

# *A REPORT BY THE NEW YORK STATE OFFICE OF THE STATE COMPTROLLER*

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**Alan G. Hevesi  
COMPTROLLER**



***NEW YORK STATE DIVISION OF THE  
LOTTERY***

***CONTROLS OVER THE SELECTION AND  
LICENSING OF LOTTERY RETAILERS***

***2004-S-11***

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**Alan G. Hevesi**  
**COMPTROLLER**

**Report 2004-S-11**

Ms. Nancy A. Palumbo  
Director  
New York State Division of the Lottery  
One Broadway Center  
Schenectady, New York 12301

Dear Ms. Palumbo:

The following is our audit report on the controls over the selection and licensing of retailers by the New York State Division of the Lottery for the period April 1, 2003 through September 30, 2004.

This audit was performed pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law. Major contributors to this report are listed in Appendix A.

*Office of the State Comptroller*  
*Division of State Services*

October 31, 2005

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**Division of State Services**  
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## **EXECUTIVE SUMMARY**

### **NEW YORK STATE DIVISION OF THE LOTTERY SELECTION AND LICENSING OF LOTTERY RETAILERS**

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#### **SCOPE OF AUDIT**

The New York State Division of the Lottery (Lottery) is an independent unit of the Department of Taxation and Finance (Department), whose commissioner appoints the Director of the Lottery. The purpose of the Lottery is to raise revenue for education in the State of New York by administering the Lottery games. For the fiscal year ended March 31, 2004 the Lottery had sales of \$5.8 billion. These sales were achieved through a network of about 16,000 licensed retailers. Critical to the Lottery's success is the sales potential and public accessibility of its retailers, which must have quality locations. Retailers must demonstrate a commitment to promote, display and train staff to sell and manage Lottery products. The Lottery has policies and procedures for the selection and licensing of Lottery retailers to protect the interests of the State.

Our audit addressed the following question relating to the Lottery's selection and licensing of retailers for the period April 1, 2003 through September 30, 2004:

- Are the Lottery's policies and procedures for selecting and licensing retailers adequate to protect the State's interests in the Lottery games, and does the Lottery adhere to these policies and procedures?

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#### **AUDIT OBSERVATIONS AND CONCLUSIONS**

Generally, the Lottery has established adequate policies and procedures for controlling the issuance of new licenses and for monitoring the existing licensees. The Lottery has also adhered to most of its procedures. However, the Lottery needs to make significant improvements to identify, in a timely manner, applicants and retailers who have outstanding tax indebtedness to the State and who have not provided evidence of appropriate steps taken with the Department to satisfy outstanding tax assessments. The Lottery also needs to reinstitute procedures to monitor the sales performance of new and existing retailers.

The Lottery is responsible for the issuance, suspension and revocation of Lottery licenses. To fulfill its responsibilities, the Lottery should have adequate

procedures to determine, in a timely manner, whether new applicants or existing retailers have outstanding unsettled tax assessments, since a retailer's tax indebtedness and the impact it may have on the public's confidence in the Lottery games are important considerations in the licensing of Lottery retailers. We found that the Lottery did not adhere to its procedures for identifying, on an annual basis, retailers with outstanding unsettled tax assessments. We determined that 3,115 taxpayers, holding 4,161 active lottery licenses, had outstanding unsettled tax assessments due the State and had not made arrangements to satisfy their liabilities. These tax assessments totaled more than \$23 million as of September 9, 2004. Over 130 of these taxpayers owed in excess of \$25,000 each. (See pp. 12 - 16)

Prior to June 2002, the Lottery had a sales monitoring program to periodically analyze the Lottery's operating costs and retailer sales performance. Lottery officials told us that they discontinued the program for various reasons, as detailed in our report. However, we believe the program should be reinstated, based on our analysis of recent sales performance data. In this analysis, we found that some Lottery retailers may not be achieving an acceptable level of minimum sales and/or adding to the bottom line profitability of the Lottery by reaching their break-even level of sales. In accordance with program policies and procedures, the Lottery would annually identify its "break-even" sales level; i.e., the level of combined instant and online sales that each retailer must achieve in order for the Lottery to cover its average operating costs from sales. We analyzed sales data for a sample of active retailers and found that many were not achieving the break-even sales level. We found that 132 retailers from a field of 406 newly licensed retailers did not reach their minimum sales level, yet Lottery took no action to eliminate these retailers from their network. (See pp. 17 - 19)

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## **COMMENTS OF LOTTERY OFFICIALS**

Lottery officials agreed with our four recommendations related to identification of retailers with outstanding, unsettled tax assessments. Officials reported that as of May 2005, the Lottery and the Department have agreed to a new memorandum of understanding to better coordinate the exchange of retailer information. Lottery officials disagreed with our one recommendation related to monitoring of retailer sales performance. Officials stated that at some point, the Lottery may redefine its focus and institute new tools or programs to help increase sales.

