



# **STATE OF NORTH CAROLINA**

## **PERFORMANCE AUDIT**

### **NORTH CAROLINA EDUCATION LOTTERY MANAGEMENT PRACTICES**

**APRIL 2008**

**OFFICE OF THE STATE AUDITOR**

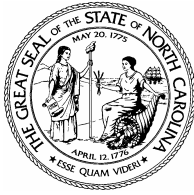
**LESLIE W. MERRITT, JR., CPA, CFP**

**STATE AUDITOR**

**PERFORMANCE AUDIT**

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MANAGEMENT PRACTICES**

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STATE OF NORTH CAROLINA  
Office of the State Auditor

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April 10, 2008

The Honorable Michael F. Easley, Governor  
Members of the North Carolina General Assembly  
Mr. Thomas Shaheen, Executive Director, North Carolina Education Lottery

Ladies and Gentlemen:

We are pleased to submit this performance audit entitled *North Carolina Education Lottery Management Practices*. The audit objectives were to determine whether the North Carolina Education Lottery (NCEL) uses performance management best practices, whether NCEL management compensation is comparable to lotteries in other states, and whether NCEL employee and vendor ethnic diversity reflects the ethnic diversity of North Carolina's general population. Mr. Thomas Shaheen has reviewed a draft copy of this report, and his written comments are included in the appendix.

We wish to express our appreciation to the North Carolina Education Lottery staff for the courtesy, cooperation, and assistance provided us during the audit.

Respectfully submitted,

A handwritten signature in cursive script that reads "Leslie W. Merritt, Jr.".

Leslie W. Merritt, Jr., CPA, CFP  
State Auditor

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# PERFORMANCE AUDIT

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## SUMMARY

### PURPOSE

This audit report evaluates North Carolina Education Lottery (NCEL) performance management practices and makes recommendations so management can take appropriate corrective action. This report also evaluates NCEL management compensation, employee ethnic diversity, and minority business participation so interested parties can determine if the compensation and diversity levels are reasonable.

### RESULTS

Our audit identified four NCEL performance management weaknesses. The NCEL is primarily a sales organization tasked with maximizing net revenues to fund education programs. As a sales organization, NCEL core management functions should include preparing accurate revenue forecasts, planning and monitoring operations, using effective marketing and advertising, improving operations, and accurately accounting for expenses. However, NCEL suffers from four performance management weaknesses, including: no documented revenue forecasting methodology, no formal strategic plan, no ongoing marketing or operational research, and no full-cost accounting of promotional events. These weaknesses may prevent NCEL from achieving its sales goals.

Our audit did not identify any issues with NCEL management compensation. NCEL management compensation is in line with lottery management compensation of bordering states. NCEL paid merit pay to personnel based on approved performance criteria.

Our audit determined that the ethnic diversity of NCEL management and staff is similar to that of North Carolina's general population. We also determined that NCEL exceeded the minority participation goals included in the North Carolina State Lottery Act (*North Carolina General Statute* 18C-141a). The Lottery Act does not require specific levels of ethnic minority business participation. However, the majority of NCEL minority participation purchases were from businesses owned by women. NCEL made less than two percent of total purchases from ethnic minority businesses.

### RECOMMENDATIONS

NCEL should document its revenue forecasting methodology, along with the underlying assumptions, and make it available to all participants in the budget process. NCEL should also analyze variances between previous revenue projections and actual results to improve the forecast methodology.

NCEL should establish a strategic plan that documents its goals, its operational plans, and its methods for measuring results. A documented strategic plan will improve accountability and enhance operational effectiveness.

NCEL should establish ongoing operational and market research to identify industry best practices, reduce costs, and improve operations. Market research will also allow NCEL to identify industry trends, evaluate advertising effectiveness, and determine customer satisfaction.

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NCEL should measure the full costs of marketing efforts, including sponsorships. Accurate cost measurement will allow the NCEL to analyze the return on marketing investment and determine cost effectiveness.

NCEL officials should review minority business participation results and determine if the intent of the legislation has been met.

### **AGENCY'S RESPONSE**

The Agency's response is included in the appendix.

### INTRODUCTION

#### **BACKGROUND**

Chapter 18C of the *North Carolina General Statutes* created the North Carolina Education Lottery (NCEL) in August of 2005 as a self-supporting enterprise fund to generate funds for education purposes. The Lottery Act established a nine-member North Carolina Lottery Commission responsible for starting, supervising, and administering the Lottery. The North Carolina Lottery Commission was appointed in September 2005 and held its first meeting on October 6, 2005. On November 17, 2005, the North Carolina Lottery Commission hired an Executive Director who began work on December 7, 2005.

NCEL headquarters is in Raleigh, North Carolina. The Lottery has regional offices in Asheville, Charlotte, Greensboro, and Greenville. The headquarters and regional offices each have a claim center, with an additional claim center in Wilmington. NCEL has 213 employees across nine divisions: human resources, legislative/corporate communications, legal/security, sales, marketing/advertising, finance, administration, management information systems, and gaming systems.

