery’s 3,000 retailers and conduct site visits on a biweekly schedule. Some sales staff are not assigned a sales route but are responsible for working with corporate retailer accounts (e.g., King Soopers, 7-Eleven) or assisting all retailers statewide.
  - Nine marketing staff members responsible for a broad range of activities designed to improve the public’s perception of and participation in the Lottery’s games. These responsibilities include conducting consumer research and product development; procuring television, radio, Internet, and point-of-sale advertising; and overseeing public and media relations.
- **Security (9.5 FTE).** Monitors and secures the Lottery’s sales offices and warehouses; supervises scratch ticket and gaming terminal receipt, post-production, and distribution to retailers; investigates suspicious incidents to help prevent game fraud; assists at Colorado jackpot game drawings; issues licenses to retailers; and performs background investigations of licensed retailers, Lottery and vendor employees, and Lottery Commission members.
- **Fiscal (10 FTE).** Handles accounting, budgeting, policy and planning, and purchasing. The fiscal section is responsible for all retailer billing,

reconciliations of daily ticket transactions, and financial transfers to Lottery beneficiaries.

- **Operations (22.5 FTE).** Operates the ticket counters and customer reception desks at the Lottery's four offices; manages the two warehouses located in Pueblo and Denver where scratch tickets and promotional inventory are stored; and oversees the state fleet vehicles that the Lottery leases. The operations section also oversees game software design, development, testing, and implementation, and includes a Drawings Manager responsible for ensuring the integrity of each game drawing.
- **Lottery IT Unit (18 FTE).** Maintains all internal hardware and software systems, including the Lottery's back office system (CLASS), which is used to manage all non-game functions.

In addition to internal staff, the Lottery utilizes a variety of contracted vendor services to administer its games, including vendors under contract to provide the jackpot gaming system, marketing services, ticket production and equipment maintenance, and scratch ticket ordering and courier services.

## Audit Purpose, Scope, and Methodology

Section 24-35-218(1)(b), C.R.S., requires the Office of the State Auditor to conduct "an analysis and evaluation of the performance" of the Lottery at least once every 5 years. The last performance audit of the Lottery was released in 2008. Statute specifies multiple factors that the State Auditor should consider, but is not limited to, in each performance audit. The audit objectives and work discussed below address each of the statutory factors. Audit work was performed from January 2013 through September 2013. We acknowledge the cooperation and assistance provided by Lottery and Department staff and the Commission.

The overall objectives of our audit were to analyze and evaluate the Lottery's management of (1) sales revenue, expenses, and proceeds available to beneficiaries; (2) the integrity and public image of its operations; and (3) significant, high-dollar contracts critical to administering games. Specifically, we evaluated:

- Whether the Lottery manages game-related and administrative expenses in an effective manner to ensure that the net proceeds available to beneficiary agencies are maximized. *We discuss our findings in this area in more detail in chapter 2.*
- Whether the Lottery provides the Commission with adequate information in sufficient time for Commission members to make informed decisions. *We discuss our finding in this area in more detail in chapter 2.*

- Whether the Lottery's procedures for handling complaints and investigations related to issues with games are effective. *We discuss our findings in this area in more detail in chapter 2.*
- Whether the Commission has adequate policies and procedures in place to solicit public input into Lottery operations and respond to concerns raised. *On the basis of the work we performed in this area, nothing came to our attention to indicate lack of compliance with state laws or other concerns.*
- Whether the Lottery has adequate controls in place to ensure employees and Commission members are in compliance with statutory restrictions on accepting gifts and gratuities. *On the basis of the work we performed in this area, nothing came to our attention to indicate lack of compliance with state laws or other concerns.*
- Whether the Lottery has adequate controls and outcome measures in place to ensure that vendors fulfill their contractual obligations and are adequately monitored. *On the basis of the work we performed in this area, nothing came to our attention to indicate lack of compliance with state laws or other concerns.*
- Whether there has been an increase in organized crime related to gambling within the State. *On the basis of the work we performed in this area, nothing came to our attention to indicate lack of compliance with state laws or other concerns.*
- Whether the Lottery is effective in collecting and assessing socioeconomic information on the player population and any changes in that population. *On the basis of the work we performed in this area, nothing came to our attention to indicate lack of compliance with state laws or other concerns.*

We assessed the effectiveness of those internal controls that are significant to the audit objectives described above. Our conclusions on the effectiveness of those controls are described in the audit findings and recommendations.

To accomplish our audit objectives, we:

- Reviewed relevant state laws, rules, and regulations, as well as Lottery and Department policies and procedures and MUSL requirements for administering the Powerball and Mega Millions games.
- Interviewed Lottery, Department, and other state agency staff, Commission members, beneficiary agency staff, Lottery contractors, and Colorado Bureau of Investigation (CBI) staff.

- Reviewed and analyzed financial data on the Lottery's sales revenue, prize payouts, game and operating expenses, and beneficiary agency proceeds.
- Assessed the Lottery's implementation of the scratch ticket auto-reorder and courier system and the system's effect on sales staff responsibilities and usage of state fleet vehicles.
- Reviewed and analyzed the Lottery's sales staff performance awards plans, incentive structures, and payments awarded to staff.
- Reviewed and analyzed the prize payout structures the Lottery established for scratch and jackpot games, as well as the prize payout structures of other state lotteries offering similar games.
- Reviewed and analyzed the Lottery's retailer compensation policies, incentive structures, and payments made to retailers.
- Assessed the Lottery's contract management processes, and tested a sample of contracts, requests for proposals, payments to contractors, and liquidated damages collected for compliance with Lottery and state requirements.
- Evaluated the Lottery's security investigation and complaint processes and reviewed a sample of cases and security-related complaints that were opened during the audit review period.
- Assessed the completeness and timeliness of Commission meeting agendas and minutes as posted for the public; the standard information packets and other supplemental information provided to Commission members by Lottery staff; and the processes the Commission and the Lottery have established for soliciting and responding to public input.
- Assessed the Lottery's controls for ensuring staff and the Commission are aware of state requirements prohibiting the acceptance of gifts or gratuities from business associates.
- Reviewed and analyzed data from CBI on organized crime and criminal cases related to gambling in Colorado.
- Assessed the Lottery's process for collecting and utilizing socioeconomic data on its game players and compared Colorado's socioeconomic information with that of other state lotteries.

We relied on sampling techniques to support our audit work as follows:

- We selected a nonstatistical judgmental sample of 29 documents supporting the Lottery's contract monitoring activities. This sample includes 13 liquidated damages assessments to Scientific Games, 10 advertising project reports completed by Cactus Communications, and six itemized invoices from United Parcel Service (UPS). We selected our sample items to assess the Lottery's contract monitoring and documentation practices conducted throughout the audit period. We designed our sample to help provide sufficient, appropriate evidence for our evaluation of the Lottery's contract monitoring process based on our audit objectives.
- We selected a nonstatistical judgmental sample of 26 payments made to Scientific Games, Cactus Communications, and UPS. We selected our sample items to provide representation of payments made throughout the audit period and to include payments and associated estimates related to the Lottery's preparations for increased sales activity during the holiday season and promotions. We designed our sample to help provide sufficient, appropriate evidence for our evaluation of the Lottery's process for reviewing and authorizing payments to contractors based on our audit objectives.
- We selected a nonstatistical judgmental sample of eight criminal investigations. We selected our sample investigations to include cases conducted during Fiscal Year 2013 that were fully investigated and closed. We designed our sample to help provide sufficient, appropriate evidence for our evaluation of the Lottery's criminal investigation process based on our audit objectives.
- We selected a nonstatistical judgmental sample of 12 retailer compliance investigations. We selected our sample investigations to include the retailer compliance investigations that were completed in Fiscal Year 2013 by security staff recently trained on the procedure. We designed our sample to help provide sufficient, appropriate evidence for our evaluation of the Lottery's retailer compliance investigation process based on our audit objectives.
- We selected a nonstatistical judgmental sample of 37 complaints made to the Lottery that were referred to security staff. We selected our sample complaints to provide representation of complaints made to the Lottery during Fiscal Years 2012 and 2013. We designed our sample to help provide sufficient, appropriate evidence for our evaluation of the Lottery's complaint process based on our audit objectives.

When samples were chosen, the results of our testing were not intended to be projected to the entire population. Rather, samples were selected to provide

sufficient coverage of those areas—such as contract management, and investigations and complaints—that were significant to the objectives of this audit. Additional detail about audit work supporting our findings, conclusions, and recommendations are described in the remainder of the report.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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# Lottery Operations

## Chapter 2

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The Colorado Lottery (the Lottery) generated approximately \$2.6 billion in ticket sales revenue during Fiscal Years 2009 through 2013 and achieved record sales in Fiscal Years 2011, 2012, and 2013. During that 5-year period, overall ticket sales increased 14.8 percent, prize expenses increased 14.6 percent, and operating expenses increased 20.9 percent. The total proceeds that the Lottery distributed to its beneficiary agencies increased 13.4 percent over the 5 years. From Fiscal Year 2009 to 2012, proceeds increased by 3 percent, and from Fiscal Year 2012 to Fiscal Year 2013, proceeds increased by 10 percent.

We reviewed the Lottery's management of game-related and operating expenses, including prize payouts, retailer compensation, sales staff bonus awards, marketing costs, ticket ordering and courier services, and state fleet usage. We also reviewed the Lottery's management of day-to-day operations that are critical to the Lottery's integrity and effectiveness, including the processes for conducting security investigations and ensuring staff are aware of state requirements prohibiting gift acceptance from business associates; practices for communicating with the Lottery Commission (the Commission) and soliciting public input; and processes governing contract procurement and management.

Overall, we found that the Lottery has made improvements in several key areas since the 2008 performance audit. Specifically, we found that the Lottery has strengthened its contract management practices and now requires that each contract have an assigned contract monitor who is trained both internally and by the Department of Revenue (the Department) on the State's contract management requirements. In addition, the Lottery has migrated its back office system, which tracks all non-game-related expenses and other key financial data, from the antiquated Wang system, the foundation of which was more than 25 years old.