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# INTRODUCTION

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## Background

The New York State Division of the Lottery (Lottery) was established in 1976. The Lottery is an independent unit of the Department of Taxation and Finance (Department), whose commissioner appoints the Director of the Lottery. The purpose of the Lottery is to raise revenue for education in the State of New York by administering the Lottery games. The New York State Lottery is one of the largest and oldest state lotteries in the United States. The Lottery maintains a central office in Schenectady, as well as other offices throughout the State. For the fiscal year ended March 31, 2004 the Lottery had sales of \$5.8 billion. These sales were achieved through a network of about 16,000 licensed retailers; some retailers have more than one license. During the fiscal year ended March 31, 2004, the Lottery employed 331 staff. According to Lottery Officials, critical to the Lottery's success is the sales potential and public accessibility of its retailers, which must have quality locations. Retailers must demonstrate a commitment to promote, display and train staff to sell and manage Lottery products. The Lottery has policies and procedures for the selection and licensing of Lottery retailers to protect the interests of the State including procedures to verify the financial responsibility and security of the business. For example, the Lottery obtains criminal background information to determine if an applicant has any convictions or any pending criminal or administrative charges that would demonstrate that the applicant could jeopardize public confidence in the integrity of the Lottery or would not act responsibly as a fiduciary of the State.

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## *Audit Scope, Objective and Methodology*

We audited the Lottery's controls over the selection and licensing of Lottery retailers for the period April 1, 2003 through September 30, 2004. The objective of our audit was to determine whether the Lottery has adequate policies and procedures for the selection and licensing of Lottery retailers to protect the State's interest in the games, and whether the Lottery adheres to these policies and procedures.

To accomplish our objective, we reviewed the New York State Tax Law and the New York Code of Rules and Regulations (NYCRR) as well as the Lottery's policies and procedures. We interviewed Lottery officials regarding the selection and licensing of retailers and reviewed documentation and reports provided by the Lottery to demonstrate adherence to their policies and procedures. In addition, we matched the Lottery's file of active retailers to the Department's accounts receivable file to determine the extent to which active retailers had unsettled tax assessments with the Department. We also analyzed sales data for newly licensed retailers to determine if they are achieving the minimum sales standards and break-even sales levels established by the Lottery.

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 of the Lottery which are included within 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, judgments and decisions made by management. We believe that our audit provides a reasonable basis for our findings, conclusions and recommendations.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State, several of which are performed by the Division of State Services. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. In addition, the Comptroller appoints members to certain boards, commissions and public authorities, some of whom have minority voting rights. These duties may be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our opinion, these management functions do not affect our ability to conduct independent audits of program performance.

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## ***Comments of Lottery Officials to Audit***

**W**e provided draft copies of this report to Lottery officials for their review and comment. Their comments were considered in preparing this report and have been included as Appendix B. Our rejoinders to Lottery officials' comments are presented in Appendix C, State Comptroller's Notes.

Within 90 days after 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 why.



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## SELECTION AND LICENSING OF LOTTERY RETAILERS

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Before the Lottery issues a license to a retailer, it undertakes a review to determine the applicant's fitness to become a Lottery retailer. This is essential because the retailer serves as an agent of the Lottery. The retailer handles extensive amounts of cash on behalf of the State and must ensure the fairness and integrity of the Lottery sales process. Accordingly, the Lottery has procedures to ensure that the selection and licensing of Lottery retailers is in compliance with New York State Law and Lottery Rules and Regulations, and to foster public trust in the Lottery through a sound and effective agent network. Before issuing a license, the Division considers such factors as:

- The financial responsibility and security of the business,
- The accessibility of the place of business to the public,
- The number of existing licenses to serve public convenience,
- Whether the place of business is predominantly frequented by persons under the age of 18 years,
- The volume of expected Lottery sales, and
- Criminal background information.

