
RHODE ISLAND LOTTERY

(AN ENTERPRISE FUND OF THE
STATE OF RHODE ISLAND)

FISCAL YEAR ENDED JUNE 30, 2011

Dennis E. Hoyle, CPA
Acting Auditor General

State of Rhode Island and Providence Plantations
General Assembly
Office of the Auditor General



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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

- ◆ INTEGRITY
- ◆ RELIABILITY
- ◆ INDEPENDENCE
- ◆ ACCOUNTABILITY

September 30, 2011

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER Gordon D. Fox, Chairman

Senator M. Teresa Paiva Weed
Senator Dennis L. Algiere
Representative Nicholas A. Mattiello
Representative Brian C. Newberry

We have completed our audit of the financial statements of the Rhode Island Lottery for the year ended June 30, 2011. Our report is contained herein as outlined in the Table of Contents and includes our *Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*.

Sincerely,

Dennis E. Hoyle, CPA
Acting Auditor General

RHODE ISLAND LOTTERY
(AN ENTERPRISE FUND OF THE STATE OF RHODE ISLAND)

FISCAL YEAR ENDED JUNE 30, 2011

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INDEPENDENT AUDITOR'S REPORT

Joint Committee on Legislative Services, General Assembly,
State of Rhode Island and Providence Plantations:

We have audited the accompanying financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2011, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 2(b), the financial statements present only the Lottery and do not purport to, and do not, present fairly the financial position of the State of Rhode Island and Providence Plantations, as of June 30, 2011, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of the Lottery as of June 30, 2011, and the changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As more fully described in Note 2(k) to the financial statements, the Lottery changed its reporting of video lottery revenue for fiscal 2011 from the gross video lottery amounts previously reported to a net presentation.

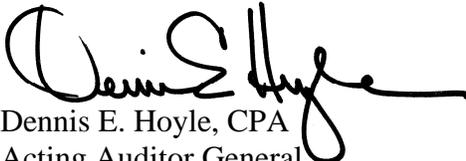
Joint Committee on Legislative Services, General Assembly,
State of Rhode Island and Providence Plantations:

As more fully described in Note 13(b) to the financial statements, the Lottery's two video lottery facility operators, from which the Lottery derives a significant portion of its revenue, have experienced financial difficulties; and, as described in Note 13(c), pending legislation to allow casinos in nearby Massachusetts, if passed, could adversely impact future Rhode Island video lottery revenue.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 29, 2011 on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 3 through 11 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Lottery's basic financial statements. The supplementary information included in Schedule 1 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Schedule 1 has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.


Dennis E. Hoyle, CPA
Acting Auditor General

September 29, 2011

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

Management of the Lottery provides this *Management's Discussion and Analysis* of their financial performance for the readers of the Lottery's financial statements. This narrative provides an overview of the Lottery's financial activity for the fiscal year ended June 30, 2011. This analysis is to be considered in conjunction with the financial statements to provide an objective analysis of the Lottery's financial activities based on facts, decisions, and conditions currently facing management.

Understanding the Lottery's Financial Statements

The Lottery, a division of the Department of Revenue of the State of Rhode Island and Providence Plantations (State), is accounted for as an enterprise fund that reports all assets and liabilities using the accrual basis of accounting, much like a private business entity. In accordance with accounting principles generally accepted in the United States of America, this report consists of a series of financial statements, along with notes to the financial statements and a supplementary schedule detailing operating revenue and the cost of gaming operations for each lottery game. The financial statements immediately follow this *Management's Discussion and Analysis* and are designed to highlight the Lottery's net assets and changes to those assets resulting from Lottery operations.

The most important relationship demonstrated within the Lottery's financial statements is the requirement that the Lottery transfer all net income to the State's General Fund. Accordingly, the primary focus of these financial statements is determining net income available for payment to the State's General Fund rather than the change in net assets of the Lottery. It is also important to note that most financial statement balances have a direct relationship to revenue. Generally, as lottery revenues increase, the amount paid to the State's General Fund also increases. Similarly, increases in revenue for a particular lottery game result in direct increases to the related prize awards and commissions expense.

Most assets included on the Statement of Net Assets represent current amounts such as cash and accounts receivable from Lottery retailers. Most liabilities represent current prize awards owed, vendor commission payments, and amounts due to the State's General Fund. Current assets approximate the amounts required to satisfy current liabilities at year end.

The deficiency in net assets of \$7.5 million reported at June 30, 2011 relates entirely to the Lottery's sale of its exclusive rights to operate its gaming systems. The Lottery sold this exclusive right to its current gaming systems provider for a 20-year period at a cost of \$12.5 million and immediately paid the proceeds to the State's General Fund. According to the terms of the agreement, if for any reason, this contract is voided prior to its completed term; the Lottery will be required to refund a pro-rata share of the sales price to the gaming system provider. In accordance with generally accepted accounting principles, the Lottery will recognize the revenue related to this transaction over the 20-year life of the contract.

Financial Highlights

- The Lottery transferred \$354.9 million to the State's General Fund for the fiscal year ended June 30, 2011, an increase of \$10.2 million in net income transfers over the prior fiscal year. The increase is notable in light of current economic conditions.
- Net video lottery revenue increased by \$24.8 million or 5.3% in fiscal 2011.
- Keno sales increased by \$3.4 million, a 4.31% increase over fiscal year 2010.

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

- The Lottery implemented a video lottery incentive program, designed to enhance the overall promotion and marketing of the State's video lottery operations by reimbursing its video lottery facilities for a share of certain qualified marketing and promotional expenses. The Lottery reimbursed the video lottery facilities \$2.2 million for qualified expenses incurred in fiscal 2011.
- Twin River, the Lottery's largest video lottery facility, received approval of their reorganization plan by the United States Bankruptcy Court during fiscal 2011. Twin River's reorganization, once finalized, should stabilize the financial position of the facility.

Assets and Liabilities

	June 30, 2011	June 30, 2010
Assets:		
Current assets		
Cash and cash equivalents	\$ 18,228,713	\$ 14,442,588
Accounts receivable, net	4,125,664	2,773,555
Other	1,043,143	1,342,403
Total current assets	23,397,520	18,558,546
Long-term assets		
Capital assets, net	469,496	690,870
Total assets	23,867,016	19,249,416
Liabilities:		
Current liabilities		
Due to State's General Fund	\$ 2,731,761	\$ 1,646,003
Due to State's General Fund - Operating Expenses	335,563	125,232
Accounts payable	11,951,432	10,462,936
Prize obligations	4,957,712	5,194,301
Compensated absences	187,195	140,745
Other liabilities	4,081,394	1,944,667
Total current liabilities	24,245,057	19,513,884
Long-term liabilities		
Compensated absences	246,959	221,081
Net OPEB obligation	-	139,451
Unearned contract revenue	6,875,000	7,500,000
Total long-term liabilities	7,121,959	7,860,532
Total liabilities	31,367,016	27,374,416
Net Assets:		
Invested in capital assets	469,496	690,870
Unrestricted	(7,969,496)	(8,815,870)
Total net assets (deficiency)	\$ (7,500,000)	\$ (8,125,000)

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

The majority of the Lottery's assets consist of cash (including amounts invested in cash equivalent type instruments) and accounts receivable derived from sales of the Lottery's games. At June 30, 2011, the Lottery's assets included \$18.2 million in cash and cash equivalents as compared with \$14.4 million at June 30, 2010. The Lottery's accounts receivable approximated \$4.1 and \$2.8 million, respectively, at June 30, 2011 and 2010.

The Lottery's liabilities included at the balance sheet date are amounts owed for vendor payables, prize obligations and a residual amount owed to the State's General Fund for June's net operations and operating expenses. The amount owed to the General Fund for June's net operations approximated \$2.7 million at June 30, 2011 and \$1.6 million at June 30, 2010. At June 30, 2011, vendor payables, made up largely of commissions due to video lottery participants, and prize obligations, attributable mostly to instant ticket games and PowerBall®, were \$12 million and \$5 million, respectively. In comparison, vendor payables and prize obligations at June 30, 2010 were \$10.5 million and \$5.2 million, respectively.

The majority of the Lottery's assets represent current resources necessary to pay the current liabilities owed to vendors, prize winners, video lottery participants, and ultimately the State's General Fund.

The deficiency in net assets reported at June 30, 2011, as previously explained, relates to the Lottery's immediate transfer, in a prior fiscal year, to the State's General Fund of all proceeds received from the sale of its exclusive rights over the operation of its gaming systems.

Lottery Operations

	<u>June 30, 2011</u>	<u>June 30, 2010</u> *
Revenue:		
On-line games	\$ 153,375,296	\$ 156,646,848
Instant games	77,217,452	77,978,026
Video lottery, net	492,594,189	467,772,084
Other income	<u>1,168,619</u>	<u>1,028,496</u>
Total revenue	<u>724,355,556</u>	<u>703,425,454</u>
Expenses:		
Cost of gaming operations	(362,978,380)	(352,169,765)
Operating expenses	(5,891,189)	(5,957,946)
Transfers to State's General Fund	<u>(354,860,987)</u>	<u>(344,672,743)</u>
Total expenses	<u>(723,730,556)</u>	<u>(702,800,454)</u>
Change in net assets	625,000	625,000
Total net assets (deficiency), beginning of year	(8,125,000)	(8,750,000)
Total net assets (deficiency), end of year	<u>\$ (7,500,000)</u>	<u>\$ (8,125,000)</u>

* Certain 2010 amounts have been reclassified or restated to conform to the current year presentation. See note 2 (k) to the financial statements.

