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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

September 6, 2006

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

Re: Controls and Accountability over Video
Lottery Revenue
Report 2006-S-4

Dear Ms. Palumbo:

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, we have audited the New York State Division of the Lottery's (Lottery) controls and accountability over Video Gaming Entertainment (Video Lottery) revenue. Our audit covered the period January 1, 2004 through March 31, 2006.

A. Background

The Lottery is an independent unit of the Department of Taxation and Finance. The purpose of the Lottery is to raise revenue for education in the State by administering Lottery games. Lottery games have raised in excess of \$23 billion in revenues for education since the Lottery's inception in 1967.

In 2001, the Governor authorized an expansion of gambling in the State that attempted to introduce Video Lottery at various horse racing tracks. However, no gaming facilities were opened under this original legislation. In an effort to improve the incentives for track operators to open Video Lottery operations, new legislation was passed in 2003 increasing the commission amount to 29 percent of the total revenue after payout for prizes, for track operators. With this change, four racetrack operators applied for and were licensed as Video Lottery Gaming Agents (Gaming Agent), authorized to open Video Lottery gaming facilities. Four Video Lottery gaming facilities opened in 2004 under the amended legislation: Saratoga, Finger Lakes, Buffalo Fairgrounds, and Monticello racetracks. The legislation was further amended in April 2005 to modify the commission and provide a marketing allowance to the operators based on percentage of sales. One additional track opened under the 2005 legislation, Batavia (May 2005). Racetracks located at Aqueduct, Yonkers, Vernon Downs and Tioga Downs are authorized to open Video Lottery gaming facilities; however, as of the completion of our fieldwork in May 2006, none were open.

Chapter 383 of the Laws of 2001 added Section 1617-a of the New York State Tax Law authorizing Video Lotteries and amended Section 1612 of that Law to provide for the disposition of Video Lottery revenues. This 2001 legislation mandated that player prizes paid would not be less than 90 percent of the total revenue.

To play the Video Lottery, a patron purchases a ticket by inserting cash into a gaming machine or by inserting a redemption voucher from previous gaming activities. The results of each game played are displayed on the gaming machine. Patrons can print a redemption voucher when they conclude play. The patron can then use this redemption voucher in another gaming machine or convert it to cash at the cashier's cage.

The Lottery currently operates the Video Lottery gaming revenue operations using six contracts. Those contracts include the central system contract held by Multimedia Games (central system contractor); the acceptance testing (Quality Assurance) contract held by Gaming Laboratories International; and the gaming machine manufacturer contracts currently held by four separate manufacturers, Bally Gaming Inc., International Gaming Technologies, Sierra Design Group, and Spielo USA Inc. Each of the four gaming machine manufacturers was awarded a contract based on the scoring of their bids. The score determined the number of gaming machines each manufacturer would supply to the Gaming Agents. There are more than 5,000 gaming machines being operated by the five Gaming Agents. On a six month basis, Lottery conducts a detailed benchmark performance review of the terminals at each Gaming Agent's facility to determine whether or not a reallocation of terminals is necessary. Additionally, some of the Gaming Agents have entered into contracts with companies to manage their gaming operations. Saratoga entered into a 5-year contract with Delaware North Companies Gaming and Entertainment (Delaware North) and Buffalo Fairgrounds entered into a 10-year contract with the same management company. Finger Lakes is owned and operated by Delaware North.

On a daily basis, Lottery receives money from each Gaming Agent for the revenues generated from video gaming via electronic funds transfer (EFT). Lottery is responsible for distributing the remaining revenue after prizes are paid out. Since the inception of Video Lottery gaming in the State from January 1, 2004 through March 31, 2006, the five Gaming Agents have generated \$316.7 million to the State Education Fund as follows:

Video Lottery Gaming Agent	Opening Date	Number of Video Gaming Machines	Education Contribution Since Opening
Saratoga	January 28, 2004	1,324	\$117.8 million
Finger Lakes	February 18, 2004	1,010	\$ 82.0 million
Buffalo Fairgrounds	March 17, 2004	990	\$ 42.0 million
Monticello	June 30, 2004	1,576	\$ 64.7 million
Batavia	May 18, 2005	586	\$ 10.2 million
Total		5,486	\$316.7 million

Lottery contracted with KPMG to review the internal controls designed and in place at four of the five Gaming Agents prior to each facility's opening day. At the end of our audit, Lottery's internal audit department was testing the internal controls at the most recent Gaming Agent, Batavia. Subsequent to the opening of each of the four facilities, KPMG performed a secondary attestation review to determine whether the internal controls were working adequately. KPMG identified several weaknesses in their reports. However, upon our examination, it was noted these were isolated instances rather than system related problems.