However, we found that there are further improvements that the Lottery can make to help reduce costs and therefore increase the amount of proceeds available to distribute to beneficiary agencies. First, the Lottery should improve the processes used to govern the implementation of the scratch ticket auto-reorder and courier system to realize efficiencies in fleet usage and sales staff responsibilities and reduce costs. The Lottery should also improve the processes used to determine and justify sales staff performance awards, prize payout amounts, and retailer compensation. Finally, the Lottery should ensure that it has a formal forum for providing complete and timely information to the Commission, and adequate

policies and procedures in place for conducting security investigations. We identified similar concerns with the auto-reorder and courier system, prize payout amounts, and retailer compensation in the 2008 performance audit. Our findings are discussed in more detail in the remainder of this chapter.

## **Auto-Reorder System and Sales Staff**

The Lottery currently operates an auto-reorder and courier system for scratch tickets. The system was fully implemented as of the end of Calendar Year 2010. The auto-reorder system calculates the supply and demand for scratch tickets for each retailer based on parameters input into the system, such as the top-selling scratch games, amount of space for games at each retail location, and the rate of depletion that triggers an automatic replenishment. Each retailer has a set day each week where the system will automatically generate and process orders for scratch products based upon the calculations and inventory at that retailer. The Lottery has incorporated several system enhancements since its implementation to improve the auto-reorder process, including a protocol that checks daily for abnormal product depletion, which then creates an emergency order. Orders can also be manually generated by sales staff, who still conduct regular sales visits, or when a retailer calls to request an order. Once an order is generated, Lottery warehouse staff will “pick and pack” products for delivery by the United Parcel Service (UPS), with which the Lottery contracts for courier delivery.

Prior to the auto-reorder and courier system’s implementation, Lottery sales representatives would handwrite orders and deliver scratch tickets to retailers—Colorado was one of two states still ordering and delivering tickets by hand in 2010. According to the Lottery, the auto-reorder system has contributed to the increase in sales over the past several years and to the decrease in the number of scratch tickets that remain unsold when a game ends and therefore must be written off as lost revenue for that game.

The Lottery currently has four sales supervisors who oversee 29 sales representatives. Sales representatives are assigned a sales route, each of which has on average about 100 of the approximately 3,000 total Lottery retailers. Sales representatives work out of their homes and use their assigned fleet vehicles to travel directly to the retailers on their route. During visits to retailers, sales representatives are responsible for assessing product inventory, monitoring the placement of marketing materials, and discussing new games and relevant Lottery developments with retailers. The Lottery attempts to balance the number of retailers and staff drive time when assigning retailers to routes. Because of geographic diversity, including the distance between retailers, routes in urban areas may have more retailers than those in rural areas. Each sales representative is assigned a permanent Lottery fleet vehicle that the Lottery leases from Colorado State Fleet Management.

## **What audit work was performed and what was the purpose?**

As part of our review of the Lottery's administrative expenses, we examined the implementation of the auto-reorder and courier system. Specifically, we reviewed the Lottery's documentation on the design of and changes to the system, including the 2008 request for proposal (RFP) and contract for the auto-reorder and courier system. We reviewed Lottery practices and interviewed sales staff responsible for oversight and use of the auto-reorder system. We also conducted a review and analysis of more than 42,000 shipments generated by the system or sales representatives from January through April 2013. We were unable to make comparisons with orders generated prior to 2013 because the Lottery only began tracking this data in January 2013. In an attempt to determine if there was a correlation between the manner in which orders were generated and the amount of sales, we analyzed both manually generated orders and automatically generated orders and compared them with sales data by region. We also looked at documentation related to staff responsibilities and staff assignment and use of fleet vehicles.

The purpose of our audit work was to determine if the auto-reorder and courier system is fully implemented as intended and whether the Lottery gained efficiencies as a result of the new system.

## **How were the results of the audit work measured?**

The Lottery's stated mission is to maximize proceeds for its beneficiaries, and statute (Section 24-35-218, C.R.S.) requires the State Auditor's review of the Lottery to consider its expenses, revenues, and the amount of proceeds for beneficiaries; whether the Lottery performs its duties efficiently and effectively; and whether administrative changes are needed to improve the operation of the Lottery.

Prior to the development of the 2008 RFP for the auto-reorder and courier system, the Lottery contracted with a company to conduct an analysis of its business practices. This analysis included recommendations to the Lottery on lottery industry best practices, including the implementation of a predictive ordering (auto-reorder) system with the following conditions:

- A predictive ordering system that is augmented by either field or phone representatives.
- Diminished reliance on sales staff due to heavy or exclusive reliance on the predictive ordering system.

- Focused retraining of sales staff during the transition to a predictive ordering and courier system to realize the economic benefits of this delivery model.
- A shift in sales staff activities to focus on product promotion, with productivity based on 15 or more stops a day when not handling product.
- Policies governing the handling of product and appropriate oversight of staff to ensure those policies are implemented.

The Lottery's contract for the system specifies that the Lottery requires an auto-reorder system that automatically manages scratch product orders and shipments. At implementation, the Lottery desired a flexible system "aimed at increasing sales and returns to the State beneficiaries," including automated and manual order creation, processing, and delivery. Since the system's implementation, the Lottery has made several upgrades to the system that were intended to further automate the process and decrease the involvement of the Lottery's sales staff.

### **What problem did the audit work identify?**

Overall, we found that the Lottery has not implemented the auto-reorder and courier system in order to realize efficiencies that would result in administrative cost savings as it intended and in accordance with industry practices.

- **Lottery sales staff do not always allow the auto-reorder system to function as designed for optimal sales.** We found that sales staff sometimes override the system and manually enter orders for some retailers, rather than allowing the system to automatically generate orders. Although there are some circumstances when it is appropriate to override the auto-reorder system and manually enter orders, such as when there is a need to provide a different mix of games than what the system generates or to supplement high-volume retailers with additional inventory to avoid depletion of stock, we found the following problems that indicate sales staff may not always be allowing the system to serve its intended purpose:
  - Specifically, we found that of the more than 42,000 orders generated during our review period, 5,700 (14 percent) were placed manually by sales representatives, rather than through the auto-reorder system. There were 12 sales representatives who manually placed more than 10 percent of all orders for their routes, including auto-replenishment orders and those generated when called in by retailers. One sales representative manually generated more than 43 percent of the orders for his or her route, and another sales representative manually generated more than 30 percent of the orders for his or her route.

- Additionally, we found that during the 4 months in our review period (January through April 2013), 441 of the 3,058 retailers (14 percent) in our sample were “turned off” from the auto-reorder system. In other words, the system was not automatically generating any orders for these retailers. Instead, the sales representatives assigned to these retailers manually entered all of the orders for these retailers into the auto-reorder system.
- **The Lottery has made limited changes to its sales force structure to reflect the implementation of the auto-reorder and courier system.** The number of sales staff and the number of sales routes have remained about the same since the auto-reorder and courier system was implemented. Since Fiscal Year 2009, the Lottery has decreased the number of sales representatives and retailer routes by only three. These three positions were eliminated due to attrition rather than through an active decision by the Lottery to reallocate sales staff. In addition, on average, each route has been assigned about 100 retailers since Fiscal Year 2009 and the average number of daily retailer visits made by sales representatives has remained the same as it was prior to implementing the automated system. On average, sales representatives visit 11 retailers per day, which is four fewer than the average of 15 daily visits that is common in the industry for representatives not carrying product. If the Lottery were to increase the average to meet the industry practice, it could consolidate routes to reduce the overall number of routes.
- **The Lottery has not significantly reduced vehicle fleet costs with implementation of the auto-reorder and courier system.** The Lottery’s fleet costs and usage have remained about the same since the auto-reorder and courier system was implemented. In Fiscal Year 2009, the Lottery spent \$392,000 on fleet costs, compared with \$388,000 in Fiscal Year 2012. The Lottery has reduced its total number of fleet vehicles by two since implementation of the auto-reorder system, but it is still incurring the same amount of leasing expenses. This is because, in part, the Lottery is continuing to use fleet vehicles designed for delivering products (i.e., large, specially equipped vans), which are more costly to lease and use more fuel. As sales representatives should no longer be delivering scratch tickets, they do not have a need for these vehicles.

### **Why did the problem occur?**

We determined that there are two reasons for the problems we identified.

- **The Lottery did not establish related policies, procedures, and oversight when implementing the auto-reorder system.** Although the

system has been in place for 3 years, the Lottery did not establish any policies and procedures for sales representatives to follow when working with their assigned retailers and using the auto-reorder and courier system until April 2013. For example, prior to the recently established policies and procedures, the Lottery did not have formal policies related to when a sales representative can manually generate an order or require supervisory approval for system overrides. The Lottery also had not established guidance on the percentage of a sales representative's orders that could be manually generated. The Lottery has indicated that it is still in a transition period from the prior system of sales representatives manually generating orders and delivering product, 3 years after the system was put into place, and is just now requiring sales representatives to comply with the recently established policies. In addition, the Lottery has not provided comprehensive training to the sales representatives on these policies.

The Lottery has attempted to increase reliance on the auto-reorder and courier system by giving sales representatives the ability to adjust parameters for retailers to optimize order amounts, adding protocols for the auto-reorder system to automatically generate emergency orders, and as of April 2013, limiting the number of retailers that can be disabled in the system per route. From January to April 2013, about 40 percent of sales representatives still manually generated a large percentage of their retailers' orders, and in many cases, completely disabled their retailers from the auto-reorder and courier system so that all orders were placed and delivered manually. According to Lottery staff, some sales representatives believe that manually generating orders helps the retailers be more responsive to customers and, as a result, increases sales. We found, however, that on average the sales routes with fewer manually generated orders had higher average ticket sales per retailer than the routes with a higher number of manually generated orders.