RHODE ISLAND LOTTERY

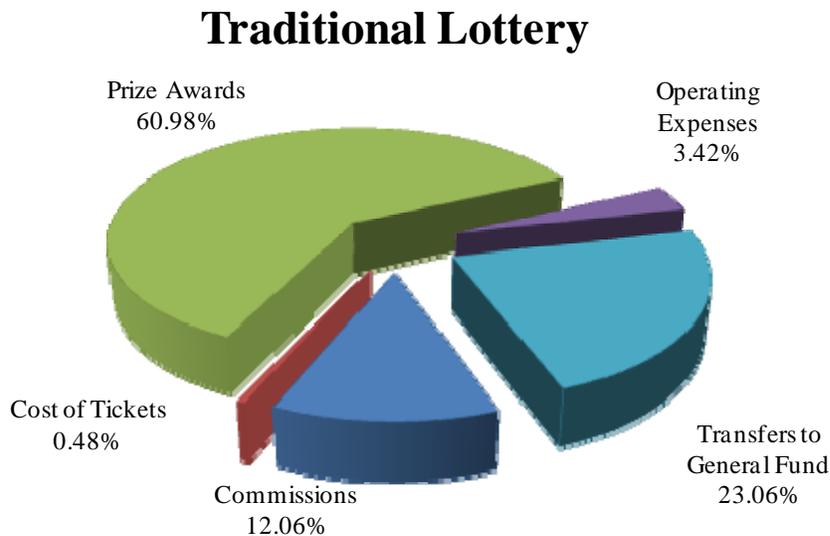
Management's Discussion and Analysis

Beginning in fiscal 2011, video lottery terminal revenue is presented as the net amount of video lottery terminal inputs (both cash and credits redeemed at the terminal) minus terminal outputs (all cash credit slips issued by the terminal). The Lottery, in previous financial reports, reported video lottery terminal activity on a gross basis with gross revenue (terminal inputs) and prize awards (terminal outputs) being reported. Both presentations are acceptable under generally accepted accounting principles, however recent accounting guidance has indicated that most gaming entities report video lottery terminal activity on a net basis. This change in financial reporting will improve the comparability of the Lottery's financial activity with other State lotteries that offer video lottery games. The Lottery has restated prior year video lottery financial activity reported in this Management Discussion and Analysis to conform to this new net presentation. This change has no impact on the Lottery's operating income or Transfers to the State General Fund amounts reported on the Statement of Revenue, Expenses, and Changes in Net Assets.

Revenue

Traditional Lottery

- Traditional Lottery games consist of on-line and instant ticket games. Distribution of the year's traditional lottery revenue was as follows:

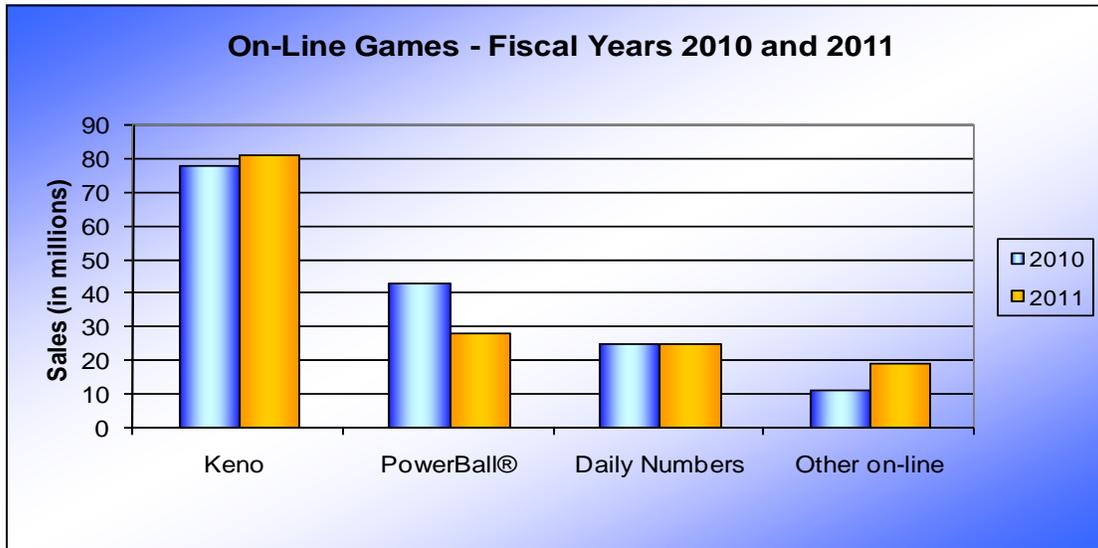


- Instant ticket revenue for the fiscal year ended June 30, 2011 decreased \$.7 million or .97% from the preceding fiscal year.
- On-line games offered were PowerBall[®], Mega Millions[®], Keno, Daily Numbers, Raffle and Wild Money at June 30, 2011. In total, on-line revenue decreased by \$3.3 million, which is mostly attributable to decreased Powerball sales.
- PowerBall[®] sales for the fiscal year ended June 30, 2011 decreased by \$14.5 million. Much of Powerball's decrease is explained by the increase in sales for a full year's offering of the Mega Millions[®] game, a second multi-state jackpot game which was first offered in Rhode Island in January 2010. Sales for Mega Millions in fiscal 2011 increased by \$7.5 million as compared to fiscal 2010 when the game was only available to the public for half the fiscal year. Overall, sales for the two multi-state jackpot games combined, decreased by \$7 million when compared to fiscal 2010.

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

The following graph depicts the Lottery's on-line sales for the fiscal years ended June 30, 2010 and 2011.

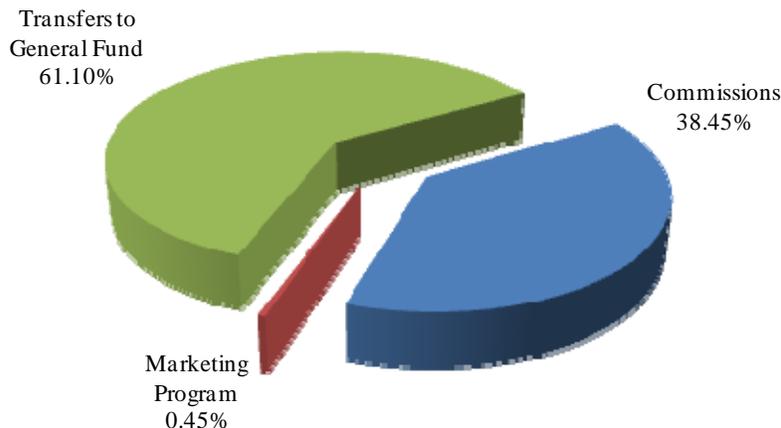


Video Lottery

- Video lottery net revenue increased \$24.8 million. The continued increase in reported video lottery net revenue is mostly attributable to the Lottery's largest video lottery facility, the popularity of virtual multi-player video table games such as blackjack and roulette that simulates the excitement of table games, and increases in State authorized player promotional credits and reimbursable marketing expenditures.
- The Lottery continued to allot credits to each video lottery facility for patrons enrolled in their player rewards program. The credits, which approximated \$19.3 million in redeemed free play during fiscal year 2011, are part of increased marketing efforts to increase video lottery revenues. These credits are designed to entice more frequent visits by patrons to the facility.

