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STATE COMPTROLLER



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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

October 15, 1996

Mr. Jeff Perlee
Director
Division of the Lottery
One Broadway Center
Schenectady, NY 12301

Re: Agent Selection and Licensing
Report 96-S-21

Dear Mr. Perlee:

Pursuant to the State Comptroller's authority as set forth in Section 1, Article V of the State Constitution and Section 8, Article 2 of the State Finance Law, we have audited selected aspects of the Division of the Lottery's agent selection and licensing practices for the period April 1, 1995 through June 30, 1996.

A. Background

The Lottery was authorized by constitutional amendment in 1966 and originally established in 1967. The New York State Division of the Lottery (Lottery) was established in 1976 by Section 1603 of the Tax Law as an independent Division of the Department of Taxation and Finance. The Lottery administers games of chance to raise revenue for public education in New York State. Section 1605 of that law authorizes the Lottery to license agents to sell lottery tickets.

Until 1995 the Lottery offered two types of lottery games: numbers games, in which winning numbers are periodically announced; and instant games, in which part of the ticket is scratched off to reveal whether the participant has won a prize. The Lottery has licensed over 11,000 agents to sell tickets for these types of games. Beginning in September 1995, the Lottery began offering a new, keno-type game called "Quick Draw." Quick Draw is offered primarily by bars and restaurants and is available every five minutes during certain hours of the day. During the fiscal year ended March 31, 1996, New York State lottery sales surpassed \$3.6 billion, with Quick Draw generating more than \$342 million of that amount in its first seven months of operation. The total sales for the year were higher than any lottery has ever achieved in North America.

B. Audit Scope, Objectives and Methodology

We audited selected aspects of the Lottery's procedures and practices for selecting and licensing agents for the period April 1, 1995 through June 30, 1996. The objectives of our performance audit were to determine whether these procedures adequately protected the State's interests in the games and whether these procedures were followed. To accomplish our objectives, we reviewed appropriate laws, rules, regulations, policies, and procedures. We also reviewed Lottery records and interviewed officials at the Lottery and the State Liquor Authority.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations which are included in our audit scope. Further, these standards require that we understand the Lottery's internal control structure and its compliance with those laws, rules, and regulations that are relevant to the operations which are included in our audit scope. An audit includes examining, on a test basis, evidence supporting transactions recorded in the accounting and operating records and applying such other auditing procedures as we consider necessary in the circumstances. An audit also includes assessing the estimates, judgements and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach to select activities for audit. We therefore focus our audit efforts on those activities we have identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, we use finite audit resources to identify where and how improvements can be made. We devote little audit effort to reviewing operations that may be relatively efficient or effective. As a result, we prepare our audit reports on an "exception basis." This report, therefore, highlights those areas needing improvement and does not address activities that may be functioning properly.

C. Results of Audit

In general, we determined that the Lottery maintains and follows procedures for selecting and licensing agents that adequately protect the State's interests in the games. However, we found the Lottery could improve its evaluation of prospective agents by documenting its assessments of the financial condition of each agent's business and the expected volume of lottery sales from that business. In addition, the Lottery could strengthen certain procedures concerning criminal background checks on agents to ensure that all agents are held to the same standards.

1. Processing of Agent Applications

The agent selection and licensing process begins when an applicant submits an agent application to a Lottery regional office to become an instant cash game agent, a full-service agent or a Quick Draw agent. The agent application is assigned to a Lottery field representative, who initiates an on-site evaluation of the applicant's business. The Lottery maintains records to document and monitor the progress of agent application reviews.

The field representative is supposed to verify the information on each application and evaluate certain factors in determining whether the applicant would make a suitable agent. These factors include the location of the applicant's business, the type of business, the type of customer base, existing Lottery sales in the immediate area, the accessibility for lottery sales, the hours of operation, and the quality of customer service. In addition, Section 1605 of the Tax Law and Lottery procedure 4G-203 state that, before issuing a license to any person, the Lottery must consider the financial responsibility and security of the applicant's business and the expected volume of lottery sales for the business.

