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## RHODE ISLAND LOTTERY

(AN ENTERPRISE FUND OF THE  
STATE OF RHODE ISLAND)

FISCAL YEAR ENDED JUNE 30, 2012

Dennis E. Hoyle, CPA  
Auditor General

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

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# Office of the Auditor General

State of Rhode Island and Providence Plantations - General Assembly

**Dennis E. Hoyle, CPA - Auditor General**

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October 5, 2012

## JOINT COMMITTEE ON LEGISLATIVE SERVICES:

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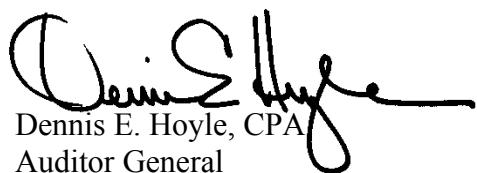
Senator Dennis L. Algiere

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, 2012. 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  
Auditor General

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

***FISCAL YEAR ENDED JUNE 30, 2012***

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# Office of the Auditor General

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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, 2012, 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, 2012, 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, 2012, 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.

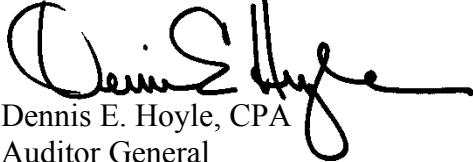
As more fully described in Note 13(c), the Lottery's video lottery operations could be adversely impacted by enacted legislation in the nearby Commonwealth of Massachusetts allowing three casinos and one slot parlor in that State. In anticipation of future competition from Massachusetts, the State of Rhode Island has passed legislation calling for a statewide referendum to allow casino style gaming at its two video lottery facilities.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated October 1, 2012 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.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 3 through 11 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

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. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the basic financial statements. The information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the basic financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the basic financial statements as a whole.



Dennis E. Hoyle, CPA  
Auditor General

October 1, 2012

## 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, 2012. 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 \$6.9 million reported at June 30, 2012 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 \$377.7 million to the State's General Fund for the fiscal year ended June 30, 2012, an increase of \$22.8 million in net income transfers over the prior fiscal year.
- Net video lottery revenue increased by \$34.7 million or 7.05% in fiscal 2012.
- A new Powerball® game structure was introduced in January of fiscal 2012. The game was changed from \$1 per play to \$2, with a larger starting jackpot and minimum jackpot increases of \$10 million

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

per draw. Sales increased for fiscal 2012 by \$4.7 million or 16.62% over the prior year. Rhode Island had two Powerball® jackpot winners in 2012, one for \$336.4 million and another for \$60 million. Both winners selected the cash option and received \$210 million and \$37 million, respectively.

- Due largely to a record breaking jackpot run to \$656 million that was won outside Rhode Island in March 2012, Mega Millions® sales increased by \$2.4 million or 20.79% in fiscal 2012.
- The Rhode Island Lottery, along with the five other New England states; Massachusetts, Connecticut, Vermont, New Hampshire, and Maine, introduced the Lucky for Life regional game in March 2012. Lucky for Life offers a top prize of \$1,000 a day for life. Sales for this game were \$3.8 million in fiscal 2012.