Distribution of the year's video lottery revenue was as follows:

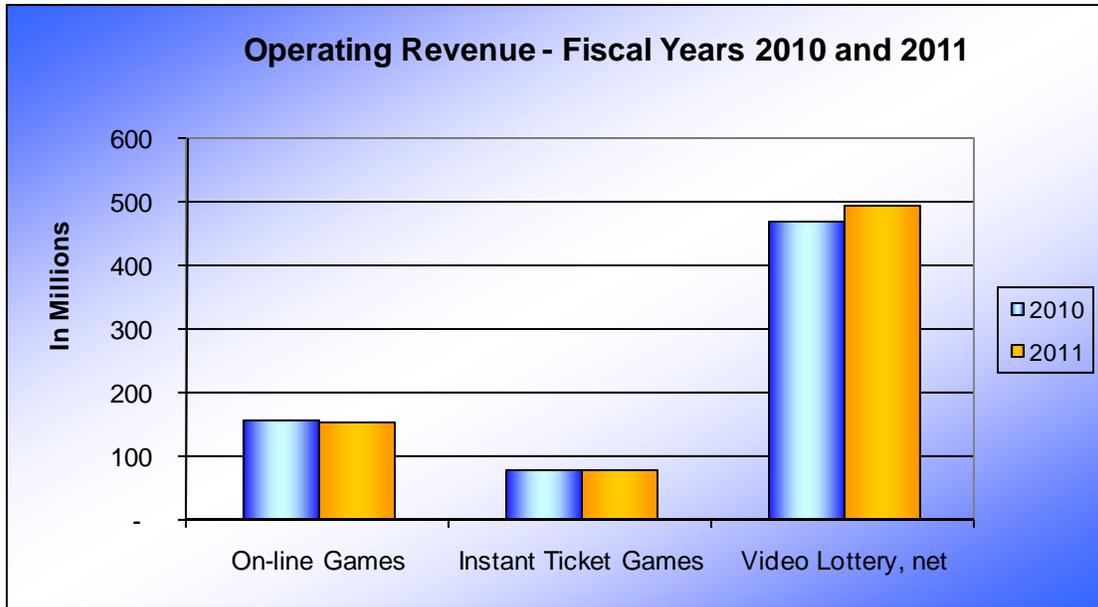
Video Lottery, net



RHODE ISLAND LOTTERY

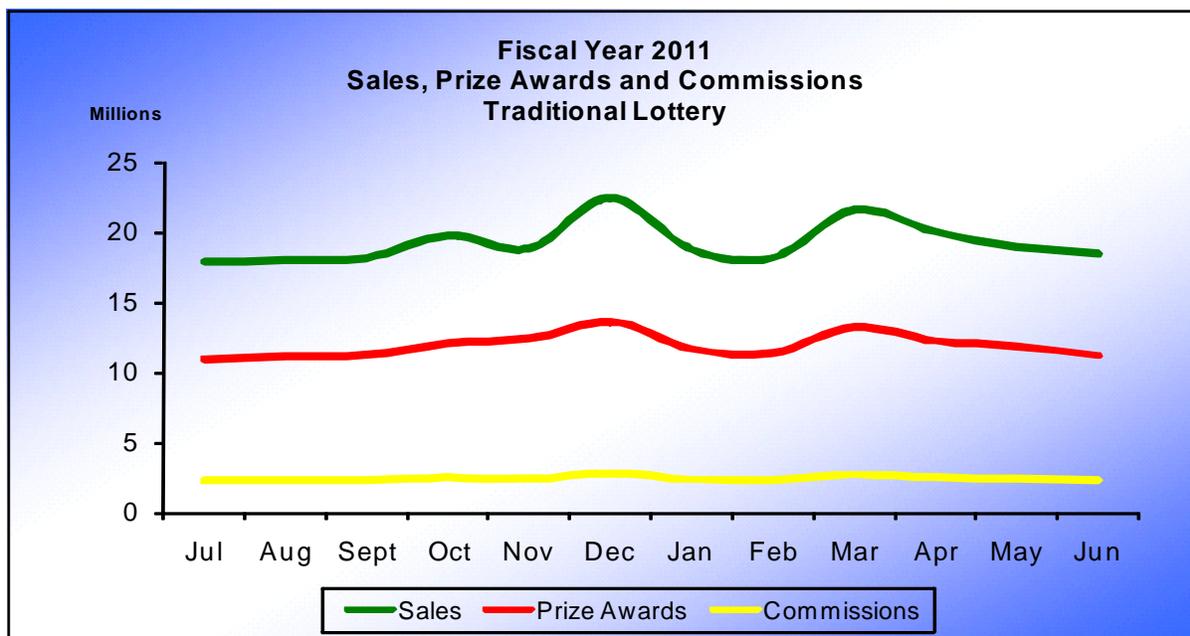
Management's Discussion and Analysis

The following graph depicts the Lottery's on-line, instant, and video lottery operating revenue for the fiscal year ended June 30, 2010 in comparison to fiscal year ended June 30, 2011.

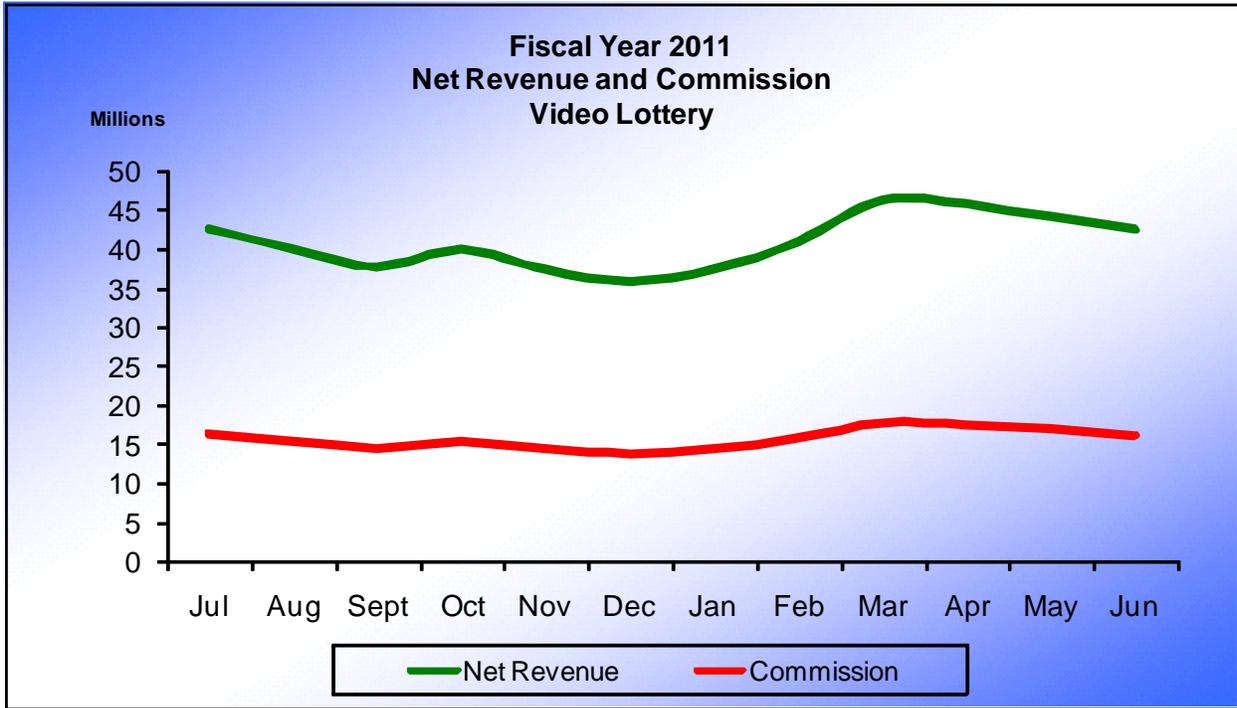


Commissions and Prize Awards Expense

As the following graphs depict, the Lottery's most significant expenses (commissions and prize awards) are predictable because they have a direct correlation to sales. As lottery revenues increase, so do the related prizes and commissions paid by the Lottery. While each Lottery game has a designed prize payout structure, the overall amount paid as prize awards expense is consistent in relation to sales. The second graph below compares video lottery net revenues to related commissions.

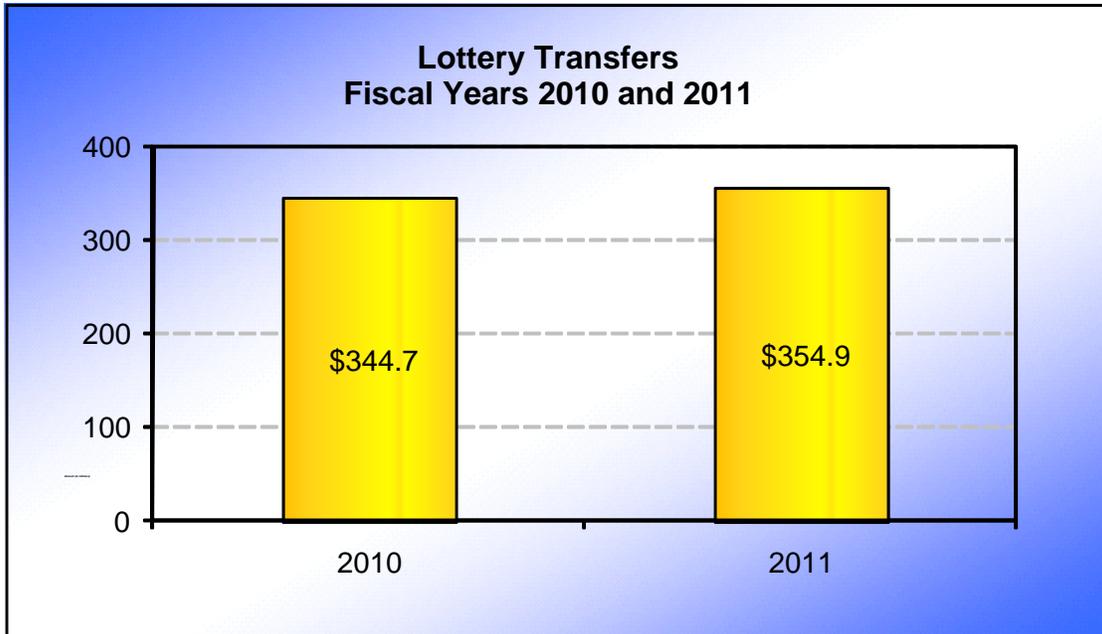


RHODE ISLAND LOTTERY
Management's Discussion and Analysis



Lottery Transfers

Net income transferred by the Lottery for the fiscal years ended June 30, 2011 and June 30, 2010 was \$354.9 million and \$344.7 million, respectively. All fiscal 2011 transfers were made by the Lottery directly to the State's General Fund, as required by the General Laws.