- **The Lottery has not conducted a comprehensive evaluation of its sales staffing needs with implementation of the auto-reorder and courier system and implemented changes to reflect those needs.** Specifically, the Lottery has not determined what the sales representatives' duties should be with respect to the retailers, including the frequency of retailer visits and how many retailers should be visited each day. The Lottery's goal in implementing the auto-reorder and courier system was to realize efficiencies and cost-savings by shifting the role of sales representatives from inventory control to product marketing. However, in examining sales representatives' job descriptions, little has changed in their job duties since the auto-reorder and courier system was implemented. Both the old and new job descriptions include analyzing and managing inventory of scratch tickets as a primary duty. Neither job description indicates how much time should be spent on this function.

In addition, the Lottery has not determined how many sales representatives and routes are needed to manage the Lottery's retailers, or the number and type of vehicles needed for these routes. The Lottery has also not provided adequate training to sales representatives on what their new role and responsibilities should include and on how to work with retailers to get their buy-in for the new system. For example, the automated system is designed to automatically select games that coincide with the Lottery's marketing efforts, and the system uses prior sales data and other parameters to stock the right amount of the most profitable games for each retailer. When retailers request that the auto-reorder system be disabled so that they may acquire scratch games that are not set up to be automatically ordered, some sales representatives comply with the request rather than coaching retailers on the benefits of relying on the automated system.

Finally, although the Lottery has conducted assessments on its overall fleet needs for all Lottery staff and is now in the process of exchanging eight fleet vehicles that have expired leases for smaller, more fuel-efficient vehicles, it has not made significant reductions or changes to its sales staff fleet. Lottery sales staff continue to use 15 vehicles classified as cargo vans, which were needed for inventory management prior to the implementation of the auto-reorder and courier system but are no longer used in that capacity. Two of these vans are beyond the lease period by nearly 4 years.

### **Why does the problem matter?**

The auto-reorder system is designed to coincide with current marketing efforts and account for sales trends when creating automated orders. By not allowing the system to create and fulfill these orders and opting instead to disable the system or create manual orders, there is an increased risk that retailers are not carrying the most profitable products at a given time, thus the Lottery may not be realizing optimal revenue.

Additionally, although the Lottery has now implemented the auto-reorder and courier system, it is not realizing the efficiencies and cost-savings that were initially envisioned. This means that the Lottery has not been able to reduce administrative costs in this area and thus increase the amount of proceeds available for beneficiaries. Implementing the system has increased the Lottery's administrative expenses by \$700,000 per year, a cost the Lottery planned on incurring in expectation of the automated system increasing ticket sales. However, the Lottery has not realized cost savings in other areas as a result of the system's implementation, such as in the number of sales representatives and fleet vehicles needed, and instead has maintained the same amount of expenses for scratch ticket delivery prior to implementing the auto-reorder and courier system.

Specifically, the Lottery has only reduced sales staff and routes by three (to 29) and continues to spend \$388,000 annually on the use of fleet vehicles for sales staff, which is the same amount spent prior to implementing the system. Additionally, although ticket sales have increased, it is difficult to determine exactly how much of that increase can be attributed to the auto-reorder system.

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### **Recommendation No. 1:**

The Colorado Lottery should establish controls that will allow the auto-reorder and courier system to operate as intended and to realize cost-savings anticipated with the system's implementation by:

- a. Fully implementing and providing training and accountability measures for the recently created policies and procedures related to the auto-reorder system.
- b. Conducting a comprehensive evaluation of sales force needs and determining where expenses can be reduced, including what the sales representatives' duties should be with respect to the retailers, the frequency of retailer visits, how many sales representatives are needed, how many sales routes there should be, and the number and type of vehicles needed for these routes.
- c. Using the results of this evaluation to reduce expenditures as determined, including adjusting the number and types of vehicles; revise sales representative job descriptions to reflect changes to roles, including decreased responsibilities for inventory control as needed; and implement a training plan for sales staff to educate them on the use of the auto-reorder system and how to maximize its benefits.

### **Colorado Lottery Response:**

- a. Agree. Implementation date: December 2013.

The Lottery has already created and fully implemented April 4, 2013, auto-reorder rules, which are a set of specific procedures detailing how sales representatives must use the auto-reorder system. The sales force has been trained on these parameters and will undergo future training to reinforce these rules and any future revisions. Performance plans for the sales force will also be updated to include the new auto-reorder performance parameters. The Lottery's sales supervisors will be responsible for monitoring, enforcing, and documenting compliance with auto-reorder procedures for each of their sales regions. Each sales

territory will be reviewed and documented by the assigned sales supervisor each quarter to ensure that field staff are adhering to the prescribed guidelines. The Lottery will also continue to evaluate the auto-reorder system and its performance on an ongoing basis and improve upon its effectiveness as needed through system enhancements and sales force training.

b. Agree. Implementation date: January 2014.

The Lottery is currently evaluating sales force needs to determine where expenses can be reduced. At the conclusion of this evaluation, recommendations will be made on optimum frequency of retailer visits, how many sales representatives are needed, how many sales routes there should be, and the number and type of vehicles needed for these routes.

c. Agree. Implementation date: June 2014.

The Lottery believes that overall the auto-reorder system has performed relatively well and has been, in part, responsible for an increase in Scratch sales of more than \$40 million since its implementation, which resulted in an additional \$6.5 million to its proceeds beneficiaries. The Lottery will, however, continue to work toward improving the system based on results throughout Fiscal Year 2014, including further refinement of override thresholds and in the training of sales staff on the system and its most effective usage in the field. The Lottery will formalize and implement a comprehensive training plan in this regard.

Based on the findings of the evaluation at the end of Fiscal Year 2014, the Lottery will manage any recommended sales staff reductions through attrition and redeployment. Therefore, any resulting FTE savings may not be fully realized by the proposed implementation date. The Lottery will also review and revise sales force job descriptions to more accurately reflect their current activities. The number and type of vehicles needed will also be adjusted accordingly based on any personnel and job responsibility changes.

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## Sales Staff Performance Awards

Since the Lottery's inception in the 1980s, the compensation package for sales staff has included a base salary as well as the potential to earn performance awards, under a written Sales Performance Awards Plan (Awards Plan) that the

Lottery develops each year. Staff who are eligible to receive incentive pay through the Awards Plan are those staff responsible for working directly with the Lottery's retailers on an ongoing basis. In Fiscal Years 2011 and 2012, eligible staff included 29 sales representatives, each of whom was assigned to a unique sales route that totaled about 100 retailers per representative; four regional managers responsible for supervising the representatives; two account specialists assigned to large corporate accounts (e.g., King Soopers, 7-Eleven); and beginning in Fiscal Year 2012, two statewide liaisons who provide customer service assistance from the Lottery's offices to the approximately 3,000 retailers.

The Lottery implemented the annual Awards Plan as a way to motivate sales staff to increase ticket sales, which in turn increases the amount of proceeds available for beneficiary agencies. The Awards Plan, which is reviewed and approved by the Department of Personnel & Administration (DPA) each year, specifies which staff are eligible to receive incentive pay for the year and the types and amounts of incentives allowed. Generally, over the past several years, the core incentives in the Awards Plan have been for achieving scratch and jackpot route sales in excess of the prior year's sales, by thresholds set by Lottery management. In addition to the incentives for exceeding prior sales, in some years the Lottery also offered incentives for recruiting new retailers and for ensuring that marketing materials were displayed by retailers appropriately.

The table below shows the total annual awards that the Lottery budgeted and staff received over the audit review period, Fiscal Years 2009 through 2012.

<b>The Colorado Lottery Annual Sales Performance Award Plan Total Amounts Budgeted and Awarded to Sales Staff Fiscal Years 2009 Through 2012</b>				
	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
Total Budgeted <sup>1</sup>	\$412,000	\$500,000	\$482,000	\$494,000
Total Awarded <sup>2</sup>	\$ 68,000	\$198,000	\$332,000	\$394,000
<b>Source:</b> Office of the State Auditor's analysis of data from the Colorado Financial Reporting System (COFRS).				
<sup>1</sup> In years in which the Lottery does not award the total amount budgeted, the remaining amount is included in proceeds provided to beneficiary agencies.				
<sup>2</sup> Over the 4-year period, 35 to 38 sales staff were eligible to receive incentive pay.				

Generally, the amount awarded to staff in incentive pay over the past several years has increased. In Fiscal Year 2008, prior to the audit review period, the total amount awarded to sales staff was \$406,000. In Fiscal Year 2013, after the audit review period, the Lottery awarded \$325,000 in incentive pay.

## **What audit work was performed and what was the purpose?**

Our review of the Lottery's expenses included an assessment of the Awards Plan and the incentive pay that the Lottery has awarded to sales staff. To assess the Lottery's policies and processes for awarding incentive pay to staff, we reviewed the annual Awards Plans that the Lottery established for Fiscal Years 2009 through 2012 and the state requirements governing incentive pay to state employees. We also interviewed the staff responsible for calculating the awards and for designing the incentives included in each year's Awards Plan. Additionally, we reviewed the quarterly awards paid to the 29 sales representatives and four regional managers during Fiscal Years 2011 and 2012 and tested the payments for compliance with the Lottery's approved Awards Plan for each year.

The purpose of our audit work was to determine whether:

- The awards were calculated and paid to staff in compliance with state requirements and the Lottery's written and approved Awards Plan.
- The incentives were designed to further the Lottery's goal of increasing sales and thus proceeds available for beneficiaries.

## **How were the results of the audit work measured?**

All state employee compensation, including compensation to Lottery staff, is governed by state regulations. Current regulations "strongly encourage" agencies to use incentives to compensate staff, but in doing so the following requirements must be met.