As part of our audit, we tested the Lottery's adherence to its procedures and found that the Lottery did comply with many of the aforementioned controls over the Lottery licensing process. We also tested other selected aspects of Lottery's issuance process. For example, we noted the following:

- We reviewed a random sample of 25 of the 446 complaints filed with the Lottery and determined appropriate action was taken and documented.

- We reviewed a random sample of 20 of the 1,299 Lottery retailer applications that were not approved (either withdrawn or rejected). We found the Lottery rejected applications for appropriate reasons.
- Additional criteria exist for the approval of Quick Draw applications. We reviewed a random sample of 50 of the 3,300 Quick Draw applications and issuing a license.
- The Lottery coordinates efforts with the Department of Health and suspends any Lottery retailer's license for six months for the sale of cigarettes to minors. The Lottery also sends warning letters to any retailer identified by Tax Enforcement in the sale of illegal cigarettes.

However, as detailed in the following sections of our report, the Lottery did not adhere to existing procedures for identifying, in a timely manner, Lottery retailers who have an outstanding unsettled tax assessment to the State, and the monitoring of sales performance of both new and existing retailers. (For this report, we are using the term "outstanding unsettled tax assessment" to indicate that the Department has issued a notice of assessment against the taxpayer and the taxpayer has either not paid the debt, not entered into another arrangement to settle the assessment, or not formally disputed the debt).

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### ***Identification of Retailers with Outstanding Unsettled Tax Assessments***

The State's Tax Law and Title 21 of the NYCRR assign the Lottery responsibility for the issuance, suspension and revocation of Lottery licenses. Both the Tax Law and NYCRR require the Lottery to consider the financial responsibility and security of the business as factors prior to issuing a license. NYCRR further requires the Lottery to consider the applicant's indebtedness, if any, to State or local government as well as the business experience and reputation of the applicant prior to issuing a license. A retailer's license can be suspended or revoked for failure to file any required returns or reports or to keep records or pay any fee or tax. The Lottery may also suspend or revoke a license for fraud, deceit, misrepresentation or any conduct prejudicial to public confidence in the Lottery. To fulfill its responsibilities, the Lottery should have adequate

procedures to determine whether new applicants or existing retailers have outstanding unsettled tax assessments, since a retailer's indebtedness and the impact it may have on the public's confidence in the Lottery games are important considerations in the licensing of Lottery retailers.

Lottery officials informed us that it has been their practice to match their Lottery retailer file to the Department's accounts receivable records on an annual basis to identify retailers with outstanding unsettled tax assessments over a pre-determined level. Lottery officials would then ask their field representatives to contact these retailers and ask them to settle these outstanding assessments with the Department. Lottery also issues letters to the retailer requesting that the retailer obtain a Tax Clearance Certificate from the Department as evidence that appropriate arrangements have been made with the Department to satisfy any outstanding unsettled liabilities.

We found that the Lottery was not completing the match on an annual basis. When we initiated our audit in June 2004, we found that Lottery last completed its match in 2002 using its year-end 2001 retailer database. Thus, for over two years, Lottery did not adhere to its key control designed to ensure that retailers who owe significant funds to the Department do not continue to serve as Lottery retailers unless they have made arrangements to satisfy outstanding unsettled liabilities.

The Lottery provided us with a computer file of all licensed retailers as of June 2004 and we asked the Department to match this file to the Department's accounts receivable computer records as of September 2004 to identify any outstanding unsettled tax assessments for these retailers. Our analysis of the match showed that 4,161 retailers (26 percent of the active retailers whose records could be matched) had an outstanding liability due the State and that these retailers, corresponding to 3,115 taxpayers, (a taxpayer may include more than one retailer) had not made arrangements to satisfy their liabilities. As the following table indicates, the 3,115 taxpayers had total outstanding unsettled tax assessments in excess of \$23 million as of September 2004.