We judgmentally selected the files relating to 48 Quick Draw and 120 on-line/instant game agent applications to determine whether Lottery field representatives verified the information on the applications and evaluated the required factors in determining whether the applicants would make suitable agents. In general, we found that the applications were processed appropriately with the exception of the required assessments of the applicants' financial responsibility and expected volume of lottery sales. We did not see evidence in the files that the applicant's financial responsibility was assessed in 31 Quick Draw and 39 on-line/instant game applications (42 percent of the total files reviewed). Similarly, we did not see evidence in the files that the expected volume of lottery sales was assessed in 39 Quick Draw and 83 on-line/instant game applications (73 percent of the total files reviewed).

Lottery officials told us that field representatives do not do formal checks into an applicant's credit history because credit reports are often not current, or are too open to interpretation for routine use. Rather, they do informal checks, such as assessing the adequacy of shelf stock as an indicator of financial security, but do not document the results of these checks. Regarding the expected volume of lottery sales, the officials told us that customer counts provided by an applicant are corroborated by the field representatives, but this corroboration is usually documented only on an exception basis (e.g., when the applicant's customer counts are not supportable and the application is denied).

Lottery officials also told us the Lottery is nearing the point at which all available terminals will be in use. Therefore, documenting the completion of the financial responsibility and volumes of sales assessments become of greater importance so that Lottery officials can be reasonably assured that as terminals become available they are placed in businesses that will likely remain a going concern (i.e., assessment of financial responsibility and security), and will provide the best opportunity to increase Lottery sales (i.e., volume of sales).

2. Criminal Background Checks

Section 1605 of the Tax Law authorizes the Lottery to obtain criminal background information on applicants for a Lottery license for the purpose of helping to determine whether a license should be granted, suspended, or revoked. In addition, according to Lottery procedure 4G-203, the Lottery is required to obtain this information, and each applicant is required to submit identifying information, including fingerprints, to the Lottery unless this information is already on file with other State agencies.

In general, after a prospective agent's application has been approved by regional and central office personnel, the Lottery's Security Unit checks the criminal background of the applicant by submitting the applicant's fingerprints to the New York State Division of Criminal Justice Services (DCJS). According to the Lottery's arrangement with DCJS, called a "search and retain" agreement, DCJS provides the Lottery with any criminal record a prospective agent has, and will notify the Lottery of any subsequent criminal activity by these agents.

The new Quick Draw game was implemented very rapidly and required the selection and licensing of 1,700 new agents between June and August 1995. In all, the Lottery licensed over 3,000 Quick Draw agents during the game's first nine months. During this period, the Lottery did not do criminal background checks for all Quick Draw license applicants. Rather, if a Quick Draw applicant already held a New York State liquor license for on-premises consumption, the Lottery relied on the State Liquor Authority's (SLA) licensing process, which includes criminal background checks. Of the 3,742 Quick Draw agents licensed by the Lottery at the time of our audit, 2,390 held a liquor license of this type. The remaining 1,352 Quick Draw agents either were on-line agents already and subject to the Lottery's criminal background checks, or were new Quick Draw applicants who did not have a SLA license and received the Lottery's normal criminal background investigation.

However, we found that the Lottery did not enter into a formal agreement with the SLA to require the SLA to inform Lottery officials of any subsequent criminal activity by the 2,390 agents who hold SLA licenses. Further, SLA officials informed us they do not plan to routinely notify the Lottery of such criminal activity. As a result, these 2,390 agents are not held to the same standards as other on-line and Quick Draw agents who are subject to the "search and retain" agreement between the Lottery and DCJS.

In addition, we found the SLA does not have fingerprints on file for persons receiving a liquor license prior to 1990. According to Lottery records, Lottery officials made over 3,300 inquiries to the SLA concerning Quick Draw applicants. The SLA responded to almost 2,000 inquiries with the comment that they no longer had fingerprints on file for these applicants.

Recommendations

1. *Ensure that the assessments of prospective agents' financial responsibility and expected volume of lottery sales are documented in the application files.*
2. *Ensure that the Lottery is notified of any criminal activity by its agents and has fingerprints on file for all licensed agents.*

Draft copies of this report were provided to Lottery officials for review and comment. Their comments have been considered in preparing this report and are included as Appendix A. Lottery officials expressed pleasure with the results of the audit and agreed with the report's two recommendations.