- Agencies must establish a plan for awarding incentive pay that includes eligibility criteria and details about the types and amounts of incentives allowed. All incentive pay awarded must be in accordance with this plan. [4 CCR 801-1, 3-21(A)]
- Agencies must submit the plan to the DPA Director for review to ensure that it is consistent with state guidance, rule, and law. [4 CCR 801-1, 3-21(B)]
- Agencies must communicate the plan to all employees prior to use and on an ongoing basis. [4 CCR 801-1, 3-21(C)]

The Lottery's annual Awards Plan includes criteria for awarding incentive pay to sales staff. The criteria include that the methods for awarding incentive pay:

- Be fair and equitable, providing equal opportunities to each eligible employee.
- Be easily understood by staff and efficiently implemented.
- Be an effective motivational tool that encourages achievement of the highest levels of sales performance.
- Tie individual sales performance to the Lottery's overall sales goals.

For Fiscal Years 2011 and 2012, the Awards Plans state that sales staff will be awarded incentive pay based on the percentage increase of current year sales over prior year sales. To calculate the percentage increase in sales, the Awards Plan requires the Lottery to calculate total actual sales by quarter for the current year and compare this to the same quarter in the prior year. For example, for Fiscal Year 2012 scratch ticket sales, the Awards Plan states that each of the 29 sales representatives could earn up to \$2,240 each quarter if they reached a threshold, set by Lottery management, of 5 percent increased Fiscal Year 2012 sales over Fiscal Year 2011 sales for the same quarter. Similarly, the four regional managers were eligible to earn up to \$2,800 each quarter for a 5 percent increase in scratch ticket sales from Fiscal Year 2011 to Fiscal Year 2012.

### **What problem did the audit work identify?**

We found that the award amounts paid to staff in recent years have not adhered to the sales incentives as designed by Lottery management and outlined in the annual Awards Plans. Additionally, we found that in some instances the incentives may not be adequately designed to tie individual sales performance to overall sales goals and thus may not be effective for increasing sales or beneficiary proceeds. We discuss our concerns in the following two sections.

- **The Lottery has not calculated incentive pay as outlined in the Awards Plan.** Overall, we found that the Lottery has not adhered to the method outlined in the Awards Plan for calculating incentive pay. Specifically, we found that the Lottery did not use total actual sales for the prior year award period to determine if sales had increased. In calculating the percentage change in sales, the Lottery used the *current year* total actual sales, but instead of using the *prior year* total actual sales for comparison purposes, the Lottery compared the current actual sales to a sales projection amount. The sales projection amount was calculated by taking actual sales data for the prior year and making adjustments to that amount to account for current changes in the sales staff member's route from the prior year. For example, if a retailer went out of business or a new retailer was added to the route, adjustments were made to the prior

year actual sales amount to reflect these changes in the projection calculation. According to the Lottery, these adjustments were approved by Lottery management. For Fiscal Year 2012, this practice resulted in about \$8,800 more in bonus award payments than would have been paid had the Lottery used actual instead of projected sales to calculate awards; for Fiscal Year 2011, about \$9,000 more.

- **The Lottery has not ensured incentives are designed to reward sales achievements.** Overall, we found that some of the incentives the Lottery has designed may not be working as intended. Specifically, we identified concerns with the incentives that the Lottery has established for jackpot ticket sales and for retailer recruitment.
  - For the jackpot sales incentive, we found that the thresholds the Lottery set for receiving an award for jackpot ticket sales may be ineffective at rewarding individual achievement for increasing sales. Specifically, we found that the thresholds the Lottery used for the jackpot sales incentive resulted in either all staff or no staff meeting the threshold amounts the majority of the time. For the eight quarters of Fiscal Years 2011 and 2012, none of the 33 staff met the incentive award threshold for jackpot ticket sales in three of the eight quarters, and in three other quarters, all staff met the threshold. In contrast, the scratch ticket sales thresholds appear to have been set at amounts where some, but not all, staff received an award each quarter. This raises questions about whether the Lottery has designed the thresholds for the jackpot sales incentive in a manner that rewards individual achievement for increasing sales.
  - For the retailer recruitment incentive, we found that the incentive ultimately did not result in an increase in the Lottery's retailer pool. Over Fiscal Years 2010, 2011, and 2012, in order to increase the total number of Lottery retailers and thus increase sales, the Lottery offered an incentive award to sales staff who enrolled new retailers. The Lottery reports that a total of about \$76,000 was awarded to sales staff through this incentive, but the retailer base remained stagnant, at about 3,050 retailers. The Lottery believes that if the incentive had not been in place over the 3-year period, the number of retailers would have decreased.

### **Why did the problem occur?**

The issues identified occurred due to the following:

- **The Lottery has not determined which method would be most appropriate for calculating individual awards for sales incentives.** The

Awards Plan provides for a clear and straightforward method of awarding sales incentives when current actual sales exceed prior actual sales by set thresholds. According to the Lottery, comparing current to prior actual sales would penalize staff in some cases, such as when a retailer is moved from one person's route to another person's route. Therefore, comparing actual sales to a calculated projection that can be adjusted is preferred. However, the Lottery has not updated the Awards Plan to reflect this approach, nor has it maintained records showing what adjustments to actual sales data were made, during which time periods, to determine the projection amounts used to calculate awards. We were unable to re-create all of the adjustments the Lottery had made because a record was not kept and in some cases the adjustments were made manually by Lottery staff who calculate the awards. Further, the staff member who calculates the awards estimated that it takes about 12 hours each quarter to manually review thousands of lines of sales data to ensure the sales projection amounts used for the award calculation have been adjusted correctly.

Additionally, there does not seem to be a significant difference in total sales incentives awarded when using actual sales amounts rather than the adjusted projection amounts. We calculated what the sales incentive awards would have been if the Lottery had used the actual sales data method included in the Awards Plan, for each of the 29 sales representatives responsible for a route and the four regional managers. Using this approach, in Fiscal Year 2012, the Lottery would have awarded about \$251,500 to staff, compared with \$260,300 under its approach using projections. In Fiscal Year 2011, the Lottery would have awarded about \$212,600 to staff, rather than \$221,600. As such, the Lottery's current practice of adjusting actual sales data to create sales projections is inefficient and does not appear to add value or be a transparent method of awarding incentives that is in accordance with the written Awards Plan and is easily understood by staff and efficiently implemented.

- **The Lottery has not demonstrated all incentives are appropriate for awarding individual achievement in increasing sales.** The Lottery began offering a jackpot sales incentive in 2010 because it established an office-wide goal to emphasize jackpot game sales, rather than the higher cost scratch ticket games, to increase overall profitability. However, the Lottery acknowledges that jackpot sales are primarily driven by the size of the jackpot prize, rather than by the efforts of individual staff. In the quarter where the Mega Millions jackpot reached a record high of \$656 million, for example, all 33 sales staff we reviewed exceeded the highest jackpot incentive threshold, and all received the maximum award for jackpot sales that quarter. The Lottery also established the office-wide goal to grow the retailer base, to in turn increase total sales, but as noted previously the number of retailers that sell Lottery products has remained

flat. The Lottery discontinued the retailer recruitment incentive for Fiscal Year 2013.

### **Why does the problem matter?**

As of 2011, Colorado was one of 15 states using bonus awards to incentivize sales staff, of the 41 states with lotteries. Bonus awards are intrinsically prone to scrutiny, especially when awarded in the public sector. This is one of the reasons for review by DPA and the Lottery's own guidance that the Awards Plan be clear and easily understandable. Overly difficult calculations or adjustments call into question the integrity of the bonus incentive awards by both the employees and the general public. Further, awards that are not supported by data showing that the employee's efforts produced the desired results also call into question the integrity of the incentives, which have amounted to hundreds of thousands of dollars each year that would otherwise have been distributed as proceeds to beneficiary agencies. Additionally, without a record of the calculations or adjustments used to determine awards, the Lottery is ultimately unable to show the awards were fair and equitable and provided equal opportunities to all eligible staff. Given the Lottery's mandate to maximize proceeds to beneficiaries, if the Lottery continues to opt to offer bonus incentive awards to staff, then it must be straightforward in designing incentives and documenting how these expenses increase sales and profitability.

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### **Recommendation No. 2:**

The Colorado Lottery (the Lottery) should ensure that any staff bonus incentive awards offered to staff are designed to meet the Lottery's goal of increasing sales in order to increase beneficiary proceeds. In designing and implementing the bonus incentives, the Lottery should:

- a. Determine the method that would be most appropriate for calculating individual awards for staff and ensure that this method is recorded in the written plan, used by the Lottery to calculate awards, and implemented in a manner that is efficient and transparent to staff and Lottery's stakeholders.
- b. Ensure that all of the incentives included in the written plan are designed to award individual achievement for increases in sales, and do not award activities that cannot be shown to result in sales increases.

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## Colorado Lottery Response:

- a. Agree. Implementation date: July 2014.

The Lottery has already established a new sales incentive plan for Fiscal Year 2014. The methodology for payment in this year's plan has already been recorded and will be implemented as specifically stated in the plan. In addition, the Lottery will no longer use adjusted forecasts to compute the awards, and will instead use simple actual prior period sales for comparison, if sales increases remain an evaluation factor in the future. This will make the bonus plan simpler, more efficient, and more transparent to staff and Lottery stakeholders.

- b. Agree. Implementation date: July 2014.

For 30 years, the Lottery has always attempted to design bonus incentive plans to increase sales and proceeds. However, the Lottery cannot always completely ensure that the incentives will be awarded for activities that unequivocally result in sales increases. The Lottery can only put forth its best effort to ensure this. It is not possible to link sales or proceeds increases to any one variable. Factors such as new products, promotions, prize payouts, mega jackpots, and advertising campaigns all can impact sales up or down, alongside the efforts of the sales force in the field.