<b>Dollar Value of Assessments</b>	<b>Number of Taxpayers</b>	<b>Number of Lottery Licenses</b>	<b>Total Dollar Value</b>
\$0 - \$2,500	2,250	2,847	\$1,384,267
\$ 2,501 - \$10,000	515	604	\$2,628,620
\$10,001 - \$25,000	217	402	\$3,344,426
\$25,001 - \$50,000	73	89	\$2,571,629
\$50,001 - \$100,000	35	49	\$2,332,941
> \$100,000	25	170	\$10,763,011
<b>Total</b>	<b>3,115</b>	<b>4,161</b>	<b>\$23,024,894</b>

Some of these unsettled liabilities were rather small, while others were quite large. Some of these retailers with outstanding unsettled tax assessments due the State had annual Lottery sales in excess of \$1 million. For example, one upstate retailer that we identified, with an unsettled assessment due of \$37,794, had Lottery sales of \$1,111,155, and earned \$66,669 in commissions; a downstate retailer with an unsettled assessment due of \$43,504 had Lottery sales of \$1,212,711 and earned \$72,763 in commissions; another downstate retailer with \$81,168 in total unsettled assessments had \$1,229,294 in Lottery sales and earned \$73,758 in Lottery commissions. While recognizing the mission of Lottery is to raise revenue for education from its sales, we strongly believe that these retailers should not be allowed to continue representing the Lottery while owing taxes to the State without having obtained a Tax Clearance Certificate as evidence of having made appropriate arrangements to satisfy their outstanding unsettled tax assessments.

Lottery officials indicated that they agree that the file match program is a useful and effective tool in assisting the Department in collecting taxes owed but contend our match amounts are overstated for several reasons based on their computer match in September 2004. For example, they indicated that some of the retailers we identified (using June 2004 retailer information provided by Lottery) were no longer active retailers as of September 2004. Lottery officials also eliminated assessment amounts below a certain dollar threshold for identifying retailers. In addition, Lottery eliminated from its match criteria certain accounts that were supposed to be only at an interim stage in the assessment dispute process, but officials

are currently re-evaluating their interim stage classification of these accounts.

Lottery officials also indicated that they have worked in the past with the Department to assist in collecting back due taxes from Lottery agents and will do so in the future. Lottery officials stated that based on their last computer match with the Department in 2001, they issued 1,162 letters to retailers with unsettled liabilities, advising them to settle their overdue taxes within seven weeks or face licensing action. Lottery officials indicated each letter was followed up by an on-site visit by a Lottery sales representative. Lottery officials stated that 23 retailers were eventually terminated based on follow up to the 2001 match.

The table of outstanding tax liability on the previous page indicates that a more focused approach to collections could target retail agents having the largest amounts of outstanding unsettled tax assessments (e.g., 25 taxpayers out of the 3,115 indicated owe over \$10 million of the \$23 million in total outstanding assessments). While we acknowledge the Lottery officials' commitment to continue the matching of Lottery agents with Department records of outstanding unsettled tax assessments, we believe that the current requirement for an annual match should be replaced with a quarterly requirement. In addition, although we are aware that the Department does not provide Lottery with any details of the retailer's assessment due to tax secrecy provisions, we recommend that the Department provide some general indication of retailer tax indebtedness. Providing a list of retailers who owe in excess of a predefined amount would enable Lottery officials to target specific retailers for more stringent enforcement action. We also believe it would be prudent and efficient for Lottery to require all retailers having outstanding unsettled tax assessments to submit a Tax Clearance Certificate within a specific time frame after receiving notice from the Lottery and for all potential retailers to submit a Tax Clearance Certificate as part of the license application process.

Lottery officials believe that it is premature to commit to a quarterly match without first streamlining the current process with the Department. Lottery officials indicated they are actively working with the Department to require potential retailers to submit a Tax Clearance Certificate as part of the license application process.

## **Recommendations**

1. Require applicants to submit a Tax Clearance Certificate from the Department prior to issuing a Lottery license.

(Officials responded that, as an alternative to this approach, Lottery will require applicants to submit a Sales Tax Certificate of Authority as part of the Lottery retailer application. Prior to issuance of the Lottery license, the Department will notify officials if a Tax Clearance Certificate is needed.)

2. Match Lottery retailer data to Department records on a frequent basis, such as quarterly, to identify any retailers with an unsettled State tax liability.

(Officials reported that the Lottery retailers data base will be matched to the Department data base weekly for proposed new retailers and semi-annually for all existing retailers.)

3. Work with Department officials to obtain file match data that provides a general indication of retailer tax indebtedness. This will allow a more focused approach to collections by targeting those retail agents having the largest amounts of outstanding unsettled tax assessments.

(Officials reported that based on a new memorandum of understanding, the information Lottery receives will be broken down by category depending on the liability.)

4. Take appropriate action against Lottery retailers who have an unsettled tax liability to help ensure that taxes owed the State are paid.