Within 90 days after the final release of this report, as required by Section 170 of the Executive Law, the Director of the Division of the Lottery shall report to the Governor, the State Comptroller and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefor.

Major contributors to this report were Jerry Barber, Kevin McClune, Marvin Loewy, Larry Wagner, Jim Nellegar, and Sandy Prabhu.

We wish to thank the management and staff at the Division of the Lottery for the courtesies and cooperation extended to our auditors during this audit.

Very truly yours,

Robert H. Attmore
Deputy Comptroller

cc: Patricia Woodworth



Jeff Perlee, Director

September 19, 1996

Mr. Kevin McClune
Director of State Audits
A.E. Smith Office Building
Albany, NY 12236

Dear Mr. McClune,

In response to your August 26, 1996 letter, enclosed are the Lottery's comments on your draft audit report (96-S-021) regarding the Division of the Lottery's agent selection and licensing practices.

We are pleased with the results of the audit and we extend our thanks to you and your auditors for their diligent efforts.

Very truly yours,

A handwritten signature in cursive script that reads "Henry L. Scott".

Henry L. Scott
Deputy Director for Administration

Enclosure

cc M. B. Labate
D. A. Taylor
D. Cadden
W. Murray
J. McNulty

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Recommendation #1

Ensure that the assessments of prospective agents' financial responsibility and expected volume of lottery sales are documented in the application files.

The Lottery agrees with the recommendation that assessments of financial responsibility, physical security, and volume of expected sales should be documented when license applications are processed.

In reviewing license applications, Lottery regional staff members evaluated the need for an agent in a particular area and then evaluate whether or not an applicant represents the best type of business for licensing. That is, whether Lottery sales would be maximized and public convenience would best be served by granting a license to the applicant.

Applicants are advised that they will need to provide documentation to verify the information shown on the application form. Typically, a copy of the most recent New York State Sales Tax Return (Form ST100) is required to substantiate the weekly sales of the business, and cash register receipts or other hard copy records are required to substantiate the number of daily or weekly customers. The documents submitted by the applicant are then reviewed to determine whether or not the reported sales and customer traffic are sufficient to warrant licensing the applicant.

In addition to reviewing records, the Lottery evaluates financial ability by noting the amount of inventory on hand, determining the length of time the business has been in operation at the location, reviewing evidence of the leasehold or ownership interest in the business premises, and observing the volume of customer traffic at the time of two separate on-site visits.

During the audit, records of the evaluations described above were maintained in the Lottery's regional offices and were not always duplicated in the licensing records maintained in the central office. A restructuring of the Lottery's organization was implemented in June 1996, which, among other things created a new Regulation and Compliance group. Regulation and Compliance is now responsible for reviewing all licensing decisions and is in the process of centralizing all licensing files to assure that appropriate documentation is created and maintained for all licensing decisions.

Recommendation #2

Ensure that the Lottery is notified of any criminal activity by its agents and has fingerprints on file for all licensed agents.

NYS Division of the Lottery Comments to Report #96-S-21 from the Office of the State Comptroller

The lottery agrees with this recommendation. As of September 1, 1996, all future applicants will be required to provide fingerprints. The Lottery will identify existing agents for whom no fingerprints are currently on file. The Lottery will then obtain fingerprints from all those agents and run background checks on them through the Division of Criminal Justice services and the Federal Bureau of Investigation.

First priority will be given to fingerprinting and checking the most recently licensed agents (since June 1995) for whom no fingerprints are currently on file. To expedite the process of clearing the backlog, the Lottery is considering the use of an outside contractor to help collect and process fingerprint identification cards.

Of more than 14,000 current Lottery agents, there are approximately 2,000 for which fingerprinting and background checking have not yet been completed. The Lottery expects to clear up most of the backlog within the next six months.

The great majority of current agents are covered by search and retain arrangements with the Division of Criminal Justice Services that provide for the Lottery to receive reports on subsequent arrests and convictions of Lottery agents that have previously been fingerprinted. When the backlog is cleared up, the Lottery will be able to receive subsequent reports on all agents.

NYS Division of the Lottery Comments to Report #96-S-21 from the Office of the State Comptroller