RHODE ISLAND LOTTERY

Management's Discussion and Analysis

Debt Administration

Jackpot prizes awarded under PowerBall® and Mega Millions® are satisfied through investments purchased by the Multi-State Lottery Association (MUSL). MUSL purchases United States government obligations, which are held in irrevocable trusts established by MUSL for the benefit of participating state lotteries. Accordingly, the Lottery does not record an obligation for PowerBall® jackpot awards which are payable in installments from funds provided by MUSL.

Capital Assets

The Lottery purchases and maintains property and equipment necessary to sell lottery products, pay prizes and perform other lottery operations.

For further information, refer to Notes to Financial Statements, Note 4.

Potential Factors Impacting Future Operations

The Lottery's mission is to maximize revenues for the purpose of maximizing payments to the State's General Fund. A continuous assessment of the State's financial environment and the Lottery's own product lines and operations are essential to accomplish this mission. The following considerations have been presented to inform those interested in the Lottery's operations about potential factors that could affect future operations:

- During fiscal 2011, the Lottery exercised the first amendment to the Master Video Lottery Contracts with its video lottery facilities, Twin River and Newport Grand. These amendments cover a second five year term under the original contracts that run through 2015. These extensions allow the facility to continue its promotional play program where the facility can reward loyal patrons with free play up to an amount of 4% of the facility's prior year net terminal income. The extension also requires the Lottery to reimburse the facility for its net terminal income share of certain qualified marketing and promotional expenses (see Note 12(b) and 12(c) for complete details). This requirement assists the facilities with the cost of marketing the State's video lottery gaming operations while ensuring that the facilities invest appropriately in the promotion of their facilities.
- Revenues overall are down at many gaming venues throughout New England due to current economic conditions. Competition among gaming venues has increased, resulting in more promotional allowances, player reward incentives being offered, and increased marketing efforts.
- The Lottery's video lottery operations currently compete with casinos in nearby Connecticut. In addition, Massachusetts lawmakers have put forth a bill to allow three casinos and one slot parlor in that State. It is anticipated that, if the law passes, there could be an adverse effect on the amount of revenue derived from video lottery facilities in Rhode Island. The Lottery and the State continually monitor the risk to gaming operations resulting from competition in nearby states.
- Recently enacted legislation has authorized a statewide ballot referendum that allows the voters of Rhode Island to approve the expansion of gaming at the Twin River video lottery facility located in Lincoln, RI. The expansion would allow Twin River to offer casino style gaming (i.e., table games) to the public subject to the operational control by the Lottery and/or Department of Business Regulation. This referendum is also subject to local (Town of Lincoln) voter approval.

RHODE ISLAND LOTTERY
Management's Discussion and Analysis

Contacting the Lottery's Financial Management

This financial report is designed to provide a general overview of the Lottery's financial activity for all those interested in the Lottery's operations. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to the Office of the Finance Administrator, Rhode Island Lottery, 1425 Pontiac Avenue, Cranston, Rhode Island, 02920.

RHODE ISLAND LOTTERY

Statement of Net Assets

June 30, 2011

Assets

Current assets:

Cash and cash equivalents (note 3)	\$	18,228,713
Accounts receivable-less allowance for doubtful accounts of \$107,383		4,125,664
Deposits with Multi-State Lottery Association (MUSL) (note 1)		51,333
Ticket inventory		991,810
Total current assets		23,397,520

Capital assets, net (note 4)

Total assets		469,496
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23,867,016

Liabilities

Current liabilities:

Due to State's General Fund (note 5)	\$	2,731,761
Due to State's General Fund - Operating Expenses		335,563
Accounts payable		11,951,432
Obligation for unpaid prize awards		4,957,712
Accrued expenses		3,229,909
Compensated absences (note 7)		187,195
Deferred revenue		226,485
Unearned contract revenue (note 8)		625,000
Total current liabilities		24,245,057

Long-term liabilities:

Compensated absences (note 7)		246,959
Unearned contract revenue (note 8)		6,875,000
Total long-term liabilities		7,121,959
Total liabilities		31,367,016

Net Assets

Invested in capital assets (note 8)		469,496
Unrestricted (note 8)		(7,969,496)
Total net assets (deficiency)	\$	(7,500,000)

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Revenue, Expenses and Changes in Net Assets

Year Ended June 30, 2011

Operating Revenue (schedule 1):	
On-line games	\$ 153,375,296
Instant games	77,217,452
Video lottery, net (note 2)	<u>492,594,189</u>
Total revenue	<u>723,186,937</u>
Cost of gaming operations:	
Commissions (note 6)	217,612,292
Prize awards	142,324,102
Incentive programs, video	2,212,253
Advertising	2,088,973
Unclaimed prize recovery	(2,368,721)
Cost of tickets	<u>1,109,481</u>
Total cost of gaming operations	<u>362,978,380</u>
Gross profit	<u>360,208,557</u>
Operating expenses:	
Personal services	4,826,364
Contract services	80,732
Depreciation	234,375
Other	<u>749,718</u>
Total operating expenses	<u>5,891,189</u>
Operating income	354,317,368
Non-operating income (expenses):	
Investment income	76,759
Other income	<u>1,091,860</u>
Income before Transfers	355,485,987
Transfers to State's General Fund (note 5)	<u>(354,860,987)</u>
Change in net assets	625,000
Total net assets (deficiency), beginning of year	<u>(8,125,000)</u>
Total net assets (deficiency), end of year (note 8)	<u>\$ (7,500,000)</u>

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Cash Flows

Year Ended June 30, 2011

Cash flows from operating activities:	
Receipts from traditional lottery sales	\$ 229,312,781
Receipts from video lottery operations, net	492,594,189
Receipts from MUSL for grand prize winners	3,293,000
Receipts from sale of other tickets	103,042
Other receipts	489,956
Payments for on-line and instant ticket prizes	(140,191,970)
Payments to MUSL grand prize winners	(3,293,000)
Payments for commissions - retailers	(8,208,460)
Payments for commissions - video lottery	(187,874,908)
Payments for commissions - on-line games contractor	(19,933,400)
Payments to suppliers for goods and services	(3,926,542)
Payments to employees for services	(4,867,093)
	<hr/>
Net cash provided by operating activities	357,497,595
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Cash flows from noncapital financing activities:	
Transfers to State's General Fund	(353,775,229)
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Net cash used for noncapital financing activities	(353,775,229)
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Cash flows from capital and related financing activities:	
Purchase of capital assets	(13,000)
	<hr/>
Net cash used for capital and related financing activities	(13,000)
	<hr/>
Cash flows from investing activities:	
Interest income	76,759
	<hr/>
Net cash provided by investing activities	76,759
	<hr/>
Net increase in cash and cash equivalents	3,786,125
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Cash and cash equivalents at July 1, 2010	14,442,588
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Cash and cash equivalents at June 30, 2011	\$ 18,228,713
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See accompanying notes to financial statements.

Continued.

RHODE ISLAND LOTTERY
Statement of Cash Flows (continued)
Year Ended June 30, 2011

Reconciliation of operating income to net cash provided by operating activities:	
Operating income	<u>\$ 354,317,368</u>
Adjustments to reconcile operating income to net cash provided by (used for) operating activities:	
Depreciation	234,375
Miscellaneous receipts classified as operating activities	77,376
Rental income and other receipts	389,483
(Increase) decrease in assets:	
Accounts receivable	(1,352,109)
Inventory	100,473
Deposits with MUSL	198,787
Increase (decrease) in liabilities:	
Obligation for unpaid prize awards	(236,589)
Accounts payable	1,488,496
Due to State's General Fund - Operating expenses	210,331
Accrued expenses and Other	2,004,257
Deferred revenue	<u>65,347</u>
Total adjustments	<u>3,180,227</u>
Net cash provided by operating activities	<u><u>\$ 357,497,595</u></u>

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization

The Lottery was created in 1974 under the General Laws of the State of Rhode Island (General Laws) to establish and operate lottery games for the purpose of generating resources for the State's General Fund. The Lottery is a division of the Department of Revenue of the State of Rhode Island (the State).

The Lottery offers:

- On-line games that include: Daily Numbers, Keno, Wild Money, PowerBall[®], Mega Millions[®], and Raffle. Powerball[®] and Mega Millions[®] are multi-state games operated in accordance with rules and agreements established by the Multi-State Lottery Association (MUSL).
- Instant tickets sold through licensed lottery retailers.
- Video lottery games which are located at two licensed facilities.

Prize payout percentages and amounts required to be paid to the State's General Fund as stipulated in the General Laws are summarized below for the various games operated by the Lottery.