(Officials reported that depending on the liability, Lottery will provide the retailer with as little as 30 and no more than 67 days to settle the outstanding liability with the Department.)

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## ***Monitoring of Retailer Sales Performance***

Prior to June 2002, the Lottery had a sales monitoring program to periodically analyze the Lottery's operating costs and retailer sales performance. This program was used to eliminate certain retailers who did not meet the minimum sales level set by Lottery. Retailer sales performance would be monitored against other retailers' performance within the same geographic region. The Lottery would also annually identify its "break-even" sales level; i.e., the level of combined instant and online sales that each retailer must achieve in order for the Lottery to cover its average operating costs from sales. The Lottery would set regionalized minimum sales standards based upon the sales volume of the lowest 5 percent of retailers in the region. Newly licensed retailers would be advised in writing that they must achieve the minimum sales standard for their region during the last ten weeks of their 26-week probationary period. Retailers were also provided with the break-even sales level. The Lottery could allow exceptions to remain in business (retailers who do not achieve the minimum level of sales or break-even sales level) for geographic and seasonal characteristics that impact the retailer's ability to achieve the minimum sales standards.

Lottery officials told us that they discontinued the sales monitoring program because they felt they had achieved their original objective of streamlining the retailer network by revoking the licenses of the lowest 5 percent of retailers in each region who were unable to increase sales to an acceptable level. In addition, Lottery officials stated that the terrorist attacks of September 11 impacted the stability of downstate retail operations. Accordingly, the Lottery's foremost business priority was to generate increasing sales of its product via retention of downstate retailers while also increasing the number of retail locations throughout the State. Lottery officials stated that in a stable environment, they would reinstitute the program.

We believe, however, the program should be reinstated because, based on our analysis of sales performance data, some retailers may not be achieving the Lottery's minimum sales levels and/or the break-even level of sales. We requested the Lottery to provide us with sales data for all 406 active

retailers who received licenses in the first quarter of the fiscal year ended March 31, 2004. We analyzed the sales activity for these retailers to determine if they achieved both the minimum sales standards for their region and the break-even sales level.

The most recent break-even sales level of \$2,645 per week was established by the Lottery in June 2002 based on financial information for the fiscal year ended March 31, 2002. We compared average sales for the last ten weeks of the retailers' 26-week probationary period to the break-even sales level. We found that 132 of the 406 active retailers did not achieve average sales sufficient to cover the break-even sales level for that period. Furthermore, for the ten week period ended August 21, 2004, the most recent period of available sales data, 100 of these 132 retailers still had not achieved the break-even sales level. For the remaining 32, four retailers became inactive and 28 did achieve the break-even sales level.

We also reviewed documentation of the regionalized minimum sales standards maintained in the retailers' licensing files. The minimum sales standards are substantially below the weekly break-even sales level of \$2,645. We compared the minimum sales standards on file with the retailers' average sales for the last ten weeks of their 26-week probationary period. We found that 59 of the 406 retailers did not achieve their minimum sales standard. In addition, we determined that 37 of these 59 retailers still were not averaging sales sufficient to achieve their minimum sales standards for the ten week period ended August 21, 2004. For the remaining 22, the status of two retailers was changed to inactive during this time period, and 20 retailers increased sales to achieve their minimum sales standards. Our review of retailers' files did not indicate any seasonal or geographical exceptions.

Our review, for example, identified one upstate retailer who averaged \$338 in sales for the last ten weeks of their probationary period. This retailer did not meet the minimum sales standard of \$1,170 or the break-even sales level of \$2,645. Furthermore, this retailer's sales for the ten-week period ended August 21, 2004 averaged \$525. The retailer still did not achieve their minimum sales standard or the break-even sales level and showed very little improvement in sales. When we discussed this retailer with appropriate regional officials, we were told that the retailer is located in an excellent spot on a busy street in a strip mall across from a major grocery store.

The regional official believes that the location has the ability to produce good sales but the retailer lacks enthusiasm and puts no effort into selling the games.

In addition, Lottery officials indicated that the break-even sales level was last established in 2002 using financial information for the fiscal year ended March 31, 2002. Without a current break-even sales level, the Lottery is unable to identify retailers who do not achieve sufficient sales to cover current operating costs.

### **Recommendation**

5. Reinstitute the sales monitoring program to identify retailers who are not achieving their minimum sales standards or break-even sales level. Take appropriate action to increase retailer sales or consider suspension for retailers who fail to achieve at least their minimum standards and/or the current break-even sales level.