In an effort to mitigate the concerns, the Lottery has already implemented a new sales incentive plan for Fiscal Year 2014 which ensures that Lottery organizational goals (sales and proceeds) be achieved before any bonus dollars are paid out. The sales staff must then meet or exceed a specific sales goal tied directly to their area of responsibility to earn any incentive pay. The total dollars that may be earned in the new plan have also been reduced by half to ensure cost savings overall. The Lottery will evaluate its Fiscal Year 2014 incentive plan at year end, determine its effectiveness and validity overall, and recommend whether to retain, revise, or discontinue the plan for Fiscal Year 2015.

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## Prize Payouts

Lottery staff and the Commission are responsible for setting the prize payout percentages for all scratch games and the state jackpot games, such as Lotto and Cash 5. For scratch games, each year Lottery staff develop an overall scratch

game production plan that includes price points, prize payout percentages, number of games, types of games, number of tickets per game, and strategies for scratch sales, including game promotion guidelines and goals for increasing sales and profitability over the prior year. When a scratch game is developed, Lottery staff propose rules to the Commission that define the game design, including the prize structure and payout percentage; the Commission must approve the game rules. Each year, the Lottery introduces about 45 total scratch games.

For jackpot games, Lottery staff conduct similar work to provide recommendations to the Commission for rules on the game design, prize structure, and projected payout percentages. The introduction of new jackpot games is less frequent than scratch games. Prize payouts for the multistate jackpot games—Powerball and Mega Millions—are set by the governing organizations for these games and cannot be adjusted by the Lottery.

During Fiscal Years 2009 through 2012, the Lottery paid out \$1.3 billion, or 62 percent of the \$2.1 billion in ticket sales revenue, in prizes. The chart below shows the breakout of prize payouts for each category of game and the percentage of the payout as compared with sales.

<b>The Colorado Lottery Prize Payouts Fiscal Years 2009 Through 2012 Dollars in Millions</b>					
	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>Total 2009 – 2012</b>
<b>Total Sales</b>	<b>\$493.4</b>	<b>\$501.2</b>	<b>\$518.9</b>	<b>\$545.3</b>	<b>\$2,058.8</b>
Colorado Jackpot Prize Payouts	32.6	36.1	44.0	34.1	146.8
Multistate Prize Payouts	47.2	53.0	45.5	56.5	202.2
Scratch Prize Payouts	221.6	224.6	237.4	252.0	935.6
<b>Total Prize Payouts</b>	<b>\$301.4</b>	<b>\$313.7</b>	<b>\$326.9</b>	<b>\$342.6</b>	<b>\$1,284.6</b>
Prize Payouts as Percentage of Sales	61%	63%	63%	63%	62%
<b>Source:</b> Fiscal Years 2009 through 2012, Colorado Lottery audited financial statements.					

**What audit work was performed and what was the purpose?**

We reviewed state statutes and Lottery rules, policies, and practices for determining and establishing scratch and state jackpot prize payout percentages. We also interviewed Lottery staff responsible for managing prize payouts. We analyzed the methods the Lottery used to determine prize payout percentages in the four annual scratch plans developed between Fiscal Years 2009 and 2012 and

for the state jackpot games active during the same period (i.e., Lotto, Cash 5, MatchPlay, Raffle). We also assessed trends in sales and designed prize payout percentages for the 157 scratch games that started and ended between Fiscal Years 2009 and 2013 and compared the prize payout percentages in game rules to the ranges the Lottery established in the scratch production plans. Additionally, we reviewed and analyzed industry information as well as information provided by other states in order to make comparisons with other state lotteries.

The purpose of our audit work was to assess whether prize payouts have complied with the Lottery's statutory requirements that, in total, prize payouts be at least 50 percent of sales while also being structured to maximize proceeds for beneficiaries.

### **How were the results of the audit work measured?**

The Lottery's stated mission is to maximize proceeds for its beneficiaries. Prize payouts accounted for 63 percent of the Lottery's expenses in Fiscal Year 2012 and as such, they have a significant impact on the amount of proceeds that go to the Lottery's beneficiaries. Statute requires total actual prize payouts to be a minimum of 50 percent of the total annual revenue from ticket sales from all games, which include scratch and both state and multistate jackpot games [Section 24-35-210, C.R.S., and DOR 1 C.C.R. 206-1(1.2)]. The multistate jackpot game payout structure is established by the multistate governing boards for each game, meaning the Lottery is responsible for ensuring that the payout structures for the games it does control result in combined, total game sales that meet the minimum 50 percent payout requirement.

Statute (Section 24-35-208, C.R.S.) provides that "the Commission shall... promulgate rules governing the establishment and operation of the [L]ottery," determine the types of games offered (to include the price of the tickets, the number of prizes, and the amount of prizes), and to promulgate rules for each of those games. Statute also provides for the Lottery, under the guidance of the Lottery Director, to furnish information to the Commission as is needed to ensure the "efficient and economical operation and administration" of the Lottery [Section 24-35-204(3)(o), C.R.S.].

In meeting the statutory requirement of providing the Commission with the information needed to operate efficiently and economically, Lottery staff create an annual scratch product plan to establish the overall parameters of the scratch games that will be offered each year and strategies to reach sales goals with the purpose of making scratch games as profitable as possible. The plan is developed with input from knowledgeable Lottery staff, including the Scratch Ticket Manager, marketing staff, and fiscal staff, and takes into consideration a number of variables.

### What problem did the audit work identify?

Overall, it appears that the Lottery may be paying more in prize payouts than is needed to achieve optimal sales, thereby lessening the proceeds available for beneficiaries. Comparisons with other states show that Colorado's overall prize payout as a percentage of sales is high. From Fiscal Year 2009 to Fiscal Year 2012, Colorado's average payout percentage increased from 61 percent to 63 percent. In Fiscal Year 2011, the most recent data available in a national study showed that the national average for prize payouts was 61 percent of sales. Colorado's overall percentage that year was 63 percent. The 2 percentage point difference in prize payout percentage equated to about \$10.2 million in Fiscal Year 2011.

According to the Lottery, states vary not only in total population and sales, but also in the number and types of games they offer. As a result, it may not be appropriate to compare the Colorado Lottery to all other state lotteries. With input from Lottery staff, we identified states that are most similar to Colorado in total population, total sales, and the types of games offered. In the table below, we compare Colorado's total prize payout percentage with these similar states in Fiscal Year 2011, the most recent year that data were available. As the table shows, Colorado paid out a higher percentage of total sales in prizes than the other states.

<b>Comparison of Lottery Prize Payouts as a Percentage of Sales Fiscal Year 2011 Dollars in Millions</b>			
<b>State Lottery</b>	<b>Total Sales</b>	<b>Total Prizes</b>	<b>Percentage of Sales Paid in Prizes</b>
Colorado	\$518.9	\$326.7	63.0%
Arizona	\$583.5	\$360.5	61.8%
Minnesota	\$504.4	\$310.9	61.6%
Wisconsin	\$502.7	\$290.5	57.8%
<b>Source:</b> Lafleur's 2012 World Lottery Almanac, 20th edition.			

We also compared Colorado's prize payout percentages with these other states for state jackpot games and scratch games, by price point, as shown in the following table.

<b>The Colorado Lottery            Comparison of Prize Payouts by Game            Fiscal Year 2012</b>		
<b>Game</b>	<b>Colorado's Prize Payouts</b>	<b>Range of Prize Payouts for Comparative States<sup>1</sup></b>
Lotto <sup>2</sup>	58%	50%—54%
Cash 5 <sup>2</sup>	55%	50%
\$20 Scratch Ticket	78%	72%—77%
\$10 Scratch Ticket	75%	70%—75%
\$5 Scratch Ticket	72%	65%—70%
\$3 Scratch Ticket	65%	63%—66%
\$2 Scratch Ticket	64%	62%—66%
\$1 Scratch Ticket	62%	59%—64%

**Source:** Office of the State Auditor's analysis of data from the Colorado, Arizona, Minnesota, and Wisconsin Lotteries.

<sup>1</sup>Range of prize payouts for comparable games in Arizona, Minnesota, and Wisconsin.

<sup>2</sup>Lotto and Cash 5 are jackpot games offered by the Colorado Lottery. These are compared with jackpot games offered in Arizona, Minnesota, and Wisconsin with the same price points and similar game characteristics.

As the table shows, Colorado's prize payout percentages for two jackpot games (Lotto and Cash 5) and three scratch game price points (\$20, \$10, and \$5) either exceed or are at the top of the average range of payout percentages for the other states.

### **Why did the problem occur?**

The issues we identified occurred because of the following:

- The Lottery has not developed a process for evaluating and documenting the impact prize payout percentages have on total sales in Colorado and the amount of proceeds available to beneficiaries.** In our 2008 audit, we recommended, and the Lottery agreed to, evaluating prize structures for all state jackpot and scratch games by looking at the effect of changes to prize payout percentages on sales and revenue to determine if adjustments were needed to maximize proceeds. However, the Lottery has not determined the level of prize payouts in Colorado that would maximize proceeds. The Lottery currently reviews payout percentages, sales history, and other factors that may impact ticket sales, and staff attend conferences and review best practices from other states on prize payout amounts. Additionally, the Lottery has worked with contractors to conduct studies on scratch game payouts. However, the Lottery continues to adjust prize payout percentages based on overall industry trends and data rather than through analysis of documented

historical outcomes in Colorado. The Lottery does not track how overall sales of scratch games by price point are affected by adjustments to payout percentages, specifically whether or not consistently lower percentages would reduce sales to a point that would result in lower overall profit. The Lottery has noted that it can take up to 3 years for changes in prize payout percentages to impact sales, revenue, and proceeds as games with old percentages are cycled out and players become accustomed to the new payout percentages. However, the Lottery's approach has been to make more frequent changes to percentages, which makes it difficult to assess the actual impact of a change. Further, many external studies provide conflicting information on whether to increase or decrease prize payout percentages as a means of improving profitability.