### Assets and Liabilities

|  | <u>June 30, 2012</u>  | <u>June 30, 2011</u>  |
|--|-----------------------|-----------------------|
| <b>Assets:</b>                                   |                       |                       |
| <b>Current assets</b>                            |                       |                       |
| Cash and cash equivalents                        | \$ 21,027,311         | \$ 18,228,713         |
| Accounts receivable, net                         | 7,569,217             | 4,125,664             |
| Other  | 818,932               | 1,043,143             |
| <b>Total current assets</b>                      | <u>29,415,460</u>     | <u>23,397,520</u>     |
| <b>Long-term assets</b>                          |                       |                       |
| Capital assets, net                              | 266,828               | 469,496               |
| <b>Total assets</b>                              | <u>29,682,288</u>     | <u>23,867,016</u>     |
| <b>Liabilities:</b>                              |                       |                       |
| <b>Current liabilities</b>                       |                       |                       |
| Due to State's General Fund                      | \$ 2,533,343          | \$ 2,731,761          |
| Due to State's General Fund - Operating Expenses | 341,713               | 335,563               |
| Accounts payable                                 | 14,063,264            | 11,951,432            |
| Prize obligations                                | 8,128,698             | 4,957,712             |
| Compensated absences                             | 171,770               | 187,195               |
| Other liabilities                                | 4,840,845             | 4,081,394             |
| <b>Total current liabilities</b>                 | <u>30,079,633</u>     | <u>24,245,057</u>     |
| <b>Long-term liabilities</b>                     |                       |                       |
| Compensated absences                             | 227,655               | 246,959               |
| Unearned contract revenue                        | 6,250,000             | 6,875,000             |
| <b>Total long-term liabilities</b>               | <u>6,477,655</u>      | <u>7,121,959</u>      |
| <b>Total liabilities</b>                         | <u>36,557,288</u>     | <u>31,367,016</u>     |
| <b>Net Assets:</b>                               |                       |                       |
| Invested in capital assets                       | 266,828               | 469,496               |
| Unrestricted                                     | (7,141,828)           | (7,969,496)           |
| <b>Total net assets (deficiency)</b>             | <u>\$ (6,875,000)</u> | <u>\$ (7,500,000)</u> |

## 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, 2012, the Lottery's assets included \$21 million in cash and cash equivalents as compared with \$18.2 million at June 30, 2011. The Lottery's accounts receivable approximated \$7.6 and \$4.1 million, respectively, at June 30, 2012 and 2011.

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 \$2.5 million at June 30, 2012 and \$2.7 million at June 30, 2011. At June 30, 2012, vendor payables, made up largely of commissions due to video lottery participants, and prize obligations, attributable mostly to instant ticket games and Lucky for Life were \$14.1 million and \$8.1 million, respectively. In comparison, vendor payables and prize obligations at June 30, 2011 were \$12 million and \$5 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, 2012, 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

|  | June 30, 2012         | June 30, 2011         |
|--|-----------------------|-----------------------|
| <b>Revenue:</b>                                      |                       |                       |
| On-line games  | \$ 165,531,966        | \$ 153,375,296        |
| Instant games  | 83,950,804            | 77,217,452            |
| Video lottery, net                                   | 527,323,124           | 492,594,189           |
| Other income   | 945,775               | 1,168,619             |
| <br>Total revenue                                    | <u>777,751,669</u>    | <u>724,355,556</u>    |
| <br><b>Expenses:</b>                                 |                       |                       |
| Cost of gaming operations                            | (393,214,425)         | (362,978,380)         |
| Operating expenses                                   | (6,205,849)           | (5,891,189)           |
| Transfers to State's General Fund                    | (377,706,395)         | (354,860,987)         |
| <br>Total expenses                                   | <u>(777,126,669)</u>  | <u>(723,730,556)</u>  |
| <br>Change in net assets                             | 625,000               | 625,000               |
| <br>Total net assets (deficiency), beginning of year | (7,500,000)           | (8,125,000)           |
| <br>Total net assets (deficiency), end of year       | <u>\$ (6,875,000)</u> | <u>\$ (7,500,000)</u> |