(Officials disagreed with this recommendation and stated that since 2002 the Lottery redefined its focus from one of "sales performance" to one of "sales penetration". Lottery believes it is important to sustain low sales levels at least on a temporary basis in these limited locations in order to obtain an increase in penetration levels.)



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## MAJOR CONTRIBUTORS TO THIS REPORT

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Arthur F. Smith  
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Nancy A. Palumbo, Director

May 13, 2005

**VIA FEDERAL EXPRESS AIRBILL # 8520 9290 2020**

Mr. Steven Sossei  
Audit Director  
Office of the State Comptroller  
110 State Street  
Albany, NY 12236

Dear Mr. Sossei:

The Lottery is in receipt of your April 15, 2005 letter relaying the draft audit report (2004-S-11) of the Office of the State Comptroller on the New York Lottery (the "Report"). We are pleased to provide to you our response within the 30-day comment period. We understand that this response will be included in the final version of the Report.

Prior to responding to the two specific issues raised in the Report, we wanted to note some relevant information concerning the New York Lottery in order to place the auditor's findings in their proper context. As you know, the New York Lottery is the most successful lottery in the country. During the last 10 years, revenue raised by the New York Lottery has almost doubled - from over \$3.6 billion during the 1995/1996 fiscal year to over \$6.27 billion for the 2004/2005 fiscal year. During 2004/2005 fiscal year, the New York Lottery contributed over \$2.03 billion in aid to education for a total of over \$27 billion in aid to education since the inception of the Lottery.

The Report discusses two issues - (1) the Lottery's need to determine the amount of any pending tax liability due the Department of Taxation and Finance (the "Department") by new or existing licensed Lottery retailers and the necessity for the Lottery to take action with respect to such liabilities; and (2) the requirement of a minimum sales performance level for new and existing Lottery retailers.

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When New Yorkers Play Responsibly, We All Win.

**Tax Liability of New and Existing Retailers**

The Report’s Executive Summary notes that the Lottery needs to make:

. . . significant improvements to identify, in a timely manner, applicants and retailers who have outstanding tax indebtedness to the State and who have not provided evidence of appropriate steps taken with the Department (of Taxation and Finance) to satisfy outstanding tax assessments.

The Lottery has previously advised your Audit Team and you, and respectfully does so here as well, that it disputes the use of the term “significant”. While the Lottery agrees that there were certain issues concerning the exchange of information with the Department of Taxation, one of the exceptions to the Report that the Lottery has advised you, since November, is that your Audit Team has insisted on using inaccurate information in reaching their conclusion.

* Note 1
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The Lottery agrees that with the Reports’ finding any Lottery retailer owing a significant tax arrearage should not continue as a Lottery retailer until such arrearage has been addressed to the satisfaction of the Department. The Report fails to note, however, that this has been the long standing position of the Lottery. Furthermore, the Report fails to reference the Lottery’s past work with the Department and the success that has been achieved in collecting arrearages owed. By way of background, for more than 14 years, the Lottery has worked with the Department to address outstanding tax arrears of Lottery retailers. The procedure agreed to by the Department and the Lottery was intended to comply with appropriate federal and state privacy rules. The difficulty in this exchange was that the Lottery received very little information on the retailers other than a tax of greater than \$100 was owed – the type of tax owed, the specific amount of tax owed, and the taxable period was not shared with the Lottery. Historically, the yearly average of retailers owing a tax liability of more than \$100 varied from 1,600 to a high of 4,192 (2001). Notwithstanding the insufficient and inefficient information delivered to the Lottery, the program was successful – most retailers cleared their tax liability, and the balance of retailers had their licenses revoked by the Lottery.