As required by the central system contract with Lottery, KPMG also performed a review of the central system contractor's computer system. This review examined the computer system controls. Although this report noted some minor exceptions, the contractor was able to make the necessary corrections. At the time of our audit, KPMG was following up its review for the year ended March 31, 2005.

B. Audit Scope, Objectives and Methodology

We audited Lottery's controls and accountability over Video Lottery revenue for the period January 1, 2004 through March 31, 2006. The objectives of our performance audit were to determine whether the State's portion of this revenue was properly accounted for and accurately distributed, and that Lottery is adequately monitoring the video gaming contracts and contractor performance.

To accomplish our objectives, we met with officials from the Lottery, Multimedia Games, Gaming Laboratories Inc., and Saratoga Gaming Agent to understand their roles and responsibilities regarding the video gaming operations. We reviewed the internal controls in place at all of the track facilities currently open (Saratoga, Finger Lakes, Buffalo Fairgrounds, Monticello and Batavia) and the internal control review work completed by Lottery's independent auditor, KPMG. We also reviewed the computer system report and the pertinent work papers that were prepared by KPMG for Multimedia Games for the period April 1, 2004 through March 31, 2005. We tested the reliability of central system reports by reviewing various reports and comparing the totals. We also tested the accuracy of the daily remittance report to the daily bank deposits for the month of January 2006 for all tracks opened. In addition, we reviewed the contracts for each of the gaming machine manufacturers, the central system and the Quality Assurance testing. During our meetings with the contractors, we reviewed the contract deliverables and supporting evidence. Additionally, we reviewed the agreements Delaware North Management Company has with Buffalo Fairgrounds and Saratoga to manage the gaming operations at each track.

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 the 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.

C. Results of Audit

Overall, we found that Lottery has an adequate system of internal controls in place to properly account for, and accurately distribute the State’s portion of Video Lottery revenue. Further, we conclude that Lottery is adequately monitoring the contracts related to the Video Lottery operations. Lottery officials have taken actions to ensure that adequate internal controls are in place to protect the State’s interest in the games. As allowed by legislation, as new track gaming facilities open in the future, we encourage officials to continue to monitor operations and work with the contractors to implement needed improvements.

1. Controls and Accountability Over Video Lottery Revenue

State Tax Law requires player prizes to be paid at not less than 90 percent of the total revenue. The remaining 10 percent is divided between the Gaming Agent, Lottery and the State’s General Fund. Since the first Video Lottery facility opened in January 2004, the legislation stipulating how the remaining 10 percent of net revenues should be distributed has been amended. As a result of new legislation, Gaming Agent commissions and the education contribution have shifted and added the distribution of a marketing allowance (funds reimbursable by Lottery) for the Gaming Agents to use towards various marketing and promotional expenses. The Gaming Agents retain their daily commission and remit the remaining revenue to Lottery.

Video Gaming Revenue Distribution (In Millions)				
Annual Revenue	Less than \$50	\$50 - \$100	\$100 - \$150	More than \$150
Education	50%	53%	56%	59%
Gaming Agent Commission	32%	29%	29%	26%
Marketing Allowance	8%	8%	5%	5%
Administration	10%	10%	10%	10%

Although the central system provides the accounting function for all video gaming revenues at each Gaming Agent facility, all components, including program code and software of the central system are tested and certified by the Quality Assurance contractor. The Quality Assurance contractor provides the Lottery with reports including the current status of testing, corrections, results of re-testing and outstanding problems. The daily reports generated by the central system are the basis for all agent and vendor settlements. Any discrepancies in the cash count and the amount reflected on the daily remittance report results in a commission loss to the Gaming Agent. Lottery is responsible for the administration of the Video Lottery revenue and, as such, requires the amount stated on the daily remittance report to be deposited within two business days. Lottery subsequently transfers the appropriate percentage of funds to the State Education Fund, administration fund, prize-pending fund, marketing allowance funds and the various contractors’ accounts.