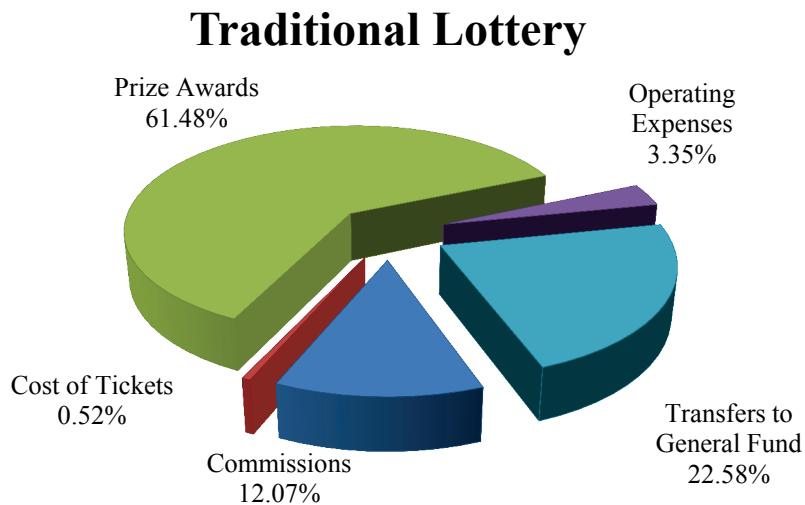
# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

### 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:

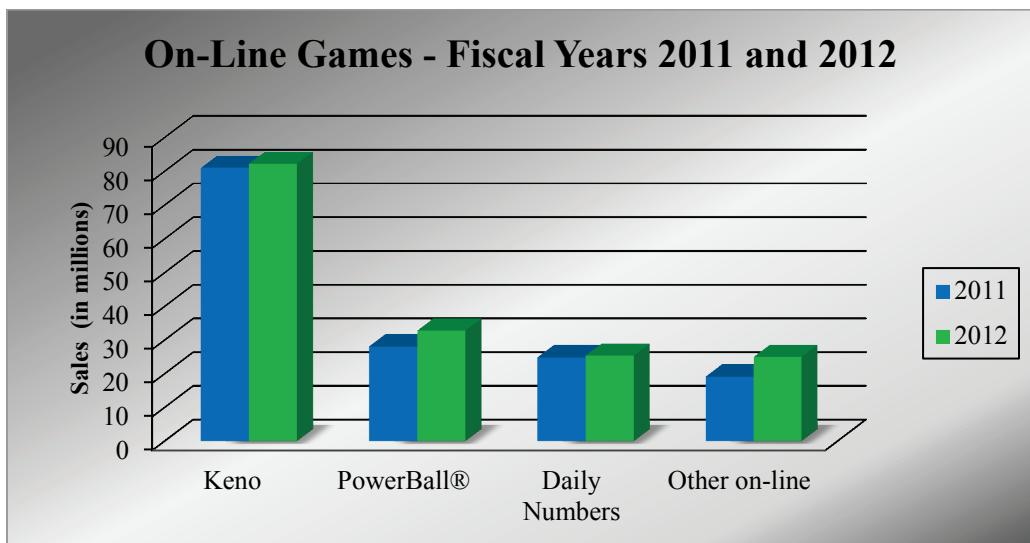


- Instant ticket revenue for the fiscal year ended June 30, 2012 increased \$6.7 million or 8.72% from the preceding fiscal year.
- On-line games offered were PowerBall®, Mega Millions®, Keno, Daily Numbers, Raffle, Wild Money and Lucky for Life at June 30, 2012. In total, on-line revenue increased by \$12.1 million.
- PowerBall® sales for the fiscal year ended June 30, 2012 increased by 16.62% or \$4.7 million. As previously stated, this increase is largely attributable to the new structure of the game. Mega Millions®, the Lottery's other Multi State Lottery offering, had an all time high jackpot of \$656 million in March 2012. Mega Millions® sales increased \$2.4 million or 20.79% in fiscal 2012.
- Lucky for Life sales began in the six New England states in March 2012. Rhode Island sales for this period were \$3.8 million. The game's top prize of \$1,000 a day for life was won a total of four times in fiscal 2012 and the Rhode Island Lottery's share of prize awards for this period of fiscal 2012 totaled \$4.5 million. Lucky for Life is designed to payout approximately 60% of revenue in prize awards over the long-term operations of the game. The "luck of the draw" however can result in prize awards in excess of sales in the short-term until sufficient game play is experienced.