<u>Game</u>	<u>Prize Payout</u>	<u>Mandated Payments to the State</u>
Daily Numbers Raffle Instant Ticket Games PowerBall [®] Mega Millions [®] Wild Money	Not less than 45% or more than 65% of sales	Payments to the General Fund - not less than 25% of ticket sales
Keno	Not less than 45% or more than 72% of sales	Payments to the General Fund - not less than 15% of ticket sales
Video Lottery	Prize payout not established by law	Payments to the General Fund - net terminal income (video lottery credits purchased less credits redeemed or redeemable, including prize contributions to multi-state video lottery progressive jackpots) minus commission payments and incentive program reimbursements.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization - (Continued)

(a) *PowerBall*[®]

The Lottery sells PowerBall[®] tickets, collects all revenues, and remits prize funds to MUSL net of low-tier prize awards. Jackpot prizes are payable in either a lump-sum cash distribution or annual installments. Annual installments are satisfied through investments purchased by MUSL. MUSL purchases U.S. government obligations, which are held in irrevocable trusts established by MUSL for the benefit of participating state lotteries. Accordingly, the Lottery does not record an obligation for jackpot awards which are payable in installments from funds provided by MUSL.

The prize pool for PowerBall[®] is 50% of each drawing period's ticket sales. MUSL has placed 2% of each drawing period's ticket sales for PowerBall[®], included as part of each member's prize liability, in prize reserve funds. The maximum balance on the prize reserve funds for PowerBall[®] is \$100.0 million. Once the prize reserve funds exceed this designated cap, the excess becomes part of the prize pool. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities, and these reserve funds are to be used at the discretion of the MUSL Board of Directors. The prize reserve funds are refundable to MUSL members if the MUSL disbands or if a member leaves MUSL. Members leaving MUSL must wait one year before receiving their remaining share, if any, of prize reserve funds. At June 30, 2011, the prize reserve funds for the PowerBall[®] game reported a balance of \$97.4 million of which the Lottery's share was \$1.5 million. The Lottery has charged amounts placed into the prize reserve funds to prize awards expense as the related sales have occurred.

All investment earnings relating to the prize reserve funds are credited to an unreserved account for each member state. This account can be utilized to offset operating costs or for the promotion of any MUSL game as approved by the MUSL Board of Directors. During fiscal year 2011, MUSL reduced the Lottery's unreserved account by \$63,700 for a pro rata share of annual operating expenses. The Lottery has recorded all income and operating expenses related to its unreserved account and has reported the balance of \$51,333 at June 30, 2011 on the Statement of Net Assets in "Deposits with MUSL".

(b) *Mega Millions*[®]

MUSL participates as a member (or party) lottery of the Mega Millions[®] Product Group (a group of lotteries participating under an agreement between the Mega Millions[®] lotteries and MUSL to offer the Mega Millions[®] game within their State jurisdictions). The Rhode Island Lottery participates as a member of MUSL, in the sale of tickets, payment of prizes, and associated activities related to the Mega Millions[®] lottery game. As such, the Lottery sells Mega Millions[®] tickets, collects all revenues, and remits prize funds to MUSL net of low-tier prizes. Jackpot prizes are payable either in a lump-sum cash distribution or annual installments. Annual installments are satisfied through investments purchased by MUSL. MUSL purchases U.S. government obligations, which are held in irrevocable trusts established by MUSL for the benefit of participating lotteries. Accordingly, the Lottery does not record an obligation for jackpot awards which are payable in installments from funds provided by MUSL.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization - (Continued)

The prize pool for Mega Millions[®] is up to 55% of each drawing period's sales after prize reserve accounts are funded, but may be higher or lower based on the number of winners at each prize level, as well as funding required to meet a guaranteed annuity grand prize. An amount of up to 5% of a participating lottery's sales is included in trust in one or more prize reserve accounts held by MUSL for its participating members. Contributions to prize reserve accounts are made only when the reserve balances are below the maximum balances designated by MUSL. The maximum deduction to be taken from the grand prize pool to fund the prize reserve account is 2.5%. As of the July 1, 2011 drawing, the deduction taken from the grand prize pool to fund the reserve account is 1.5%. The MUSL Board of Directors, with the approval of the Finance and Audit Committee, is responsible for establishing the maximum prize reserve amount. The Mega Millions[®] reserve may be adjusted with refunds to a participating lottery as needed to maintain the approved maximum balance and shares to the participating lottery. Any amount remaining in a prize reserve account at the end of this game shall be carried forward to a replacement prize reserve account or expended in a manner as directed by the product group in accordance with the jurisdiction law. At June 30, 2011, the prize reserve fund for the Mega Millions[®] game reported a balance of \$9.1 million of which the Lottery's share was \$142,499. The Lottery has charged amounts placed into the prize reserve funds to prize awards expense as the related sales have occurred.

MUSL issues a publicly available annual financial report that may be obtained by writing to the Multi-State Lottery Association, 4400 NW Urbandale Drive, Urbandale, Iowa 50322.

(c) *Video Lottery*

Chapter 42-61.2 of the General Laws authorizes the Division of Lotteries to conduct and control video lottery games. This chapter stipulates the allocation of video lottery net terminal income (video lottery credits purchased less credits redeemed or redeemable). Consistent with the General Laws, net terminal income is distributed to licensed video lottery facility operators, the technology providers (video lottery terminal providers), the central communications system provider, the city or town in which the video facility is licensed and the Narragansett Indian Tribe. All residual net terminal income after mandated commission payments, other transfers, and reimbursable marketing expenses is remitted to the State's General Fund.

(2) Summary of Significant Accounting Policies

(a) *Basis of Accounting*

The financial records of the Lottery, an enterprise fund, are accounted for using the economic resources measurement focus and are maintained on the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recognized at the time the related liabilities are incurred. The Governmental Accounting Standards Board (GASB) has the responsibility for establishing generally accepted accounting principles for governmental proprietary fund type activities.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(2) Summary of Significant Accounting Policies – (Continued)

In accordance with GASB Statement No. 20, in the absence of specific guidance from a GASB pronouncement, pronouncements of the Financial Accounting Standards Board (FASB) issued on or before November 30, 1989 have been followed.

The Lottery has considered the impact and requirements of newly issued GASB Statements in the preparation of these financial statements.

(b) *Reporting Entity*

The Lottery, a division of the Department of Revenue of the State of Rhode Island and Providence Plantations (State), is accounted for as an enterprise fund for financial reporting purposes. Accordingly, its annual financial statements are included in the State's Comprehensive Annual Financial Report (CAFR). The accompanying financial statements are not intended to present the financial position and results of operations of the State.

(c) *Revenues and Expenses*

The Lottery defines all revenues and expenses deriving from on-line, instant ticket and video lottery sales as operating. All other revenues and expenses are defined as non-operating. The Lottery accrues for the maximum prizes payable. Prize obligations, other than those relating to prizes payable in installments, that remain unclaimed one year after the drawing date are reported as a reduction to cost of sales.

Revenue from the sale of lottery tickets and video lottery, and expenses for prizes and commissions are recognized as follows:

1. On-line lottery games with specific drawing dates - when the related drawings are held.
2. Instant ticket lottery games - when ticket packets are charged to retailers. Prize expense is recognized in proportion to the number of tickets sold based on the stated prize structure for a specific instant ticket game.
3. Video lottery games - gross revenue is recognized when game credits are purchased via cash or credit redemption at the terminal (gross terminal inputs). Related prizes are recognized when game credits are issued by a video lottery terminal making them redeemable as credits in another video terminal or for cash by a patron (gross terminal outputs). Beginning in fiscal year 2011, video lottery revenue is reported in the Statement of Revenue, Expenses, and Changes in Net Assets as the net of gross terminal inputs and outputs resulting from video lottery operations.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(2) Summary of Significant Accounting Policies – (Continued)

The gross video lottery terminal inputs and outputs for fiscal 2011 and reported video lottery net revenue are detailed in the following schedule:

Schedule of Video Lottery Net Revenue For the Fiscal Year Ended June 30, 2011	
Video Terminal Cash-In (Gross Terminal Inputs):	
Cash collected from video lottery terminals	\$ 1,398,834,202
Plus: Credit vouchers redeemed for play in video lottery terminals	<u>1,496,174,176</u>
Total cash in reported by video lottery terminals	2,895,008,378
Less:	
Video Terminal Cash-out (Gross Terminal Outputs):	
Video lottery credit vouchers issued by video lottery terminals	2,401,387,066
Plus: Contributions to progressive video jackpots from patron play	<u>1,027,123</u>
Total cash-out amounts reported by video lottery terminals	<u>2,402,414,189</u>
Video lottery revenue, net	<u><u>\$ 492,594,189</u></u>

(d) *Capital Assets*

Capital assets are stated at historical cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets. The Lottery's capitalization threshold is \$5,000.

(e) *Cash Equivalents*

Cash equivalents consist of highly liquid investments with a maturity of three months or less at the time of purchase and are stated at cost plus accrued interest which approximates fair value.

(f) *Ticket Inventory*

Inventory consists of the cost of tickets for the instant games, which is expensed as a percentage of sales from instant ticket games.