The Lottery sold tickets for three months in the 2006 fiscal year and achieved revenues of \$205.7 million. In the 2007 fiscal year, the Lottery had revenues of \$885.6 million. Lottery ticket retailers receive a 7% commission on each lottery ticket sold. Lottery administration expenses are limited to 8% of revenues, and no more than 1% of this amount may be spent on advertising. NCEL pays out at least 50% of revenues in prizes and, to the extent practicable, transfers 35% of revenue to the Education Lottery Fund. In the 2007 fiscal year, \$325.4 million was transferred to the Education Lottery Fund to support class size reduction, More at Four programs, school construction, and scholarships for students qualifying for Federal Pell Grants at North Carolina universities and colleges.

#### **OBJECTIVES, SCOPE, AND METHODOLOGY**

The audit objectives were to determine whether NCEL uses performance management best practices, whether management compensation is comparable to lotteries in other states, and whether NCEL employee and vendor ethnic diversity reflects the ethnic diversity of North Carolina's population.

The State Auditor initiated this audit at the request of the North Carolina Legislative Black Caucus Economic Development Committee.

The audit scope included operations of the North Carolina Educational Lottery from its beginning on March 30, 2006, until September 30, 2007.

To accomplish our audit objectives, we observed operations at the NCEL. We also interviewed personnel at the NCEL, Lottery contractors, General Assembly Fiscal Research Division, and Office of the Governor. We obtained operational and performance information from lotteries in bordering and similar size states. We reviewed contracts and performed analyses and tests of information and documentation.

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

This report contains the audit results, including conclusions and recommendations. Because of the test nature and other inherent limitations of an audit, together with limitations of any system of internal and management controls, this audit would not necessarily disclose all weaknesses in the systems or lack of compliance.

We conducted the fieldwork from August 2007 to December 2007. We conducted this audit under the authority vested in the State Auditor of North Carolina by *North Carolina General Statute 147.64*.



## FINDINGS AND RECOMMENDATIONS

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### 1. LOTTERY PERFORMANCE MANAGEMENT PRACTICES NEED IMPROVEMENT

The North Carolina Education Lottery (NCEL) is primarily a sales organization tasked with maximizing net revenues to fund education programs. As a sales organization, NCEL core management functions should include preparing accurate revenue forecasts, planning and monitoring operations, using effective marketing and advertising, improving operations, and accurately accounting for expenses. However, NCEL suffers from four performance management weaknesses, including: no documented revenue forecasting methodology, no formal strategic plan, no ongoing marketing or operational research, and no full-cost accounting of promotional events. These weaknesses may prevent NCEL from achieving its sales goals.

#### **Lack of documented revenue forecasting methodology**

One weakness in NCEL performance management practices is the lack of a formal documented revenue forecasting methodology. Instead, the Lottery revenue forecast in the State budget is a consensus between the NCEL Executive Director, Legislature, and Governor's Office. The lack of formal documentation could result in miscommunication and inaccurate revenue forecasts.

The NCEL Executive Director said he did not have formal documentation for the 2007 lottery revenue projection methodology, but he would attempt to recreate the thought process. When preparing his original revenue projection, the NCEL Executive Director tried to meet estimates made by the Fiscal Research Division and the Governor's Office. The Executive Director said the first year revenue estimate, \$1.2 billion in sales and \$425 million (35%) in return, were determined prior to the Lottery getting started. He wrote "I tried to back into the \$1.2 billion predetermined number as close as possible. In the end, the closest I felt comfortable with was \$1.148 billion based on the information I obtained and that was a stretch."

Based on the NCEL Executive Director's response that the Lottery revenue projection was predetermined, we asked the Senior Policy Advisor for Fiscal Affairs at the Governor's Office for documentation of the revenue forecast methodology. The Governor's Office responded that it researched and discussed the matter with the Fiscal Research Division of the General Assembly, but it did not have detailed support for the methodology. The Governor's Office referred us to the Fiscal Research Division for the supporting documentation.

The Fiscal Research Division did not provide formal documentation for its original Lottery revenue estimate, but a representative discussed the revenue forecast methodology with us. Fiscal Research based its forecast on the lottery experience of Georgia, Florida, Virginia, South Carolina, Tennessee and the budgeted first year numbers for the new Oklahoma lottery. Fiscal Research, however, did not consider its original lottery forecast as a predetermined number. A Fiscal Research representative told us, "The first year 'planning estimate' of Fiscal Research was \$425 million. I use the term 'planning estimate' because in the spring of 2005 there was no formal revenue

## FINDINGS AND RECOMMENDATIONS

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estimate requirement, and we did not know the details of the final lottery legislation. The final details were hashed out in the final budget process.” Fiscal Research believed they had reached a consensus with the NCEL Executive Director and said, “In a meeting with the new director of the NC lottery around this time, the director indicated that \$425 million was achievable under the commission’s planned aggressive roll-out of new games.”