- **The Lottery has not developed an ongoing process to review and revise state jackpot prize payout amounts.** Jackpot prize payout amounts can vary depending on several factors beyond the Lottery's direct control, including the number of players and number of winners at each prize level. However, the Lottery has not implemented a systematic process for reviewing the factors that it can control to determine if adjustments are needed to optimize proceeds for beneficiaries. Between Fiscal Years 2009 and 2012, the Lottery has only recommended one adjustment to a state jackpot game to the Lottery Commission. In 2011, the Lottery determined that it could decrease the jackpot growth rate without negatively impacting overall sales. The Lottery projected that the adjustment would provide an additional \$1.23 million in proceeds to beneficiaries. Despite the potential increase in proceeds, the Lottery indicated this was a one-time review and change. Aside from the one-time change to the jackpot allocation rate, the Lottery has not reviewed other areas where adjustments could be made.
- **The Lottery sets scratch game prize payout percentages outside the annual scratch product plan.** Our review of the 157 scratch games active during Fiscal Years 2009 through 2013 identified 78 games (50 percent) where the prize payout percentage was not set within the range laid out in that fiscal year's scratch product plan. Of the 78 games, 50 games paid out a lower percentage of prizes and 28 games paid out a higher percentage of prizes than was established in the annual plan. Staff indicated that when scratch game percentages are set outside of what was proposed in the scratch product plan it is to achieve sales goals. However, the Lottery does not document the specific projected impact that changing the payout percentage will have on sales and proceeds to show that the change is justified, nor does it provide the documentation to the Commission as to why prize payouts should be set outside of the plan. According to Lottery staff, the prize payout percentages included in the scratch product plan are based on sales history and other factors. Diverting from the plan without

providing adequate justification diminishes the usefulness of the plan and brings into question the appropriateness of the payout percentages.

### **Why does the problem matter?**

Because the Lottery deals with such large dollar amounts, small changes in payout percentages can have a significant impact on payout amounts. Had Colorado's overall prize payout percentage been at the national average of 61 percent during Fiscal Year 2011, and all other factors remained equal, it would have paid out about \$316.5 million in prizes instead of the \$326.7 million it actually paid out that year. This difference of \$10.2 million could have gone to beneficiaries. Although it is possible that the lower payouts might have resulted in lower overall sales, the Lottery has not gathered the needed information to make that determination.

Additionally, Lottery staff advise the Commission on setting prize payout percentages to achieve the Lottery's mission of maximizing proceeds for beneficiaries. However, Lottery staff cannot demonstrate that the recommended changes to scratch game payout percentages and the existing jackpot prize payout structure ensure they are achieving this mission. As a result, there is a risk that the Lottery's beneficiaries have missed out and will continue to miss out on the maximum potential proceeds.

Furthermore, because the Lottery has no control over the payout structures for the two multistate games available in Colorado—Powerball and Mega Millions—it is all the more important that the Lottery take the steps needed to ensure that state-operated games are as profitable as is possible and that proceeds for beneficiaries are maximized.

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### **Recommendation No. 3:**

The Colorado Lottery (the Lottery) should ensure that prize payout structures result in the maximum proceeds for beneficiaries by:

- a. Establishing and adhering to a process for evaluating and documenting the specific impacts that prize payout percentages have on total sales in Colorado for both scratch and state jackpot games and ensuring that these reviews are conducted on a regular basis as state demographics and other factors change over time. The Lottery should report back to the Legislative Audit Committee and its Interim Committee of Reference in the fall of 2014 on the results of its evaluation.

- b. Providing documented reasoning to the Lottery Commission when proposed prize payout percentages for scratch games differ from those included in the annual scratch product plans and requiring that these proposed changes be supported by data showing the projected impact that changing the payout percentage will have on sales and proceeds.

### **Colorado Lottery Response:**

- a. Agree. Implementation date: October 2014.

The Lottery will establish a process for evaluating and documenting impacts of prize payout percentages on a regular basis. However, since there are so many variables besides payout affecting sales and profits, the evaluations cannot be definitive. Rather, they will be estimates of the effects, which will be based on the best available information. Any additional known market variables that are deemed to have had a possible positive or negative impact will be cited along with the estimates. This additional information will help provide a thorough understanding of the analyses and suppositions. The evaluation for past games will be developed by December 31, 2013, and projected effects for new or modified games will be completed by June 30, 2014. The Lottery will utilize these analyses to report to the Legislative Audit Committee and the Interim Committee of Reference in the fall of 2014.

- b. Agree. Implementation date: August 2013.

At the start of each fiscal year, the Lottery Commission will approve the Scratch Product Strategy, which will include projected prize payout estimations. Any new scratch games deviating from this plan will be brought to the Commission for approval, and include data to support the projected impact of existing and proposed changes to payout percentages.

The Lottery Commission approved the Fiscal Year 2014 Scratch Product Strategy on August 14, 2013.

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## **Retailer Compensation**

Each fiscal year Lottery staff develop a retailer compensation and bonus plan. The plan is designed as an incentive program for marketing and selling Lottery

products with the goal of increasing sales and strengthening relationships with retailers. Total retailer compensation consists of four components:

- **Sales compensation.** The standard rate of compensation to retailers, which is 6 percent of jackpot ticket sales and 7 percent of scratch ticket sales.
- **Selling bonus.** A bonus ranging from \$200 to \$50,000 to eligible retailers that sell a top-prize-winning ticket for a jackpot game and some scratch games with high top prizes.
- **Cashing bonus.** A bonus of 1 percent of all prizes to eligible retailers that redeem winning tickets of less than \$600; winning tickets of \$600 or more must be redeemed directly through the Lottery.
- **Retailer Award Incentive for Sales Excellence (RAISE) bonus.** A bonus of 6 percent of jackpot and 7 percent of scratch sales above the sales for the same quarter the previous year to retailers who meet Lottery standards related to product availability and placement of product dispensers and promotional materials.

The standard sales compensation, cashing bonus, and RAISE bonus are automatically calculated and applied to a retailer's account by the Lottery's back office system as they occur. The selling bonus is manually calculated and applied to a retailer's account by Lottery fiscal staff. All compensation and bonuses are paid out quarterly by Lottery's fiscal staff. In total, the Lottery paid retailers \$41.6 million in compensation during Fiscal Year 2012.

### **What audit work was performed and what was the purpose?**

We reviewed the Lottery's retailer compensation and bonus plans for Fiscal Years 2009 through 2012. We also reviewed state requirements and Lottery rules, policies, and practices regarding retailer compensation and bonuses. We interviewed Lottery staff responsible for developing compensation and bonus payment plans and managing the payments to retailers. Though we considered all four elements of total retailer compensation, we identified greater risks and concerns in the areas of the standard sales compensation and RAISE bonuses. For those two areas, we reviewed the amounts paid to all retailers by quarter for Fiscal Years 2009 through 2012.

The purpose of our audit work was to assess the extent to which the Lottery's sales compensation and RAISE bonus plans are designed to maximize sales and thus provide beneficiaries with the greatest proceeds.

## **How were the results of the audit work measured?**

The Lottery's stated mission is to maximize proceeds for its beneficiaries. As stated in the Lottery's retailer compensation and bonus plan, the plan is "designed to increase the visibility of all Lottery products and ultimately generate incremental Lottery sales at all participating locations." One of the plan's stated objectives is to increase sales for all Lottery products by providing retailers with a measurable incentive program for marketing and selling Lottery products. The Lottery evaluates and revises the plan annually. As part of the evaluation, the Lottery reviews prior year sales, plan participation, retailer compliance with RAISE bonus parameters, budgetary considerations, new marketing initiatives, and sales projections. The Lottery also includes major retailers, fiscal staff, and the Commission in the development and approval of the plan.

Statute [Section 24-35-208 (3)(a), C.R.S.] requires the Commission to establish rules for the manner and amount of compensation to be paid to retailers that sell the Lottery's products. The Commission established in its rules [DOR 1 C.C.R. 206-1 (5.17), (10.13), (10.A.10), (10.B.9), (10.D.9), (10E.9), (14.A.14), and (14.C.14)] the type of compensation retailers will receive, including the amounts for ticket sales and bonuses. The Commission's rules delegate authority for determining the criteria for receiving the marketing (RAISE) bonus to the Lottery Director.

According to LaFleur's 2012 World Lottery Almanac, which is the industry-recognized statistical guide on state and international lotteries, for the 39 other reporting states with complete data, the national average scratch and jackpot commissions to retailers are each 5.5 percent.

## **What problem did the audit work identify?**

We found that the Lottery sales compensation and RAISE bonuses paid to retailers may not be set to a level that controls expenses while still incentivizing retailers so as to provide the greatest proceeds for beneficiaries. Specifically, we found that the Lottery's scratch and jackpot sales compensation percentages are higher than the national averages. Of the 39 other states with complete data in LaFleur's 2012 World Lottery Almanac, 35 states had lower scratch compensation percentages than Colorado. The average rate for these 35 states was 5.3 percent. The remaining four states set their compensation rates to 7 percent, the same as Colorado. For jackpot games, 27 states had lower rates than Colorado. The average rate for these 27 states was 5.1 percent. Of the remaining states, seven states had the same 6 percent rate as Colorado, and five had higher rates.

Additionally, the Lottery's RAISE bonuses do not appear to have a demonstrable effect on sales. We found that from Fiscal Year 2009 through Fiscal Year 2012,

RAISE bonuses increased 114 percent (from \$1.2 million to \$2.6 million), whereas sales have only increased 11 percent (from \$493 million to \$545 million). However, the Lottery cannot provide documentation to show that there is a correlation between the increase in sales and the increase in RAISE bonus payments. Further, three times between Fiscal Year 2009 and Fiscal Year 2012, the Lottery Director, in accordance with the authority delegated to him, changed the RAISE bonus payment amounts to retailers without documentation to show why these changes were needed or how they would help to increase sales and maximize proceeds. As a result of a change in one quarter, the Lottery paid out about \$194,000 more in RAISE bonuses than it would have under the original plan. The Lottery lowered RAISE bonus amounts in Fiscal Year 2013 and has indicated that it intends to keep the lower rate and tie RAISE bonuses strictly to jackpot games in Fiscal Year 2014.