2. Video Gaming Contract Monitoring

The Lottery has three types of contractors for Video Lottery operations; the Central System contractor, the gaming machine contractors and the Quality Assurance contractor. Overall, we conclude that Lottery is adequately monitoring these contractors. Lottery contracted with Multimedia Games to provide the installation, setup, and maintenance of the central computer system that supports gaming machines at each Gaming Agent's facility throughout the State. The system generates reports to meet the needs of the Gaming Agents and Lottery. The format and information contained in the reports are determined by the Lottery. Lottery maintains independent records of all data, which is reconciled to the central system reports. In addition to generating reports, the system creates the ticket inventory used in the gaming machines. The ticket inventories are created and disbursed among the gaming facilities randomly. The central system contractor has comprehensive policies and procedures related to program code changes and authorization which are tested annually in the computer system review done by independent auditors.

Lottery contracted with Gaming Laboratories, Inc. to perform Quality Assurance of the central system and of each gaming machine manufacturer's hardware and software. The Quality Assurance contractor performs various tests, reviews the test results, and verifies the completion of all Lottery requirements prior to approving video gaming hardware or software. The Quality Assurance contractor provides Lottery reports describing the current status of testing, any corrections received and the results of re-testing, and/or any outstanding problems to date. The Quality Assurance contractor issues a certification report describing all those functions that have met the testing requirements and all that have not. Gaming Laboratories, Inc. is certified by the American Association for Laboratory Accreditation and is considered a leader in quality assurance testing in the gaming industry.

Lottery has contracts with Bally Gaming Inc., International Gaming Technologies, Sierra Design Group, and Spielo USA Inc., to provide the more than 5,000 gaming machines at Gaming Agents. Lottery determined what the percentage of gaming machines provided by each manufacturer at each Gaming Agent would be. Initially the number and placement of gaming machines were based on the contract bidding scores (technical and cost components). Lottery performs benchmark performance assessments every six months which result in reallocation of the percentage of gaming machines provided by each manufacturer. Benchmark performance assessments are based on the amount of revenue each gaming machine manufacturer has yielded. Lottery staff physically counts the gaming machines after each benchmarking to ensure that the proper changes have taken place and the distribution of machines is correct. Because Lottery monitors the performance of the gaming machine manufacturers and reallocates the number of gaming machines provided by each manufacturer based on their machine's revenue, the Lottery can be assured the gaming patrons are getting the games they want to play and thus, are providing the maximum revenue possible.

We provided draft copies of the matters discussed in this report to Lottery officials for their review and comment. Their comments were considered in preparing this report and are attached as Appendix A.

Major contributors to this report were Kenneth Shulman, Arthur F. Smith, Erika M. Akers, Sarah Purcell, Jennifer Van Tassel and Susan DiFiore. We wish to thank the management and staff at the Division of Lottery for their courtesies and cooperation extended to our auditors during the audit.

Very truly yours,

Steven E. Sossei
Audit Director

cc: Lisa Ng, Division of the Budget
Gardner Gurney, Division of the Lottery



Nancy A. Palumbo, Director

August 22, 2006

Mr. Steven E. Sossei
Audit Director
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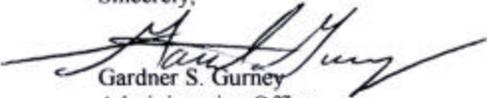
Dear Mr. Sossei,

The New York Lottery has reviewed the draft audit report #2006-S-4 entitled *Controls and Accountability over Video Lottery Revenue* which you recently forwarded. We are pleased that your report determined that the Lottery's controls over video lottery gaming revenue are suitably designed and operating effectively. At the direction of Governor Pataki and Director Palumbo, the Lottery's employees have expended considerable effort in launching video lottery gaming to ensure the creation of a control environment that supports fiscal integrity, accountability, and responsibility.

Since your auditors completed their fieldwork, the Lottery has successfully opened another video lottery gaming facility located at Tioga Downs Gaming Racing and Entertainment in Nichols, New York. We also anticipate that two more facilities, Empire City at Yonkers Raceway and Vernon Downs Gaming Racing and Entertainment in Verona, New York, will open this fall. These facilities will utilize the same internal control procedures that you reference in your audit report.

On behalf of Director Palumbo, we would like take this opportunity to extend the Lottery's sincerest thanks to you and your audit team for the diligent efforts they put forth in performing this audit. Your report will provide the taxpayers of New York with valuable assurance that the video lottery gaming operations have been successfully implemented.

Sincerely,



Gardner S. Gurney
Administrative Officer

Cc: Nancy Palumbo
Robert McLaughlin
John R. McNulty

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