We reviewed the Government Finance Officers Association (GFOA) recommended practices to identify management best practices. GFOA promotes policies and practices that enhance sound financial management of public resources. GFOA also awards the Certificate of Achievement for Excellence in Financial Reporting that North Carolina has received every year since 1994 for its Comprehensive Annual Financial Report.

GFOA recommends that “The forecast, along with its underlying assumptions and methodology, should be clearly stated and made available to participants in the budget process. It also should be referenced in the final budget document.”<sup>1</sup> Following this advice would help ensure that a true consensus is reached. Also, if revenue projections are not achieved, a documented forecast methodology will help NCEL management determine what went wrong.

Further, GFOA recommends “To improve future forecasting, the variances between previous forecast and actual amounts should be analyzed.” A documented forecast methodology would help NCEL management perform this analysis. NCEL prepares quarterly financial reports with variances noted between actual revenues and budgeted revenues, but the reports do not include a variance analysis to identify the factors that influenced Lottery revenues and forecast assumptions.

It is important to develop a reliable revenue forecasting methodology because schools and students were promised Lottery receipts for new construction, class size reduction, and scholarships. The 2007 fiscal year State budget called for \$1.2 billion in Lottery sales and \$425 million in education transfers. Actual sales for 2007 were short by \$325 million, and education transfers fell short by nearly \$111 million.

NCEL does not have formal documentation of the underlying assumptions and methodology for the 2008 fiscal year revenue forecast. The 2008 fiscal year budgeted Lottery sales and transfers are approximately 20 percent less than the 2007 fiscal year projections. The 2008 fiscal year State budget calls for \$957.7 million in Lottery sales and \$341 million in education transfers. Lottery sales for the first half of the 2008 fiscal year were only \$433 million. If sales for the last half of the year are the same, Lottery sales will be about \$91 million short of projections for the year, and education transfers will fall short by nearly \$32 million from the original projections.

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<sup>1</sup> GFOA, Financial Forecasting in the Budget Preparation Process, 1999

## FINDINGS AND RECOMMENDATIONS

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### **Lack of a formal strategic plan**

Another weakness in NCEL performance management practices is the lack of a formal strategic plan. A strategic plan documents an agency's goals, planned operations, and methods to measure results. A strategic plan can improve accountability and operational effectiveness. A strategic plan can be considered an agency's business plan.

GFOA recommends that "all government entities use some form of strategic planning to provide a long-term perspective for service delivery and budgeting, thus establishing logical links between authorized spending and broad organizational goals."<sup>2</sup> We identified several state lotteries that use strategic planning including California, Delaware, Iowa, Idaho, Texas, Florida, Minnesota, and Washington. GFOA recommends that strategic plans include the following:

- Mission Statement - broad but clear statement of an organization's primary purpose.
- Environmental Assessment - thorough analysis of an organization's internal (resources, capabilities) and external (society, economy, competitors, technology, political, legal) environment that identifies strengths, weaknesses, opportunities, and threats (SWOT).
- Goals - address the most critical issues identified in the environmental assessment.
- Action Plan - describes how strategies will be implemented and includes activities and services to be performed, associated costs, designation of responsibilities, priority order, and time frame involved for the organization to reach its strategic goals.
- Measurable Objectives - specific, measurable results to be achieved that can be expressed in quantities, or are at least verifiable statements, and ideally include time frames.
- Performance Measures - provide information on whether goals and objectives are being met.

NCEL does not have a documented strategic plan or a business plan. There was no formally documented business plan for the start of the Lottery, only an outline for the first three years. There are marketing plans for the first full year and the current year, which NCEL management views as a business plan. Marketing plans, however, are not as comprehensive as strategic plans. The NCEL marketing plan lacks three necessary components of a strategic plan.

First, the 2006 and 2007 NCEL marketing plan lacks an environmental assessment. The marketing plan does not identify risk factors that could prevent the Lottery from achieving its goals, nor does it identify ways to mitigate those risks. A separate Microsoft PowerPoint presentation titled "North Carolina Education Lottery Fiscal Year 2007 Marketing Plan" identifies some challenges and opportunities; however, they are limited to marketing and advertising. NCEL did not document a comprehensive SWOT

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<sup>2</sup> GFOA, Recommended Budget Practice on the Establishment of Strategic Plans, 2005

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analysis. A similar presentation titled “North Carolina Education Lottery Fiscal Year 2008 Marketing Plan” includes a SWOT analysis, but it mainly focuses on 2007 marketing achievements and 2008 marketing objectives.

As an example of a more comprehensive environmental assessment, risks identified in Washington’s 2007-2009 State Lottery Business Plan include: rapidly changing buying practices, core customers aging, relationships and communication with stakeholders, decreasing playership, loss of revenue to Internet gaming, advertising challenges, and loss of knowledge due to employee retirements. The plan then identifies several opportunities that will help the Washington Lottery achieve its goals.