Although the Lottery agrees that, for a variety of reasons, some beyond the control of the Lottery, the informal annual match with the Department did not occur for a two year period (2002-2004), the Lottery respectfully disputes the magnitude of this failure as set forth in the Report. The Lottery sent a file of all then active licensed retailers to the Department in May, 2004. Your office requested a different file – a listing

\* See State Comptroller's Notes, p. 31

of all active retailers during the entire 18 month audit period. Notwithstanding our warning that this latter file would contain numerous retailers who were no longer active, and was therefore outdated and obsolete (especially given the current 80% rate of attrition), your office submitted this outdated file to the Department. The discrepancies in the responses from the Department to these two different files were entirely expected. The Department's response to the file submitted by the Lottery contained 1,291 retailers with an outstanding tax liability as of September, 2004 of amounts greater than \$500. By the time this response was delivered to the Lottery, 129 retailers were no longer active. Therefore, the actual number of Lottery retailers owing a tax liability to the Department of greater than \$500 as of September, 2004 was approximately 7% of the Lottery network. By comparison, the response of the Department to the outdated file submitted by the Audit Team (which contained numerous non-active retailers, some of whom had presumably gone out of business) contained more than 4,100 retailers with a tax arrearage of more than \$100. The Lottery believed then and believes now that this number does not reflect an accurate number of then active licensed Lottery retailers. Of the 1,162 active licensed retailers having a tax liability greater than \$500 to the Department as of September, 2004, 972, or 84%, have been cleared by the Department. Of the balance, 12%, no longer have a license with the Lottery (through natural attrition), and the balance have been revoked by the Lottery.

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Note  
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The Lottery does appreciate your efforts in bringing certain deficiencies in the match program to the Department's attention. Since the Lottery last met with you, the divisions' have been working on a memorandum of understanding to better coordinate the exchange of retailer information. As of May, 2005, the Lottery and the Department have agreed to a new MOU which will provide for weekly exchanges of taxpayer identification information for proposed new retailers and semi-annual exchanges of information for existing retailers. The information the Lottery receives will be broken down by category depending on the liability. Depending upon the liability, the Lottery will provide the retailer with as little as 30 and no more than 67 days to settle the outstanding liability with the Department. If the liability is not settled within the stated time frames, the retailer's lottery terminal will be disabled.

\* See State Comptroller's Notes, p. 31

In conclusion, to address your specific recommendations:

- The Lottery will require applicants to submit a Sales Tax Certificate of Authority as part of the Lottery retailer application
- The Lottery retailer base will be matched to the Department database weekly for proposed new retailers and semi-annually for all existing retailers
- The Department will provide useful retailer information to the Lottery.
- Appropriate action will continue to be taken against Lottery retailers who have an unsettled tax liability.

### **Monitoring Retailer Sales Performance**

The second finding in the Report discusses the monitoring of retailer sales performance levels. The Report accurately describes the sales monitoring performance program that was discontinued by the Lottery in 2002. As we have advised the Audit Team and you on several occasions, this sales monitoring performance program was useful to the Lottery to determine those retail locations which were producing minimal sales. As you know, the Lottery employs a network of over 100 sales representatives who not only search for new retail locations, but also are required to meet regularly with the existing retailers to generate additional sales.

As with any business, procedures change from time to time. In the late 1990's, the Lottery's games were still primarily of the on-line variety. The use of a sales monitoring program was both logical and prudent. As the products of the Lottery have grown, the goals have also changed. Starting in 2002, in light of certain events previously described to you, the Lottery redefined its focus from one of "sales performance" to one of "sales penetration". The focus on penetration was necessitated, in part, by reason of the current 80% attrition rate among active retailers (i.e., for every 100 new retailers added, 80 leave the system for a variety of reasons). Lottery products, to be sold successfully, must penetrate those markets where the Lottery has traditionally not been available, even if sales by ordinary standards are low. The Lottery believes that it is important to sustain low sales levels at least on a temporary basis in these limited locations in order to obtain an increase in penetration levels. The increase in penetration should increase awareness of the Lottery's products, thereby leading to increased sales overall.

* Note 2
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The success of the current approach is self-evident. Revenue for the Lottery has grown from over \$4.7 billion to over \$6.27 billion over a three year period, an increase of over 40%. In that same time period, the retailer network has grown from just over 15,200 to over 16,000. As the Lottery noted to the Audit Team on several occasions, at some point, the Lottery may redefine its focus yet again and institute new tools or programs to help increase sales. Certainly, a version of the sales monitoring program would be reconsidered. However, to implement the discontinued sales program at a time when penetration is the Lottery's goals, especially in light of the fact that the attrition rate remains high, would, in the Lottery's opinion, be imprudent. Accordingly, the Lottery respectfully disagrees with the recommendation to reinstitute the sales monitoring performance program at this time, but reserves the right to do so once the retailer network is maximized to its full potential.

**Conclusion**

The Lottery appreciates the Comptroller's thoughts on these issues and looks forward to a continued cooperative working relationship.