## RHODE ISLAND LOTTERY

### Management's Discussion and Analysis

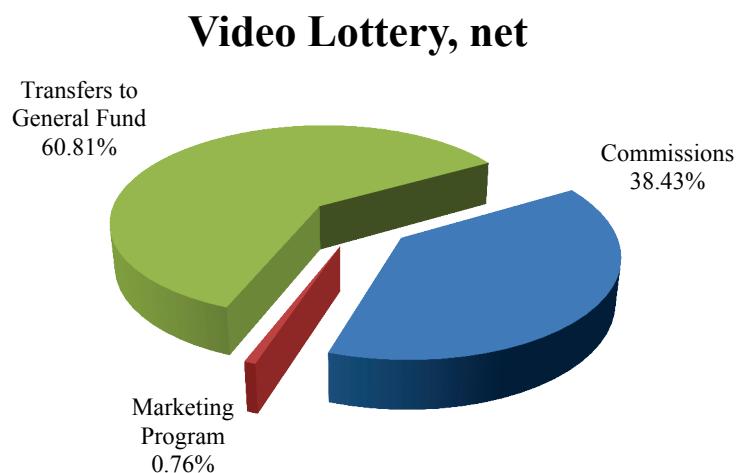
The following graph depicts the Lottery's on-line sales for the fiscal years ended June 30, 2011 and 2012.



### Video Lottery

- Video lottery net revenue increased \$34.7 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 \$21.7 million in redeemed free play during fiscal year 2012, 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.

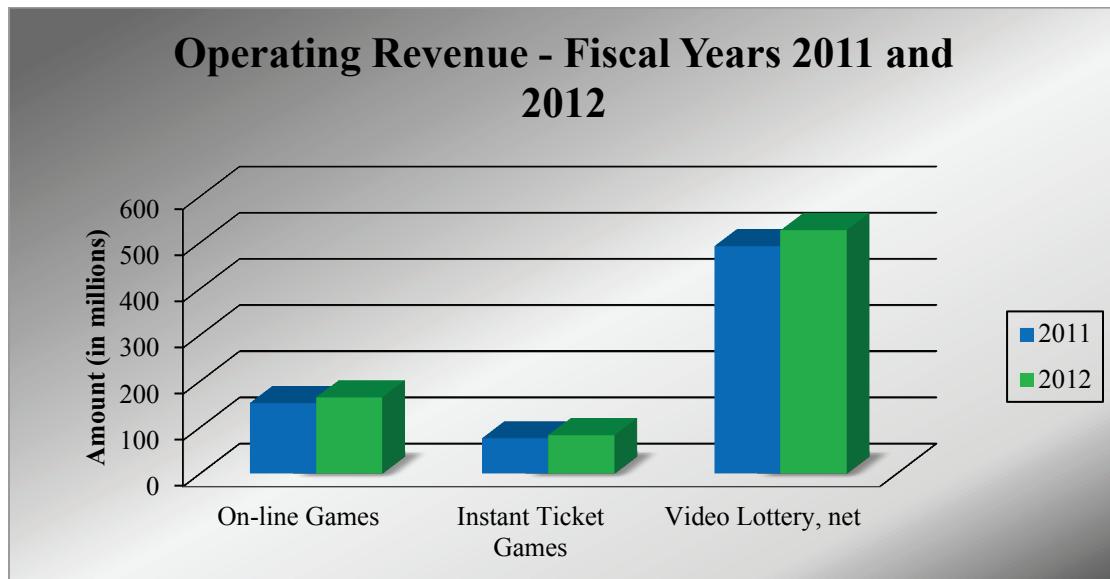
Distribution of the year's video lottery revenue was as follows:



## RHODE ISLAND LOTTERY

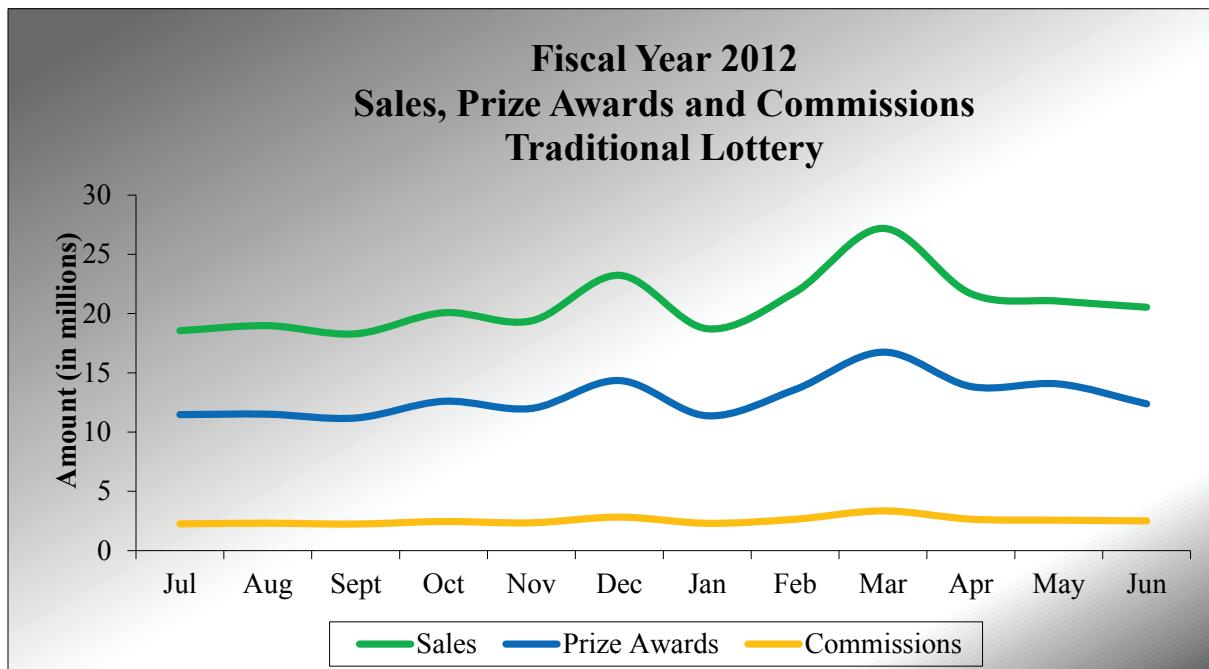
### Management's Discussion and Analysis

The following graph depicts the Lottery's on-line, instant, and video lottery operating revenue for the fiscal year ended June 30, 2011 in comparison to fiscal year ended June 30, 2012.