Second, the NCEL marketing plan lacks measurable goals and objectives. Of the documented 2006 and 2007 NCEL Marketing Plan advertising objectives and goals “to maximize proceeds,” 15 out of 18 are not expressed as measurable or verifiable statements. Without stated measurement criteria, it is difficult to determine whether the Lottery has achieved its stated goals. The 2008 NCEL marketing plan also lacks measurable goals and includes undefined marketing objectives such as:

- Create excitement and communicate key benefits of Instant Scratch-Off tickets in order to grow the brand
- Foster a positive public image by reinforcing the mission to raise revenue for education
- Project an entertaining, socially acceptable brand image
- Emphasize NCEL success via healthy beneficiary communications
- Create excitement by promoting lottery winners

Third, the NCEL marketing plan does not identify the performance measures that it will use to track progress toward achieving the stated marketing objectives. GFOA recommends, “Performance measures should be based on program goals and objectives that tie to a statement of program mission or purpose and measure program outcomes.”<sup>3</sup>

Although they are not documented in the marketing plan, NCEL maintains a list of monthly task-oriented measures including:

- Ensure proper jackpot amounts updated on all outdoor boards
- Issue winner press release twice weekly
- Internal upward mobility
- Retailer website availability
- All vehicles must be serviced according to Motor Fleet Management “Schedule of Preventative Maintenance”

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<sup>3</sup> GFOA, Performance Management: Using Performance Measurement for Decision Making, 2007

## FINDINGS AND RECOMMENDATIONS

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While these are important measures to the Lottery, they do not measure progress toward achieving the marketing objectives listed in the NCEL marketing plan. For example, the task “Issue winner press release twice weekly” may contribute to the marketing objective “Create excitement by promoting winners,” but it does not measure how much excitement has been created. The Texas and Maryland lotteries collect data for a variety of performance measures that may be relevant to the NCEL marketing objectives, such as:

- Customer satisfaction
- Retailer satisfaction
- Public awareness
- Revenue received per advertising dollar
- Percent of eligible players served
- Public approval

A formally documented strategic plan can be instrumental in improving lottery performance. In Minnesota, lottery proceeds to the state had declined from \$87 million in 2000 to \$79 million in 2003 as a result of increasing operational expenses and decreasing sales. As part of its response to a 2004 legislative audit, the Minnesota State Lottery developed a strategic plan that included a SWOT analysis, purpose statement, vision statement, mission statement, long-term goals, values, and key strategies. As part of the process, lottery management also performed market research, developed new marketing plans, and identified operational cost savings. As a result of these efforts, the Minnesota State Lottery increased sales, decreased operational costs, and increased proceeds to the state. Proceeds to the state reached \$100 million by the end of 2004 and a record high of \$120 million by the end of 2006.

### **Lack of operational and market research**

Another weakness in NCEL performance management practices is the lack of ongoing operational and market research. Ongoing operational research is necessary to identify industry best practices, reduce costs, and improve operations. In addition, market research is necessary to identify industry trends, evaluate advertising effectiveness, and determine customer satisfaction.

Other state lotteries conduct a range of research activities. For example, the Minnesota State Lottery surveyed 39 state lotteries in 2004 to identify best practices in lottery organization and oversight. The Florida Lottery conducts studies and surveys to determine consumer purchasing preferences, game awareness, and public attitudes. And the Texas Lottery uses focus groups to evaluate instant game concepts and to receive feedback from players on game issues.

The NCEL has not established similar operational or market research practices. The Lottery receives some market information from the public and retailers through its hotline

## FINDINGS AND RECOMMENDATIONS

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and sales force. Also, Oberthur Gaming Technologies conducted a retailer survey for the Lottery in late 2006, and Mindful Research conducted focus group studies on general game play and ticket appearance preferences in early 2007. But the NCEL has not performed the research required by the Lottery Act or the FY 2007 marketing plan.

Although there is no specific time requirement, *North Carolina General Statute* §18C-120(b)(8) requires the NCEL Executive Director:

*“To study the operation and administration of other lotteries and to collect demographic and other information concerning the Lottery and make recommendations to improve the operation and administration of the Lottery to the Commission, to the Governor, and to the General Assembly.”*

Also, the NCEL FY 2007 Marketing Plan says the Lottery will:

- *Develop a research plan to obtain information concerning the Lottery and make recommendations to improve the operation and administration of the Lottery.*
- *Conduct quarterly tracking studies to track playership, advertising awareness and corporate beneficiary awareness and understanding.*
- *Develop market based information through communications with other lotteries to improve existing products.*

However, NCEL management has not submitted improvement recommendations to the Lottery Commission, Governor, or General Assembly. Also, the NCEL has not performed surveys to evaluate advertising awareness or effectiveness.