(g) *Deferred Revenue*

Tickets can be purchased in advance of scheduled drawing dates. Revenue from advance ticket sales is recognized during the period in which the related drawing is held. Sales pertaining to future drawings are reported as deferred revenue.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(2) Summary of Significant Accounting Policies – (Continued)

(h) *Unearned Contract Revenue*

Unearned contract revenue relates to the sale of the exclusive rights to the operation of the Lottery's gaming systems. The revenue is recognized ratably over the life of the contract.

(i) *Incentive Programs – Video*

Beginning in fiscal 2011, the Lottery began reimbursing its contracted video lottery facilities for the State's share (net terminal income percentage) of certain marketing and promotional expenses incurred by the facilities. Complete details of the Lottery's reimbursement are disclosed in Note 12, Commitments.

(j) *Use of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual amounts could differ from those amounts.

(k) *Changes in Presentation*

For fiscal 2011, net video lottery terminal revenue is included in the financial statements as compared to gross video lottery revenue and prize awards reported in prior periods. Prior period amounts included in Management's Discussion and Analysis have been restated to conform to the new net presentation.

Beginning in fiscal 2011, advertising expense for on-line and instant ticket games is reported as a direct cost of gaming operations. The Lottery previously reported its advertising as an operating expense not specifically attributable to any one gaming category. Schedule 1, provided as supplementary information, details advertising expense by lottery game.

(3) Deposits and Investment Risk

(a) *Deposits*

The Lottery's cash deposit balances at June 30, 2011 totaled \$790,468, with corresponding bank balances totaling \$804,120. The bank balances consisted of \$259,676 in demand deposit accounts and \$544,444 in collateralized deposit investment accounts.

All deposits were in the custody of the State General Treasurer. Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are (a) uncollateralized, (b) collateralized with securities held by the pledging financial institution, or (c) collateralized with securities held by the pledging financial institution's trust department or agent but not in the Lottery's (or State's) name.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(3) Deposits and Investment Risk - Continued

In accordance with Chapter 35-10.1 of the General Laws, depository institutions holding deposits of the State, its agencies or governmental subdivisions of the State, shall at a minimum, insure or pledge eligible collateral equal to one hundred percent of time deposits with maturities greater than 60 days. Any of these institutions which do not meet capital standards prescribed by federal regulators shall insure or pledge eligible collateral equal to 100% of deposits, regardless of maturity. None of the cash deposits of the Lottery were required to be collateralized at June 30, 2011 pursuant to Chapter 35-10.1 of the General Laws. However, the State Investment Commission has adopted a collateralization requirement for institutions holding the State's deposits. Financial institutions are required to pledge collateral equal to 102% of the uninsured deposit amounts. Of the total bank deposit balance totaling \$804,120 at year end, the entire amount was either covered by federal depository insurance or collateralized by securities held by an independent third party custodian.

(b) Investments

All investments, principally cash equivalent type investments, are made by the State General Treasurer in accordance with guidelines established by the State Investment Commission (SIC), which is responsible for the investment of all State funds. Pursuant to Chapter 35-10 of the General Laws, the SIC may, in general, "invest in securities as would be acquired by prudent persons of discretion and intelligence in these matters who are seeking a reasonable income and the preservation of their capital."

At June 30, 2011, the Lottery's investment balance consisted of a money market mutual fund as follows:

Investment Description	Fair Value at June 30, 2011	Credit Rating	Average Maturity
BlackRock Liquidity Funds – FedFund Institutional Shares	\$ 17,438,245	AAAm (S&P) Aaa-mf (Moody's)	31 days

Custodial Credit Risk: Investment securities are exposed to custodial risk if the securities are uninsured, are not registered in the name of the government and are held by either: a) the counterparty or b) the counterparty's trust department or agent but not in the government's name. Pursuant to guidelines established by the SIC, securities purchased, or underlying collateral, are required to be delivered to an independent third party custodian.

Interest Rate Risk: Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Based on SIC policy, the State's short-term investment portfolio, whenever possible, will be structured to minimize interest rate risk, by matching the maturities of investments with the requirements for funds disbursement. The Lottery's investments are typically money market mutual funds or investments with maturities less than 30 days thereby minimizing the Lottery's exposure to interest rate risk.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(3) Deposits and Investment Risk - Continued

Credit Risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The SIC has adopted policies regarding acceptable short-term investment types. Credit risk is mitigated by the SIC's minimum rating criteria policy, collateralization requirements, and limiting the maximum participation by any one issuer to 35% of the State's total short-term investment portfolio. Credit risk policies have been developed for investments in commercial paper.

Concentration of Credit Risk: The SIC has adopted limitations as to the maximum percentages of the State's total short-term investment portfolio that may be invested in a specific investment type or with any one issuer of securities.

(c) Cash and Cash Equivalents

Cash and cash equivalents on the Statement of Net Assets consist of the following:

Cash deposit balance per books	\$ 790,468
Investments classified as cash equivalents	<u>17,438,245</u>
Cash and cash equivalents	<u>\$ 18,228,713</u>

(4) Capital Assets

Lottery headquarters are situated on land owned by the State of Rhode Island. The State has assigned custody, control and supervision of the land to the Lottery at no cost. However, since title to such land remains vested in the State, it is not recorded in the statement of net assets.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(4) Capital Assets - Continued

A summary of capital assets follows:

<u>Cost</u>	<u>Estimated Useful Life</u>	<u>Balance at July 1, 2010</u>	<u>2011 Additions</u>	<u>2011 Disposals</u>	<u>Balance at June 30, 2011</u>
Building	20	\$ 1,468,983	\$ -	\$ -	\$ 1,468,983
Building improvements	10	1,947,226	-	-	1,947,226
Ticket production equipment	10	14,938	-	-	14,938
Office equipment	10	104,202	-	(366)	103,836
Furniture and fixtures	10	92,332	-	-	92,332
Lottery drawing equipment	3	86,402	13,000	-	99,402
Automobiles	3	271,044	-	-	271,044
Computer equipment	3	236,947	-	(5,487)	231,460
Trucks	3	22,445	-	-	22,445
Total		<u>\$ 4,244,519</u>	<u>\$ 13,000</u>	<u>\$ (5,853)</u>	<u>\$ 4,251,666</u>
<u>Less: Accumulated Depreciation</u>					
Building		\$ 1,451,453	\$ 1,553	\$ -	\$ 1,453,006
Building improvements		1,406,558	187,083	-	1,593,641
Ticket production equipment		14,939	-	-	14,939
Office equipment		29,554	8,159	-	37,713
Furniture and fixtures		72,664	7,347	-	80,011
Lottery drawing equipment		86,402	2,871	-	89,273
Automobiles		237,422	25,095	-	262,517
Computer equipment		232,212	1,743	(5,330)	228,625
Trucks		22,445	-	-	22,445
Total		<u>\$ 3,553,649</u>	<u>\$ 233,851</u>	<u>\$ (5,330)</u>	<u>\$ 3,782,170</u>
Capital assets, net		<u>\$ 690,870</u>	<u>\$ (220,851)</u>	<u>\$ (523)</u>	<u>\$ 469,496</u>

(5) Transfers to the State

The Lottery is required to transfer net proceeds from the Lottery's games in accordance with RI General Laws sections 42-61-15 and 42-61.2-7 as follows:

- (a) Transfers to the State's General Fund for fiscal 2011 are reported as follows in the Lottery's financial statements:

Due to State's General Fund, beginning of year	\$ 1,646,003
Transfers to State's General Fund	354,860,987
Cash paid during fiscal year	<u>(353,775,229)</u>
Due to State's General Fund, end of year	<u>\$ 2,731,761</u>

RHODE ISLAND LOTTERY

Notes to Financial Statements

(6) Commissions

The Lottery pays commissions to ticket retailers and its on-line games contractor based on a percentage of gross ticket sales. Video lottery commissions, as specified in the General Laws, are paid to the facility operators, technology providers (video lottery terminal providers), the central communications provider and others based on various percentages of net terminal income (video lottery credits purchased less credits redeemed or redeemable plus progressive jackpots).

The General Laws provide for reductions of certain video lottery commissions. The amount reduced is to be credited to the State's Distressed Communities Relief Fund, which is part of the State's General Fund. The Lottery has reflected the actual video commissions paid as an expense. The amount to be credited to the Distressed Communities Relief Fund is included in the payments to the State's General Fund.

(7) Compensated Absences

The Lottery accrues an estimated liability for vested benefits relating to future compensated absences. This includes an expected obligation in connection with vacation credits, pay reduction credits, and accumulated vested sick pay for those employees eligible for retirement. The liability for compensated absences was approximately \$434,154 and \$361,826 as of June 30, 2011 and 2010, respectively, and is recorded as a liability in the Statement of Net Assets. The current portion of \$187,195 as reported was estimated based on a two year average of employee utilization experience.