### **Why did the problem occur?**

There are two causes for the problems we identified with retailer compensation:

- First, the Lottery has not conducted a comprehensive analysis of sales compensation and RAISE bonus percentages to measure the impact of changes in the percentages on sales and proceeds. We noted in our 2008 audit that retailer sales compensation percentages had not been adjusted since 1998 and recommended that the Lottery examine whether retailer compensation should be reduced to lower costs. However, the Lottery has not conducted an analysis to determine the impact that changes could have on sales and, thus, to proceeds, and compensation rates have remained the same. Scratch compensation rates have remained set at 7 percent and jackpot compensation rates at 6 percent. Lottery staff stated that they have considered making changes to these percentages, but because they have been established for so long, staff believe changes would not be well received by retailers. In addition, even though the goal of the RAISE bonus plan is to create a measurable incentive for retailers, the Lottery has not taken steps to determine whether providing retailers the RAISE bonus has a correlation to increased sales.
- Second, although the Commission has established the rules for retailer compensation, including the base sales compensation amounts for scratch and jackpot sales, the Commission does not provide formal oversight of the RAISE bonus program, including the annual formulation of the plan or amendments to those plans. Currently, the Commission only provides input when requested by Lottery staff and the Commission's input is not needed to make amendments to the plan.

### **Why does the problem matter?**

In total, the Lottery paid retailers \$41.6 million in compensation during Fiscal Year 2012. In our 2008 audit of the Lottery, we noted that sales compensation for the Lottery was higher than 34 of the 42 states reporting data, and that Colorado's average sales compensation rate of 6.5 percent of sales was over the national average of 5.7 percent. We recommended then that Colorado seek cost-savings by considering its retailer compensation and taking appropriate action to realize savings where it could. Although in follow-up documents to the 2008 audit the Lottery reported conducting an ongoing review of retailer compensation and in doing so it has gathered data on other states' retailer compensation, the Lottery continues to pay a higher rate than many other states without evidence to demonstrate an impact on sales. The Lottery's retailer compensation is meant to provide a measurable incentive to retailers to increase sales in order to maximize proceeds to beneficiaries. When the Lottery does not measure the impact of retailer compensation on sales, it risks paying an amount that is not optimal for maximizing proceeds to the Lottery's beneficiaries. For example, if scratch and jackpot compensation amounts had been set at the national average of 5.5 percent from Fiscal Year 2009 through Fiscal Year 2012, and other factors remained equal, the Lottery would have saved \$23.7 million that could have been paid to beneficiaries. However, because the Lottery is not collecting, documenting, and evaluating measurements, there is no way to tell if these savings could be realized.

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### **Recommendation No. 4:**

The Colorado Lottery (the Lottery) and the Colorado Lottery Commission (the Commission) should work together to develop sales compensation and Retailer Award Incentive for Sales Excellence (RAISE) bonus plans that incentivize retailers and maximize proceeds for beneficiaries by:

- a. Establishing a comprehensive ongoing process to collect, analyze, and utilize data to assist in the development of a long-term retailer compensation strategy that aligns with the Lottery's organizational goals. The Lottery should report back to the Legislative Audit Committee and its Interim Committee of Reference in the fall of 2014 on the measures it has put in place to reduce retailer compensation.
- b. Amending Lottery rules for retailer compensation as needed to ensure the Lottery Commission has appropriate oversight of the retailer bonus plan, including the RAISE bonus, and amendments to those plans and to require that justification be provided to demonstrate how changes to retailer compensation will result in increased sales.

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## **Colorado Lottery Response:**

- a. Agree. Implementation date: October 2014.

Overall, the Lottery is committed to reviewing the retailer compensation plan and learning from best practices in the industry with the intent of reducing overall expense without negative consequences to the bottom line. However, because there are so many variables besides payout affecting sales and profits, the evaluations cannot be definitive. Rather, they will be estimates of the effects, which will be based on the best available information. Any additional known market variables that are deemed to have had a possible positive or negative impact will be cited along with the estimates. This additional information will help provide a thorough understanding of the analyses and suppositions.

After conducting an initial analysis, the Lottery will make recommendations regarding retailer compensation by January 31, 2014. The Lottery had already restructured its Fiscal Year 2013 retailer bonus plan and its current Fiscal Year 2014 plan to realize cost savings and more appropriately align the plan with organizational goals. The Lottery will work together with the Commission to develop any resulting changes to retailer compensation. The Lottery will report back to the Legislature on the specific measures taken in this regard in reducing retailer compensation.

- b. Agree. Implementation date: March 2014.

Lottery staff will discuss with the Commission what level of oversight and approval authority they would like regarding retailer compensation to include the RAISE bonus plan and any amendments to the plan. We will make rule changes as appropriate based on the Commission's direction. In addition, we will make sure that any changes to the plan are properly documented and justified.

## **Colorado Lottery Commission Response:**

- Agree. Implementation date: March 2014.

Based on a detailed analysis from Lottery staff, the Lottery Commission should review retailer compensation, including bonus plans, to ensure their overall effectiveness.

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## The Lottery Commission

The majority of state lotteries are overseen by a lottery commission, the purpose of which is, generally, to act as an oversight entity that helps to ensure that the state's legalized lottery is properly administered. In Colorado, the Commission is the oversight entity for the Colorado Lottery. The Commission is responsible for promulgating rules governing the establishment and operation of the Lottery, including games, prizes, and retailers. The Commission meets monthly with Lottery staff to discuss Lottery operations and vote, when necessary, on rule changes, such as whether to establish new scratch or jackpot games.

### What audit work was performed and what was the purpose?

We interviewed Commission members and Lottery staff and observed Commission meetings. We also reviewed the statutory responsibilities of the Commission and Lottery management, as well as Commission meeting minutes and the monthly information packets the Lottery prepared for Commission members for January 2012 through June 2013.

The purpose of our audit work was to determine whether Lottery staff provide Commission members adequate information in sufficient time for the Commission to make informed decisions to fulfill their oversight role of the Lottery's administration.

### How were the results of the audit work measured?

The Commission has a statutory obligation to identify and address any concerns with the Lottery's operations. Per statute [Section 24-35-208(1), C.R.S.], the Commission is responsible, in part, for:

- Promulgating rules governing the Lottery's operations.
- Conducting hearings on Lottery-related complaints.
- Reporting to the Governor, Attorney General, and Legislative leadership any recommendations for statutory changes needed to improve the Lottery's administration.
- Requiring Lottery management to provide Commission members with information as needed to fulfill their responsibilities.

Lottery management has a statutory obligation to ensure that the Commission is adequately instructed on the Lottery's operations so that it may fulfill its

obligations. Per statute [Section 24-35-204(3), C.R.S.], the Lottery Director is responsible for:

- Conferring with the Commission, as is necessary or desirable and not less than once each month, on the Lottery's operations.
- Attending Commission meetings.
- Responding to any Commission member's request for information.
- Advising and making recommendations to the Commission on any improvements to the Lottery's operations that he deems necessary and advisable.
- Providing the Commission with a full and complete statement of the Lottery's revenue, prize disbursements, and other expenses for each month.

### **What problem did the audit work identify?**

We found that communication between Commission members and Lottery management regarding the Lottery's operations could be improved. Specifically, we found that the Lottery could improve the timeliness and completeness of the information provided to the Commission so that it can make informed decisions related to new product development. Some Commission members reported that the Lottery has not always provided complete and timely information that the Commission needs to make decisions related to establishing new lottery games in Colorado. For example, some Commissioners indicated that although they had requested specific information on the new Pick 3 jackpot game when it was proposed by the Lottery in 2012, they did not receive all of the requested information prior to when they had to vote to approve or reject the game. This information included why the Lottery recommended Pick 3 rather than another jackpot game option, and why the Lottery recommended a \$.50 price point for the game rather than a \$1 price point. Commission members also indicated in interviews and in Commission meeting minutes that they felt "rushed" to vote on the game without having complete information. Commission members reported similar complaints with the information provided by the Lottery prior to the Commission having to vote on whether Colorado would join the Mega Millions jackpot game in 2010 and whether to approve the Raffle jackpot game in 2011.

### **Why did the problem occur?**

To date, Lottery management and the Commission have not established a standard, formalized forum to discuss each month whether Commission members

need any further information from Lottery staff and whether previously requested information has been sufficiently provided. Currently, the Commission's monthly meeting agenda always includes time to discuss the standard information the Lottery provides on routine decision items, such as when and how scratch ticket games will be phased in and out, and time for public comment, but time has not been set aside each month to discuss the status of special or one-time information requests, such as those made prior to the Commission voting on a new game. As such, both Lottery management and Commission members do not have a high level of assurance that miscommunication between meetings has not occurred and that all needed requests are fulfilled in a timely and complete manner prior to the deadlines for significant votes.

Each month, the Lottery provides Commission members with a packet of information that will be discussed at the next Commission meeting. These packets contain standard items, such as sales reports on current games, statistics on all calls and complaints the Lottery has received, and copies of marketing campaign materials. In recent months, the Lottery has started to include more extensive information related to upcoming, significant votes, such as information on the changes to the Mega Millions game that Commission members voted on in June 2013. The Lottery also established a secure, online portal for sharing information with Commission members electronically beginning in January 2013. At this time, though, the monthly paper packets and online portal resource do not include all of the special or one-time information requests made by Commission members. Instead, this information is provided to Commission members on an ad hoc basis.