NCEL may miss opportunities to reduce expenses due to a lack of research. NCEL may not identify inefficient operational procedures because NCEL does not research best practices. Additionally, NCEL could spend funds on ineffective advertising or marketing activities. NCEL spent approximately \$8.8 million for advertising and marketing in FY 2007 to increase awareness, improve acceptance, and increase sales. Due to a lack of surveys and other market research methods, the NCEL cannot quantify the effectiveness of any individual marketing effort.

### **Lack of full cost accounting for marketing activities**

Another weakness in NCEL performance management practices is the lack of full cost measurement for promotional events. NCEL reported approximately \$1.6 million in expenditures for sponsorships and related items in FY 2007. NCEL post-promotional event analyses account for contract costs such as trailer and booth space. But the cost of salaries, wages, sales commissions, vehicles, meals, lodging, and shared costs associated with the events are not included. In addition, the costs of promotional items are not consistently included in the analyses.

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Other lotteries measure the full costs of promotions. The Washington State Lottery measures everything associated with promotions. The Oklahoma Lottery measures the cost of transporting lottery trailers, employee travel costs, promotional items, and employee salaries. The Maryland Lottery measures the costs of the event, staff, booth design, supplies, and promotional gifts.

The Government Finance Officers Association (GFOA) recommends that “governments calculate the full cost of the different services they provide.”<sup>4</sup> Measuring the full cost of organization activities is useful for measuring performance, benchmarking, measuring cost efficiency and effectiveness, and determining the rate of return.

NCEL cannot accurately evaluate the cost effectiveness of event and sports sponsorships because NCEL does not measure the full costs of these marketing efforts. As a result, the Lottery may incur marketing costs with no beneficial rate of return.

Promotional events may not necessarily result in an immediate return on investment. NCEL management said,

*“Our primary purpose of doing events is to reach out to the public, educate them on lottery games and benefit programs, and to give something back to the communities that support the lottery.”*

NCEL management said that participating in promotional events results in long term benefits that cannot be measured.

However, the Advertising Research Foundation (ARF)<sup>5</sup> identifies several methods for measuring the short and long-term benefits of marketing efforts, including promotional events. ARF is an advertising industry association whose mission is “to improve the practice of advertising, marketing, and media research in pursuit of more effective marketing and advertising communications.” Marketing goals generally fit into one of three categories: (1) improving product or service image, (2) increasing public awareness, or (3) increasing sales. ARF lists methods for measuring return on marketing investment such as surveys, focus groups, experiments, and sales analysis. As noted above, NCEL lacks ongoing market research efforts to determine if its marketing efforts are effective.

**Recommendations:** NCEL should document its revenue forecasting methodology, along with the underlying assumptions, and make it available to all participants in the budget process. NCEL should also analyze variances between previous revenue projections and actual results to improve the forecast methodology.

NCEL should establish a strategic plan that documents its goals, its operational plans, and its methods for measuring results. A documented strategic plan will improve accountability and enhance operational effectiveness.

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<sup>4</sup> GFOA, Measuring the Cost of Government Service, 2002

<sup>5</sup> [www.thearf.org](http://www.thearf.org)

## FINDINGS AND RECOMMENDATIONS

NCEL should establish ongoing operational and market research to identify industry best practices, reduce costs, and improve operations. In addition, market research will allow NCEL to identify industry trends, evaluate advertising effectiveness, and determine customer satisfaction.

NCEL should measure the full costs of marketing efforts, including sponsorships. Accurate cost measurement will allow the NCEL to analyze the return on marketing investment and determine cost effectiveness.

### 2. NCEL MANAGEMENT COMPENSATION IS COMPARABLE TO SURROUNDING STATES

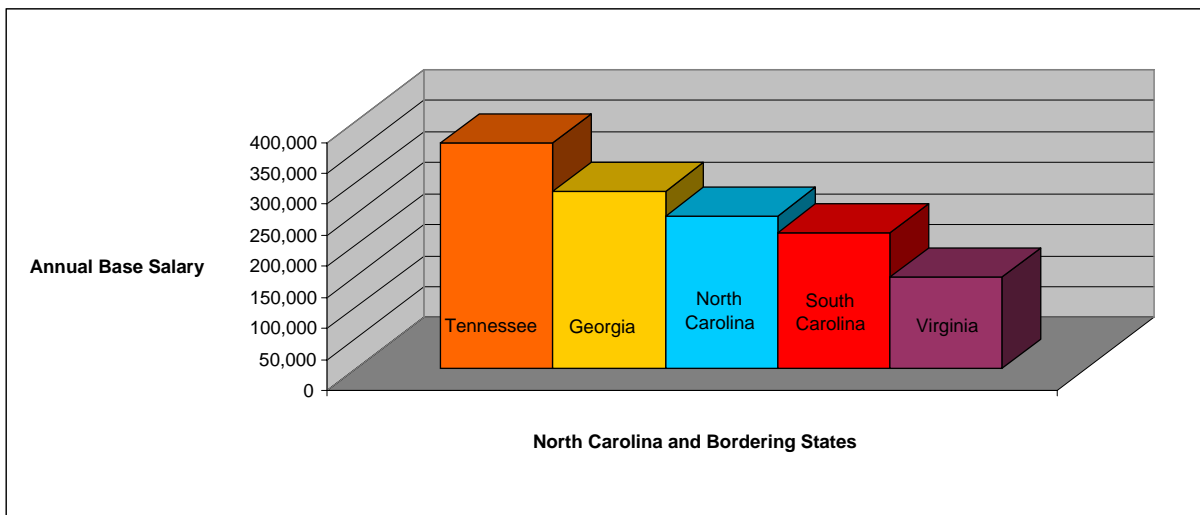
North Carolina Education Lottery (NCEL) management compensation is in line with lottery management compensation of bordering states. NCEL paid merit pay to personnel based on approved performance criteria.