Sincerely,



Nancy A. Palumbo  
Director

NAP:ymf



Nancy A. Palumbo, Director

May 24, 2005

Mr. Steven Sossei  
Audit Director  
Office of the State Comptroller  
110 State Street  
Albany, NY 12236

Dear Mr. Sossei:

Thank you for the opportunity to submit this supplemental response to the Audit Report of the New York Lottery. The Lottery wanted to respond to some of the questions that Art Smith raised with me during our telephone conference last week.

The Audit Report included recommendations which your office believed would improve the effectiveness of the periodic verification of retailers' tax indebtedness. In its May 13, 2005 response letter, the Lottery acknowledged that certain improvements could be made and advised that it had formalized an improved process through a MOU (copy enclosed) with the Department of Taxation and Finance (the "Department"). The following will identify the changes underway in Lottery's assistance to the Department in collecting outstanding assessments. We are confident that, after review of the new controls set forth below, the auditors will agree that the Lottery is poised to achieve the objectives of the Audit Report's recommendations with a robust process of verification and follow-up.

The Department and the Lottery have agreed to:

- Increase the frequency of exchanging the entire file of Lottery retailers for Tax indebtedness to twice annually:
  - All licensed retailers will be screened against outstanding tax liabilities over a set threshold.
  - Those identified as owing more than the threshold will be categorized as to their liability.
  - All identified retailers will be given instructions to settle their indebtedness with Tax (or file a protest against such assessments).
  - Those with higher liabilities will be given a shorter timeframe within which to settle their debt with Tax.
  - For retailers who do not resolve their Tax debt within the prescribed time frame will have their Lottery license suspended with the intent to revoke.
  - Compliant retailers will continue to sell Lottery product unimpeded.

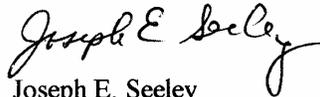
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(518) 388-3300 Fax (518) 388-3403  
[www.nylottery.org](http://www.nylottery.org)

When New Yorkers Play Responsibly, We All Win.

- Implement a weekly file exchange of all new license applicants with Tax indebtedness:
  - Each week, the Tax Identification Number of all new applicants within that week for Lottery licensure will be submitted to Tax for comparison against the outstanding liabilities file.
  - As per the semi-annual file exchanges, all retailers identified as owing an outstanding assessment will be identified, stratified and communicated to Tax by the Lottery for follow-up. License suspension/revocation will be pursued as per above.
  - Applicants with no outstanding debts will continue to sell Lottery products unimpeded.
  
- Errors identified in the exchange process (i.e. Tax identification errors) will be rectified within the weekly file exchange process.

In light of the robust measures under way by the Lottery and the Department, as set forth above, we ask that you include these comments within your final report in order to ensure that you provide balance between what you recommend and what the Lottery has agreed to provide.

Sincerely,



Joseph E. Seeley  
Director of Operations

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## ***State Comptroller's Notes***

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1. Lottery officials are correct that our auditors did request and receive a file that listed all retailers that were active at sometime during the 18 month period. However, our comparison of Lottery retailers to the Department's records was limited to only the retailers that were "active" as of June 21, 2004. (This is clearly described in the audit report.) We compared Lottery's list of active retailers as of June 21, 2004 to the Department's records as of September 8, 2004. This would result in some differences as some retailers did become inactive during the period June 22, 2004 to September 7, 2004 and may have incurred an outstanding unsettled tax debt after they became inactive. However our comparison also does not include any new retailers that became active during the period June 22, 2004 to September 7, 2004, yet owed the Department taxes.

Further, we did review the Department's records for the Lottery retailers that were deactivated between June 22, 2004 and September 7, 2004 and found that in only 24 instances did the retailer incur the tax indebtedness after it became inactive. This number is insignificant when compared to the 4,161 Lottery licenses we identified in our comparison. The differences between Lottery's numbers and our numbers are caused by the Lottery using a \$500 threshold in their match versus the \$100 threshold that we used for our match. The \$100 match had been the Lottery's traditional match level. In addition the Lottery failed to include certain cases that should have been included in the match results.

We did not use inaccurate information as Lottery suggests.

2. We recognize that it is important to sustain low sales levels on a temporary basis in order to increase penetration levels. However, we feel that the Lottery needs to identify and take action to address consistently poor performers. Low sales performers do not add to the bottom line performance of the Lottery.