### **Why does the problem matter?**

The Lottery generates half a billion dollars in ticket sales and provides more than \$100 million in proceeds for beneficiary agencies each year. Lottery management and the Commission are both responsible for ensuring that the Lottery's operations are effective and have the proper oversight so that sales and the proceeds available to beneficiary agencies are maximized. Commission members need complete and timely information from the Lottery to fulfill their statutory responsibilities.

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### **Recommendation No. 5:**

The Colorado Lottery (the Lottery) and the Colorado Lottery Commission (the Commission) should work together to ensure that communication on the Lottery's operations is optimal for both entities. This work may include establishing a standard, formalized forum to discuss information requests made by Commission members and the status of the requests. In particular, the Commission's monthly

agenda could include time that is set aside to discuss the status of special or one-time information requests, such as those made prior to the Commission voting on a new game, to help ensure that miscommunication between meetings does not occur and all needed requests are fulfilled in a timely and complete manner prior to the deadlines for significant votes.

### **Colorado Lottery Response:**

Agree. Implementation date: December 2014.

The Lottery wants to give the Commission all the information it requires to help ensure that miscommunication between meetings does not occur and all needed requests are fulfilled in a timely and complete manner prior to the deadlines for significant votes. With the Commission's agreement, the Lottery will modify the monthly agendas to include an agreed-upon time to discuss the status of special or one-time information requests or any other information the Commission would like to discuss.

### **Colorado Lottery Commission Response:**

Agree. Implementation date: December 2014.

The Lottery Commission would agree to a regular agenda item to review the status of all information exchanges. The presentation of an annual strategic plan for game enhancements or expansions would provide an excellent framework to ensure complete information is available to all parties.

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## **Security Investigations**

The Lottery's Security Division is responsible for ensuring that Lottery business is conducted with integrity, ethics, and efficiency. During the audit, the Security Division consisted of a security director; seven criminal investigators, two of whom are supervisors and one of whom works part-time; a retailer compliance investigator; an IT security analyst; a licensing specialist; and an administrative assistant.

The Security Division conducts investigations in the following four areas:

- **Background investigations** are conducted for all Lottery staff, vendors, and retailers. In general, background checks include a fingerprint-based

criminal history check, confirmation the individual is current on state tax payments, and a personal interview.

- **Criminal investigation cases** are opened generally when lottery tickets have been stolen or compromised. The Lottery's criminal investigators work with retailers and local law enforcement to investigate issues that appear criminal in nature. If an investigator has sufficient evidence and determines a crime has been committed, he or she will work with local authorities to file charges.
- **Retailer compliance investigations** are conducted at random to monitor retailers to ensure that they abide by rules established by the Lottery and the Multi-State Lottery Association (MUSL), which administers the Powerball and Mega Millions jackpot games, as well as to advise retailers on best practices to protect themselves from the theft of lottery tickets.
- **Complaints** from consumers or retailers are also addressed by the Security Division when there are issues with validating lottery tickets or paying prizes for winning tickets or when there are inquiries about scams. Complaints investigated by the Security Division may also lead to a retailer compliance investigation being opened.

### **What audit work was performed and what was the purpose?**

We reviewed statutes and rules regarding the security and integrity of the Lottery, as well as the Lottery's policies and procedures on conducting investigations for background checks, criminal issues, retailer compliance, and complaints. We also interviewed security supervisors and six security staff, including three investigators. We reviewed data on all of the investigations conducted by the Security Division during the period of January 2010 through May 2013, and we tested a sample of eight criminal and 12 retailer compliance investigation reports from Fiscal Year 2013 and 37 complaints made to the Lottery in Fiscal Years 2012 and 2013.

The purpose of our audit work was to determine whether the policies and procedures the Security Division employs to handle investigations are adequate to protect the security and integrity of the Lottery.

### **How were the results of the audit work measured?**

The Lottery Director has a statutory obligation to take action necessary to protect the security and integrity of the lottery games [Section 24-35-204(3)(m), C.R.S.]. As such, the Lottery has established policies and procedures for conducting investigations. These include, in part, the following:

- **Background investigations.** In response to a recommendation in the 2008 performance audit, the Lottery established a policy in 2009 requiring that background checks be updated every year for all Lottery employees and all vendor employees with access to Lottery data.
- **Criminal investigations.** All criminal investigations must be entered into the Lottery's criminal investigation database and must remain open in the database until resolved—whether the resolution consists of providing information to a local law enforcement agency or working with a retailer to file charges against a suspect.
- **Compliance investigations.** All retailer compliance investigations must include a completed Retailer Compliance Report form which the Lottery uses to document information related to compliance with the Lottery's and MUSL's requirements and industry best practices, such as information about the retailer's surveillance system.
- **Complaints.** All complaints must be entered into the Lottery's complaint database and should be responded to within 1 business day. Investigators are to document whether the complaint was sustained or not, and explain how the complaint was resolved.

### **What problem did the audit work identify?**

We found the following deficiencies in the Lottery's background and criminal investigation policies and procedures.

- **Vendor background rechecks not conducted consistently.** We found that the Lottery does not track which vendor employees should undergo annual background rechecks. For the 277 vendor employees who received initial background checks between January 2008 and June 2012, the Lottery conducted a recheck for only 20 of these and could not say whether the other 257, or others, should have also received one or more annual rechecks. Vendor employees who have not undergone annual rechecks include Scientific Games employees who have access to the Lottery's gaming system and gaming terminals, and Cactus Communications employees who provide services that promote the Lottery and its image.
- **Improper classifications of criminal investigations.** Of the eight criminal investigation cases we reviewed in the investigation database, we found that an investigator closed one case even though it was still active and a decision to file charges had not yet been made.

## Why did the problem occur?

The issues we identified occurred because the Lottery's policies and procedures for conducting security investigations contain the following deficiencies.

- **Written policies and procedures are not comprehensive.** The Lottery has not established comprehensive, written policies and procedures that give adequate detail on conducting and documenting criminal and compliance investigations. Specifically:
  - For criminal investigations, the Lottery relies on an investigation database, rather than on written policies and procedures, to provide guidance to investigators. Investigators are instructed to use the database data fields as the written guidance on what should comprise a criminal investigation, but these data fields do not include detailed, comprehensive instructions, such as how to categorize cases, when follow up on a case is warranted, or when it is appropriate to close a case. Investigators have received verbal direction from supervisors, but this direction has not been consistent.
  - For compliance investigations, the Lottery relies on a paper checklist, the Retailer Compliance Report form, rather than on written policies and procedures to provide guidance to staff. This method has resulted in inconsistencies in the level of detail investigators document on the form. For example, some of the retailer compliance investigation reports we reviewed contained detailed information on the retailer's surveillance system, whereas others simply stated whether or not there was a surveillance system in place. Because the Lottery does not have written guidance on the level of detail that should be included, we could not determine, for the 12 cases we tested, whether the level of detail provided by the investigators was appropriate.
- **Supervisory review is inconsistent and not documented.** For vendor background rechecks, the Lottery was not aware that staff were not conducting rechecks because a supervisor was not monitoring staff to ensure all rechecks were occurring. For criminal investigations, both security supervisors stated that they regularly meet with the four staff investigators to discuss investigations and will review some cases at their discretion. However, the meetings and file review are not being documented or conducted systematically and thus, they could not confirm which cases had been reviewed or what the reviews had entailed.
- **Training should be improved.** The Lottery's investigators reported that, in addition to a lack of comprehensive written guidance and systematic

supervisory review, they have had to learn how to conduct investigations “on the job” in large part, and through trial and error. Investigators stated that having additional guidance would be helpful.

According to the Lottery, in 2012 it began experiencing problems with the functionality of the investigation database, including not being able to access the system, print case reports, generate workload reports of opened and closed cases, or record supervisory review of case files. The Lottery reports that it has been working with the software vendor and the Governor’s Office of Information Technology since October 2012 to make the system more reliable but has been hesitant to implement further written guidance on conducting investigations or monitoring investigators until the database issues are addressed. However, the temporary absence of the database tool should not preclude the Lottery from establishing comprehensive guidance for investigative staff on the standards to adhere to for conducting and documenting investigations and monitoring activities.

### **Why does the problem matter?**

It is important that the Lottery have the appropriate controls in place to help ensure the integrity of the Lottery, as well as that of its retailers and vendors. Sufficient controls should be in place to ensure that those who compromise the integrity of the Lottery, including those who commit criminal acts, are properly disciplined. Failing to conduct regular vendor background rechecks increases the risk that a vendor’s employees may have criminal histories that prohibit access to Lottery information and could result in the loss of player confidence, the loss of lawmaker confidence, and ultimately the loss of revenue. Additionally, failing to completely and accurately document the results of investigations makes it difficult for supervisors to monitor the investigation process and ensure that the Lottery takes the appropriate steps. Also, the Lottery uses data about the retailer compliance investigations as one of the performance goals in its annual Strategic Plan, and as such, it is also important that these investigations are consistently represented.

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### **Recommendation No. 6:**

The Colorado Lottery should improve its investigation processes by:

- a. Establishing comprehensive, written policies and procedures for conducting all types of investigations, including which staff are responsible for which aspects of the process, and when and how follow-up actions should occur.

- b. Establishing a system of supervisory review that ensures cases will be closed appropriately and all investigative activities will be clearly delegated and documented.
- c. Providing ongoing training to staff as needed after comprehensive investigative processes have been implemented.

### **Colorado Lottery Response:**

- a. Agree. Implementation date: January 2014.

The Lottery will establish the necessary processes and policies in writing for conducting all types of investigations, which will include staff responsibilities and expected follow-up actions.

- b. Agree. Implementation date: January 2014.

The Lottery will establish a system of supervisory review to ensure appropriate case closure. The Lottery will also adopt policies to ensure that all investigative activities are clearly delegated and documented.

- c. Agree. Implementation date: January 2014.

The Lottery will develop an ongoing training plan and start the appropriate training for Security staff after establishing comprehensive guidance for investigative staff on the standards to adhere to for conducting and documenting investigations and monitoring activities.

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