#### Management compensation

Compensation should not be excessive, but it should be sufficient to attract and retain personnel with the skills and abilities necessary to effectively manage operations.

Salary comparisons indicate that the NCEL Executive Director compensation is in line with salaries of other lottery executive directors in bordering states. The executive director qualifications and responsibilities at surrounding state lotteries, except for Virginia, are comparable to those at NCEL. Virginia's Executive Director is a gubernatorial appointed position and does not require prior lottery experience. Chart 1 below shows that executive director base salaries in surrounding states ranged from \$146,943 to \$363,264.

**Chart 1 - Executive Director Compensation**



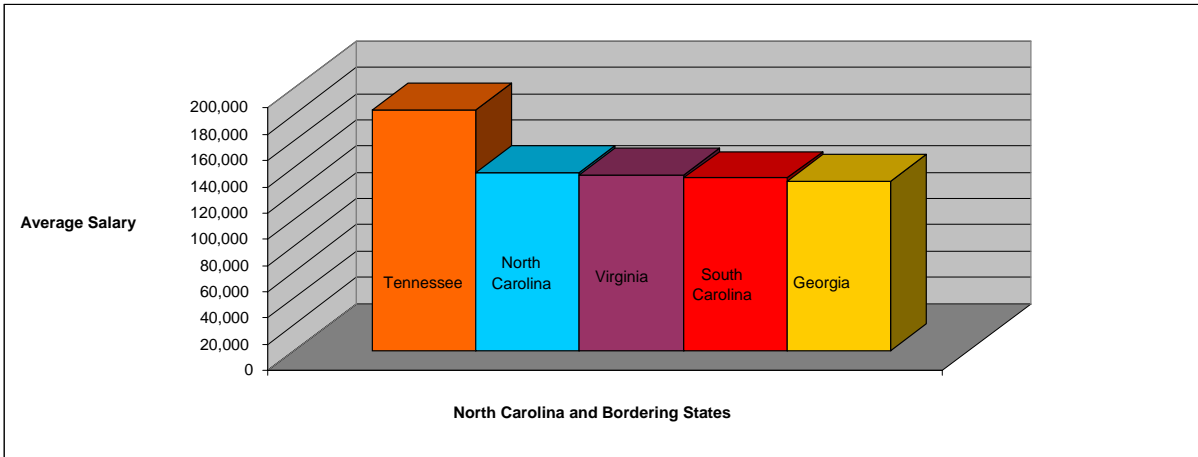
**Source:** Audit staff inquiry of state lotteries



## FINDINGS AND RECOMMENDATIONS

Salary comparisons also indicate that the NCEL executive management compensation (excluding the Executive Director) is in line with salaries of other lottery executive managers in bordering states. Executive management qualifications and responsibilities also vary among the state lotteries. Chart 2 below shows that executive management base salaries in surrounding states ranged from \$129,333 to \$185,226.

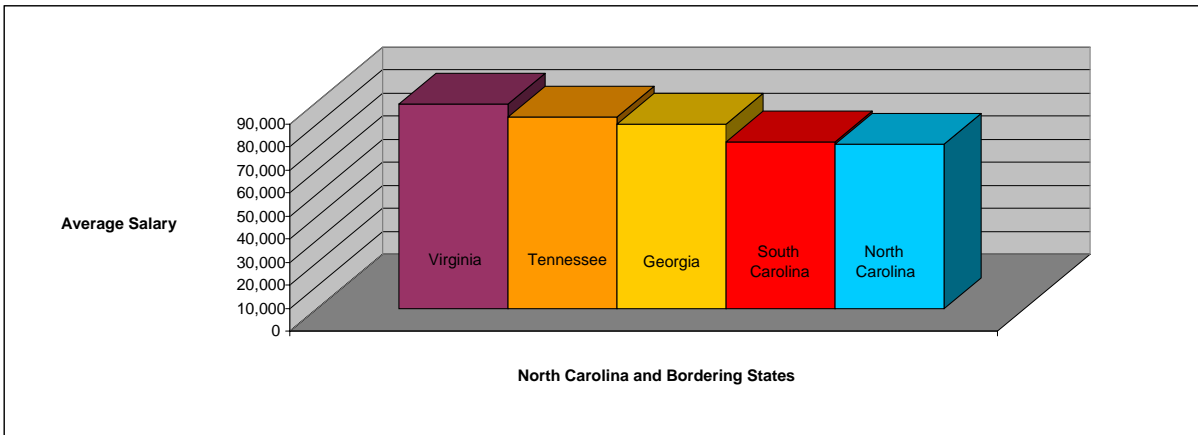
**Chart 2 - Executive Management Compensation**