Changes in the reported liability for compensated absences for fiscal 2011 are as follows:

	Balance at July 1, 2010	Increase	Decrease	Balance at June 30, 2011
Liability for Compensated Absences	\$ 361,826	\$ 347,240	\$ 274,912	\$ 434,154

(8) Net Assets - (Deficiency)

On May 12, 2003, the Lottery entered into a 20-year contract, effective July 1, 2003, with its current gaming system provider. The contract granted the provider the right to be the Lottery's exclusive vendor of hardware and software, together with the related services necessary for the operation of the Lottery's computerized games, through June 30, 2023. In return, the provider made a one-time payment of \$12.5 million to the Lottery as consideration for this exclusive contract right. The Lottery recorded unearned contract revenue in the amount of \$12.5 million and transferred the cash to the State's General Fund on June 30, 2003. This prior year transfer of unearned contract revenue resulted in a deficiency in net assets at June 30, 2011 of \$7.5 million. As the contract revenue is recognized over the twenty-year life of the contract, the deficiency in net assets will be reduced by \$625,000 per year. Accordingly, the Lottery has recognized \$625,000 as the current portion of unearned revenue as of June 30, 2011.

Net assets reported by the Lottery also include its investment in capital assets, net of accumulated depreciation. The Lottery had no debt related to capital assets at June 30, 2011.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(9) Retirement Plan

Plan Description:

All Lottery employees must participate in a cost-sharing multiple-employer defined benefit pension plan administered by the State of Rhode Island Employees' Retirement System (ERS). The plan provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. The level of benefits provided to state employees is established by Chapter 36-10 of the General Laws, which is subject to amendment by the General Assembly. The ERS issues a publicly available financial report that includes financial statements and required supplementary information for plans administered by the system. The report may be obtained by writing to the Employees' Retirement System, 40 Fountain Street, Providence, RI 02903.

Funding Policy:

The funding policy, as set forth in the General Laws, Section 36-10-2, provides for actuarially determined periodic contributions to the plan. Lottery employees are required to contribute 8.75% of their annual covered salary. The Lottery is required to contribute at an actuarially determined rate; the rate was 20.78% of annual covered payroll for the fiscal year ended June 30, 2011. The Lottery contributed \$595,558, \$582,513 and \$586,324 for the fiscal years ended June 30, 2011, 2010 and 2009, respectively, equal to 100% of the required contributions for each year.

(10) Postemployment Healthcare Plan

Plan Description:

The Lottery contributes to the State Employees' defined benefit post-employment health care plan, a cost sharing multiple employer plan administered through the Rhode Island State Employees' and Electing Teachers OPEB System (OPEB System). The State of Rhode Island OPEB Board (Board) was authorized, created and established under Chapter 36-12.1 of the RI General Laws. The Board was established to independently hold and administer, in trust, the funds of the OPEB system. The plan provides medical benefits to certain retired employees of participating employers including the Lottery.

Pursuant to legislation enacted by the General Assembly, a trust was established in fiscal year 2011 to accumulate assets and pay benefits and other costs associated with the system.

Beginning with the fiscal year ended June 30, 2011, the OPEB system will issue a stand-alone financial report. A copy will be available at the web site of the Office of Accounts & Control – <http://controller.admin.ri.gov/Financial%20Reports/index.php>.

Funding Policy:

RIGL Sections 36-12.1, 36-12-2.2, and 36-12-4 govern the provisions of the OPEB system. The contribution requirements of plan members, the State, and other participating employers are established and may be amended by the General Assembly. Active employees make no contribution to the OPEB plan. Employees who retired after October 1, 2008 must contribute 20% of the annual estimated benefit cost (working rate) or annual premium for Medicare supplemental coverage. Employees retiring before October 1, 2008 have varying co-pay percentages ranging from 0% to 50%

RHODE ISLAND LOTTERY

Notes to Financial Statements

(10) Postemployment Healthcare Plan - Continued

based on age and years of service at retirement. Further information about the contributions of plan members can be found in the financial report of the OPEB system.

Effective in fiscal year 2011, all participating employers are required by law to fund the actuarially determined annual required contribution (ARC), which for fiscal year 2011 was 6.74% of covered payroll. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal costs each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years. The Lottery's contribution to the plan for the year ended June 30, 2011 was \$193,447. Prior to the creation of the OPEB trust in fiscal year 2011, the contributions to the plan were made on a pay as you go basis.

In prior years, the Lottery contributed to the State Employees' OPEB plan, which consistent with GASB 45 provisions, was administered as an agent multiple employer plan because no separate legal trust had been created. The transition by the State of its OPEB plan in fiscal 2011 to an OPEB Trust resulted in the State Employees' Plan being redefined as a cost sharing multiple employer plan. In accordance with the requirements of GASB 45, the Lottery's net OPEB obligation recorded in previous years has been reduced to zero.

(11) Deferred Compensation

Employees of the Lottery may participate in a deferred compensation plan offered by the State. Required disclosures are reported in the State's CAFR.

(12) Commitments

(a) Gaming Systems Provider – GTECH (an indirect wholly-owned subsidiary of Lottomatica Group S.p.A.)

During May 2003, the Lottery entered into a 20-year master contract with its gaming systems provider granting them the right to be the exclusive provider of information technology hardware, software, and related services for all lottery games. This contract is effective from July 1, 2003 through June 30, 2023, and amends all previous agreements between the parties.

As consideration for this exclusive right, the gaming systems provider paid the Lottery \$12.5 million. In the event that the contract term is not fulfilled, the Lottery will be obligated to refund a pro-rata share of this amount to the gaming systems provider. Additionally, GTECH was obligated to invest \$100 million in connection with the construction of a new corporate headquarters and expansion of its manufacturing operations in the State. The gaming system contractor is also required to employ no less than 1,000 full time active employees during the term of the agreement.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments - Continued

The contract mandates commission percentages as detailed in the following chart.

Commission Percentages	
On-Line and Instant Tickets	
Total Lottery Sales in the Year	Percent Thereof
\$0 - \$275 Million	5.00%
Over \$275 Million - \$400 Million	1.00%
Over \$400 Million	5.00%
Video Lottery Central System	
Total Net Terminal Income for the Year	Percent Thereof
\$0 - \$500 Million	2.50%
Over \$500 Million - \$1 Billion	1.00%
Over \$1 Billion	2.50%

The Lottery also leases to the vendor a portion of its headquarters to house the computer hardware and office space necessary for the operation of the Lottery's games. The term of the lease is five (5) years, commencing October 19, 2007 and the square footage leased is 5,101 square feet. The annual lease amount for the first year approximated \$87,000 and the four (4) remaining years will increase by four percent (4%) per annum, effective October 19. The tenant has two (2) renewal options; an additional five (5) year term and an additional four (4) year term. The base rate for the renewal options will be an increase of four percent (4%) per annum unless a mutually acceptable rate is negotiated.

(b) Video Lottery Facility Operator – UTGR, Inc. (Twin River)

On July 18, 2005, the Lottery entered into a five (5) year Master Video Lottery Terminal Contract with UTGR, Inc. (UTGR), the owners of Twin River, to manage one of the State's licensed video lottery facilities. The contract entitles UTGR to compensation ranging from 26% to 28.85% of video lottery net terminal income at the facility. UTGR and the lottery extended the contract and signed the first five-year extension term commencing on July 18, 2010. The second term would commence on July 18, 2015. Certain extensions are contingent on UTGR's compliance with full-time employment mandates.

The First Amendment to the Master Contract provides for a promotional points program of up to 4% of the facility's prior year net terminal income. The general laws require a base of \$750,000 to be expended before the previously authorized 4% of prior year net terminal income. The First Amendment requires the Lottery to reimburse UTGR for allowable marketing expenses at an amount not to exceed \$6 million multiplied by the Lottery's percentage of net terminal income (61.08% for fiscal 2011). The reimbursement of marketing expenses by the Lottery occurs only after UTGR has incurred \$4 million in qualified marketing expenses (with marketing expenses defined by the Lottery) and is contingent on the State receiving net terminal income from UTGR at least equal to fiscal year 2009 amounts. These amounts were pro-rated on a partial year basis for fiscal year 2011.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments - Continued

(c) Video Lottery Facility Operator – Newport Grand Jai Alai, LLC (Newport Grand)

On November 23, 2005, the Lottery entered into a five (5) year Master Video Lottery Terminal Contract with Newport Grand to continue to manage one of the State's licensed video lottery facilities.

Newport Grand and the Lottery extended the contract and signed the first five-year extension term of the contract commencing on November 23, 2010. The second term, which would commence on November 23, 2015, is contingent on Newport Grand's compliance with full-time employment mandates specified in the 2010 law.

The First Amendment also provides for a promotional points program of up to 4% of the facility's prior year net terminal income and requires the Lottery to reimburse Newport Grand for allowable marketing expenses at an amount not to exceed \$840,000 multiplied by the Lottery's percentage of net terminal income (61.69% for fiscal 2011). The reimbursement of marketing expenses by the State occurs only after Newport Grand has incurred \$560,000 in qualified marketing expenses (with marketing expenses to be defined by the Lottery). These amounts are pro-rated on a partial year basis for fiscal year 2011. Additionally, the First Amendment provides an allocation of video lottery net terminal income to Newport Grand equal in percentage to that of UTGR.