**Source:** Audit staff inquiry of state lotteries

Lastly, salary comparisons indicate that the NCEL middle management compensation is also in line with salaries of other lottery middle management in bordering states. Chart 3 below shows that middle management base salaries in surrounding states ranged from \$71,071 to \$88,474.

**Chart 3 - Middle Management Compensation**



**Source:** Audit staff inquiry of state lotteries

## FINDINGS AND RECOMMENDATIONS

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### **Lottery merit pay**

Management best-practices require NCEL to base merit pay and other incentives on performance evaluations.

NCEL paid merit pay to personnel based on approved performance criteria. The North Carolina Lottery Commission authorized one time “start-up” merit pay for all employees on December 8, 2005. The start-up pay was contingent on Lottery ticket sales starting by April 5, 2007. Lottery scratch-off ticket sales began on March 30, 2007, and NCEL personnel received merit pay pro-rated according to individual pay rates and employment start dates.

Merit pay was paid to 162 Lottery employees and totaled \$624,104. Merit pay amounts ranged from \$50,000 for the Executive Director to \$250 awarded to eleven employees in the lowest salary band and hired after March 15, 2006.

***Recommendations:*** There are no recommendations for this issue.

### **3. NCEL MANAGEMENT, STAFF, AND VENDORS ARE ETHNICALLY DIVERSE**

The ethnic diversity of North Carolina Education Lottery (NCEL) management and staff is similar to that of North Carolina’s general population. NCEL has exceeded the minority participation goals included in the North Carolina State Lottery Act. However, the majority of NCEL minority participation purchases are from businesses owned by women. NCEL made less than two percent of total purchases from ethnic minority businesses.

### **Management and staff diversity**

Diversity in the workplace improves decision-making and operations due to contributions from individuals with different backgrounds, experiences, and ideas.

NCEL is “committed to an employment policy of non-discrimination” and has established appropriate policies. As a result of its human resource practices, the ethnic diversity of NCEL management and staff closely reflects that of North Carolina’s general population.

## FINDINGS AND RECOMMENDATIONS

Tables 1 - 3 below compare the ethnic diversity of NCEL employees to North Carolina's population statistics from the U.S. Census Bureau.

<b>Table 1 - Executive Management Diversity</b>			
	<u>NCEL</u>		<u>North Carolina</u>
	<u>Number</u>	<u>%</u>	<u>%</u>
Caucasian	6	85.7	67.9
African American	1	14.3	21.7
Hispanic	0	0	6.7
Asian	0	0	1.9
American Indian	0	0	1.3
Other	0	0	0.5

**Source:** NCEL personnel records and U.S. Census Bureau

<b>Table 2 - Middle Management Diversity</b>			
	<u>NCEL</u>		<u>North Carolina</u>
	<u>Number</u>	<u>%</u>	<u>%</u>
Caucasian	26	68.4	67.9
African American	8	21.0	21.7
Hispanic	2	5.3	6.7
Asian	2	5.3	1.9
American Indian	0	0	1.3
Other	0	0	0.5

**Source:** NCEL personnel records and U.S. Census Bureau

<b>Table 3 - Staff Diversity</b>			
	<u>NCEL</u>		<u>North Carolina</u>
	<u>Number</u>	<u>%</u>	<u>%</u>
Caucasian	99	58.6	67.9
African American	64	37.9	21.7
Hispanic	5	2.9	6.7
Asian	1	0.6	1.9
American Indian	0	0	1.3
Other	0	0	0.5

**Source:** NCEL personnel records and U.S. Census Bureau

## FINDINGS AND RECOMMENDATIONS

### Minority business participation

*North Carolina General Statute* 18C-141a establishes a goal of 10% participation by minority businesses in the total value of NCEL contracts with an estimated expenditure of \$90,000. Minority businesses are businesses with majority-ownership by one or more minority persons. Minority persons are defined by *North Carolina General Statute* as Black, Hispanic, Asian American, American Indian, or Female.

NCEL has exceeded the Lottery Act minority participation requirements. The minority participation rate only includes the businesses from which NCEL purchases goods or services. The retailers who sell lottery tickets are not included in the participation rate. NCEL has a 23.45% minority business participation rate for total purchases during our audit period.

The Lottery Act does not require specific levels of ethnic minority business participation. However, businesses owned by women account for the majority of the NCEL minority business participation. Ethnic minority business participation accounts for only a small percentage of total NCEL expenditures, as shown in Table 3 below.

<b>Table 4 - Minority Business Participation</b>		
	NCEL Purchases	
	Dollars	%
Women	8,422,452	21.54
African American	732,096	1.87
Hispanic	9,500	0.03
Asian	3,530	0.01
American Indian	0	0
Minority Business Purchases:	9,167,578	23.45
Other Purchases:	29,939,573	76.55
Total Purchases:	39,107,151	100

**Source:** NCEL 2006 and 2007 financial statements and minority participation records

**Recommendations:** NCEL officials should review minority business participation results and determine if the intent of the legislation has been met.

## APPENDIX

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John R. McArthur  
Commission Chairman



Thomas N. Shaheen  
Executive Director

*The North Carolina Education Lottery (NCEL) appreciates this opportunity to respond to the recent Performance Audit conducted by the Office of the State Auditor.*

*The audit scope stated in the Performance Audit was from the lottery's first ticket sales on March 30, 2006 until September 2007 during which time the NCEL had been in operation for 18 months. This audit covered the majority of the start-up period for the NCEL. We appreciate the State Auditor's thoroughness in looking at every area of the NCEL operation.*

**Recommendations:** NCEL should document its revenue forecasting methodology, along with the underlying assumptions, and make it available to all participants in the budget process. NCEL should also analyze variances between previous revenue projections and actual results to improve the forecast methodology.

NCEL should establish a strategic plan that documents its goals, its operational plans, and its methods for measuring results. A documented strategic plan will improve accountability and enhance operational effectiveness.

NCEL should establish ongoing operational and market research to identify industry best practices, reduce costs, and improve operations. In addition, market research will allow NCEL to identify industry trends, evaluate advertising effectiveness, and determine customer satisfaction.

NCEL should measure the full costs of marketing efforts, including sponsorships. Accurate cost measurement will allow the NCEL to analyze the return on marketing investment and determine cost effectiveness.

NCEL officials should review minority business participation results and determine if the intent of the legislation has been met.

### **Response:**

#### Revenue Forecasting Methodology

*We agree that since inception the NCEL has not had a formal documented revenue forecasting methodology. The first year's revenue forecast was established before the lottery began. For both FY07 and FY08, insufficient sales history existed to do a trend analysis. Given that we did not have any sales history for FY08 from which to forecast*

## APPENDIX

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future revenues, the NCEL base its revenue projections on per capita sales. Our Executive Director, with more than 20 years of lottery industry experience, consulted with other lotteries using the same per capita methodology. In order to use trend analysis we would need to compare revenue changes for several years and compute an average. For FY09, the NCEL will apply a more formal approach as recommended by utilizing two years of history.

### Strategic Plan

The NCEL does have an annual budget which serves as the comprehensive financial plan for the organization. The budget preparation process served a crucial role in guiding NCEL's management planning for the future, foreseeing problems and developing future policies. Although not coordinated into one document, the budget coupled with comprehensive marketing plan and a detailed project plan for start-up and thereafter guided the actions of the NCEL. The NCEL concurs that a strategic plan would benefit the organization and has begun work on such a plan to be in place for FY09. At start-up, the focus was on getting the organization up and running as quickly as possible with the greatest offering of game choices available to players in order to maximize the amount of money raised for education.

### Operational and Market Research

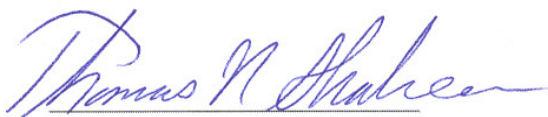
The NCEL's focus at start-up was to minimize administrative cost in order to maximize the return to education. We have relied heavily on North American State and Provincial Lotteries (NASPL) resources to identify industry best practices and industry trends. Objective, proprietary research concerning players, non-players, potential players, games, and advertising messaging and effectiveness are items that could cost \$100,000 or more for a single initiative. We will consider research for the future provided the NCEL commission and the legislature support such expenditures. The NCEL initiated a study of the operation and administration of other lotteries in June of 2007 in accordance with the North Carolina State Lottery Act. The Lottery Act does not specify a time for this to be done. A completed report will be provided to the Board of Commissioners at their May 2008 meeting.

### Cost Measurement of Promotion Events


We agree. While the NCEL has a methodology in place for evaluating the benefit and return on investment of promotion events, including sports sponsorships, we will improve our methodology to include some of the promotional costs highlighted in the audit.

### Minority Business Participation

As stated in this report, the NCEL has exceeded the Lottery Act minority participation requirements.



Thomas N. Shaheen  
Executive Director



Date



## **ORDERING INFORMATION**

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