(13) Contingencies

- (a) The Lottery's master contracts with its video lottery facilities contain revenue protection provisions in the event that existing video lottery facilities incur revenue losses caused by new gaming ventures within the State.
- (b) A significant portion of the Lottery's revenues are derived from video lottery conducted at two licensed video lottery facilities. As more fully described below, each of these facilities has experienced financial difficulties.

In March 2008, the owner and manager of the Twin River video lottery facility (debtors) defaulted on a loan payment to its lenders. On June 23, 2009, the debtors commenced a Chapter 11 bankruptcy filing for relief in the United States Bankruptcy Court for the District of Rhode Island (Court). A consensual reorganization plan was approved by the Court, with the lenders becoming the new owners of the facility.

In October 2010, the Director of the Department of Business Regulation approved an application for a change in ownership and management structure of the facility. Thereafter, on November 5, 2010 the Division of State Lottery, Department of Revenue issued a video lottery license to the new owners. A motion was filed in May 2011 by the reorganized debtors seeking a final decree closing the Chapter 11 bankruptcy. The federal bankruptcy judge withheld entry of the final decree pending receipt of additional information relative to certain representations of the facility regarding the impact of the potential allowance of table and casino-style gaming at Twin River. The debtors filed additional information with the Court on or before July 31, 2011. On September 29, 2011, the Court issued a Decision and Order approving the debtors' Motion for Entry of Final Judgment and the Final Application for Fees and Expenses.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(13) Contingencies – Continued

In 2008, Newport Grand entered into a \$25,000,000 financing agreement with two banks for expansion and renovation of its video lottery terminal facility. Prior events of default relative to failing to meet earnings levels amended the loan agreement which required additional partner contributions, quarterly deposits and restricted dividend distributions. During fiscal 2011, further events of default were triggered for failing to meet minimum loan to value ratio requirements. Subsequent loan amendments required continued deposits and new loan covenant requirements.

The Department of Revenue, Division of State Lottery, and the Department of Business Regulation continue to closely monitor these facilities; however, the Lottery does not anticipate any material impact to video lottery operations or the revenue derived thereof.

- (c) The Lottery's video lottery operations could be adversely impacted by legislative efforts in Massachusetts to allow three casinos and one slot parlor in that State. If successful, and depending on the resulting location of the facilities within Massachusetts, video lottery revenues in Rhode Island could decrease.

The Rhode Island General Assembly enacted legislation that calls for analysis of competitive casino gaming operations and a statewide referendum (November 2012) to allow casino style gaming at Twin River. Subsequently, the constitutionality of that legislation is being challenged by the Narragansett Indian Tribe. The State does not believe that the Tribe's law suit seeking a declaratory judgment will be successful.

- (d) The Lottery has recorded a receivable of \$638,931 at June 30, 2011 from Twin River for promotional points awarded and redeemed by the video lottery facility during fiscal 2011 in excess of 4% of the facility's prior year net terminal income. Twin River is currently disputing the amount owed to the State at June 30, 2011. Lottery management believes this amount is supported by the terms of the promotional points program. The Lottery has also recorded a liability of \$69,937 at year-end for the related commissions due to other video lottery participants (i.e., technology providers, central communications provider, Town of Lincoln, etc.) for the impact on net terminal income.

(14) Risk Management

The Lottery is exposed to various types of risk related to its operations. These risks can result in losses incurred from property damage or destruction, inability to operate gaming activities and worker compensation claims. The Lottery manages these risks through the purchase of commercial insurance. During fiscal 2011, the Lottery maintained its amount of purchased insurance coverage. Claims and settlements incurred for fiscal years 2011, 2010 and 2009 have not exceeded the Lottery's insurance coverage.

The Lottery participates in the health insurance program for all State employees.

Supplementary Information

RHODE ISLAND LOTTERY

Operating Revenue and Cost of Gaming Operations

Year Ended June 30, 2011

Schedule 1

	Revenue or Net Terminal Income	Commissions	Prize Awards Expense	Unclaimed Prize Recovery	Cost of Tickets	Advertising	Incentive Programs	Cost of Gaming Operations	Gross Profit
Lottery games:									
On-line games									
Keno	\$ 81,061,025	\$ 10,539,809	\$ 53,571,262	\$ (347,970)	\$ -	\$ 493,571	\$ -	\$ 64,256,672	\$ 16,804,353
PowerBall®	28,175,659	3,663,488	14,090,541	(634,767)	-	315,291	-	17,434,553	10,741,106
Daily Numbers	24,933,177	3,241,890	12,930,219	(173,193)	-	137,037	-	16,135,953	8,797,224
Mega Millions®	11,543,667	1,500,944	6,037,357	(42,733)	-	261,996	-	7,757,564	3,786,103
Wild Money	5,261,888	684,167	2,837,428	(55,230)	-	37,557	-	3,503,922	1,757,966
Raffle	2,399,880	312,040	1,204,800	(4,000)	-	273,856	-	1,786,696	613,184
	<u>153,375,296</u>	<u>19,942,338</u>	<u>90,671,607</u>	<u>(1,257,893)</u>	<u>-</u>	<u>1,519,308</u>	<u>-</u>	<u>110,875,360</u>	<u>42,499,936</u>
Instant tickets	77,217,452	8,208,460	51,652,495	(991,844)	1,109,481	569,665	-	60,548,257	16,669,195
Video Lottery, net *	492,594,189	189,461,494	-	(118,984)	-	-	2,212,253	191,554,763	301,039,426
Totals	<u>\$ 723,186,937</u>	<u>\$ 217,612,292</u>	<u>\$ 142,324,102</u>	<u>\$ (2,368,721)</u>	<u>\$ 1,109,481</u>	<u>\$ 2,088,973</u>	<u>\$ 2,212,253</u>	<u>\$ 362,978,380</u>	<u>\$ 360,208,557</u>

Video Lottery Commissions - Detail

Facilities	135,622,669
Technology Providers	33,850,290
Central Communications Provider	12,314,853
City/Town	6,921,646
Narragansett Indian Tribe	752,036
Total	<u>\$ 189,461,494</u>

*See note 2 (c) (3) for detail of gross video lottery terminal activity.



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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

- ◆ INTEGRITY
- ◆ RELIABILITY
- ◆ INDEPENDENCE
- ◆ ACCOUNTABILITY

**INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN
ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS**

Joint Committee on Legislative Services, General Assembly
State of Rhode Island and Providence Plantations:

We have audited the financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2011, and have issued our report thereon dated September 29, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Lottery is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the Lottery's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Lottery's internal control over financial reporting.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Joint Committee on Legislative Services, General Assembly
State of Rhode Island and Providence Plantations:

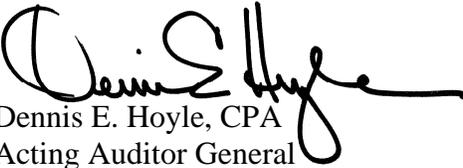
Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

We did note a matter required to be reported under *Government Auditing Standards* that is included in the Schedule of Findings and Responses as Finding 2011-1.

We also noted a matter intended to enhance the Lottery's internal control and security over its information systems that is summarized in Finding 2011-2.

This report is intended solely for the information and use of the Joint Committee on Legislative Services and the Lottery and the State's management, and is not intended to be and should not be used by anyone other than these specified parties.


Dennis E. Hoyle, CPA
Acting Auditor General

September 29, 2011

SCHEDULE OF FINDINGS AND RESPONSES

Finding 2011-1

OTHER MATTER REQUIRED TO BE REPORTED UNDER GOVERNMENT AUDITING STANDARDS

In May 2011, the Lottery became aware of a potential fraud involving the bonus play rewards program (“bonus play program”) at Twin River, a licensed video lottery facility. An employee with access to the bonus play system allegedly awarded bonus play credits to themselves and family members for unauthorized gain. This potential fraud, which was discovered by compensating controls employed at the facility, was investigated by the Lottery and the State Police and led to the arrest and arraignment of the employee. The Lottery plans to seek reimbursement from Twin River for the amount of any loss attributable to this unauthorized bonus play activity.

Twin River is currently planning to install a new version of their bonus play rewards software. This updated version of the software is expected to address the current system access design limitations that facilitated the potential fraud described above.

Finding 2011-2

INFORMATION SYSTEMS SECURITY POLICIES AND PROCEDURES

The Lottery has comprehensive information system security policies designed to safeguard the information systems utilized within its operations. Due to the highly computerized nature of the Lottery’s operations, these policies are key to ensuring the integrity of these computerized systems. The Lottery ensures compliance with these policies through monitoring procedures performed by information technology (IT) security personnel as well as contracted IT security professionals who assist with evaluating compliance by the Lottery’s gaming systems contractor and licensees involved in the operation of video lottery games.

In conjunction with our review of the Lottery’s monitoring procedures, including reviews by contracted IT security personnel, we have summarized observations and recommendations to enhance the Lottery’s comprehensive system security policies and procedures. These observations and recommendations mostly focus on improving the overall information system security practices of the Lottery’s contractors which include its gaming systems provider and two video lottery facilities.

Our observations and recommendations are being communicated confidentially, as permitted by General Law Section 22-13-10 – *Audit of information security systems*, to safeguard the integrity of the system security information of the Lottery and its contractors.