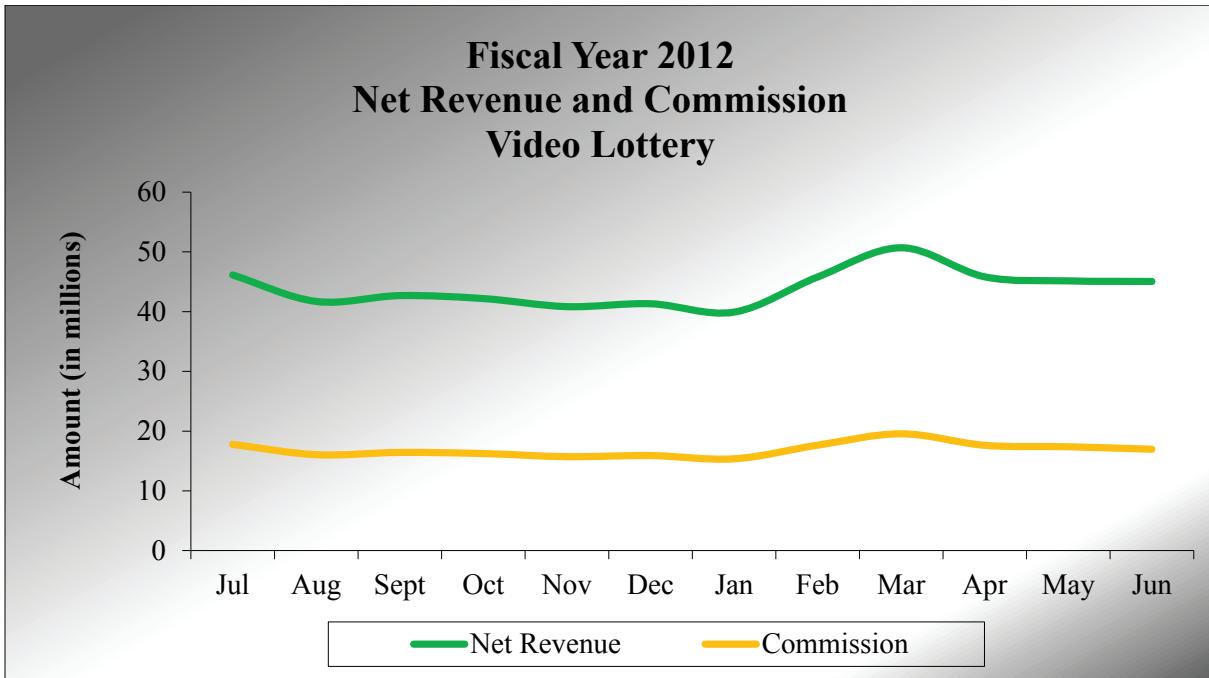
### Commissions and Prize Awards Expense

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, 2012 and June 30, 2011 was \$377.7 million and \$354.9 million, respectively. All fiscal 2012 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.

The Lucky for Life regional game requires each selling lottery to purchase an insurance annuity to fully fund the top prize won in that state. All participating lotteries share in the cost of the insurance annuity, however, the selling lottery is responsible for settling the top prize liability. Annuities shall be purchased in accordance with the applicable laws of the state purchasing the annuity. Qualified insurance companies must meet the minimum rating requirements established by each participating state. Rhode Island has not had a top prize winner to date but plans to purchases its annuities for any future top prize winners through MUSL with a minimum insurance company rating of AA.

#### 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:

- The Lottery has executed Master Video Lottery Contracts and amendments thereto with its video lottery facilities, Twin River and Newport Grand. These amendments allow the facilities to operate promotional play programs where the facilities reward patrons with free video terminal play up to an amount authorized by the Lottery, see note 12 to the financial statements. These agreements also require the Lottery to reimburse the facilities for its net terminal income share of certain qualified marketing and promotional expenses (see Note 12(b) and 12(c) for complete details). These agreements expire in 2015 and assist the facilities with the cost of marketing the State's video lottery gaming operations while ensuring that the facilities continue to invest appropriately in the promotion of their facilities.
- The Lottery's video lottery operations currently compete with casinos in nearby Connecticut. In addition, Massachusetts lawmakers have passed a bill to allow three casinos and one slot parlor in that State. Massachusetts has developed a two-phase application process for potential operators and developers. The process is anticipated to be completed and operators selected by spring 2014. It is anticipated that there could be an adverse effect on the amount of revenue derived from video

## RHODE ISLAND LOTTERY

### Management's Discussion and Analysis

lottery facilities in Rhode Island. The Lottery and the State continually monitor the risk to gaming operations resulting from competition in nearby states.

- A statewide referendum question will be placed before the voters in the November 2012 general election to approve casino gaming at Twin River and Newport Grand. Casino gaming includes all table and casino-style games played with cards, dice, or equipment, for money, credit, or any representative value. If the referendum passes both statewide and locally in the communities that currently host Twin River (Town of Lincoln) and/or Newport Grand (City of Newport), the Lottery Division shall promulgate rules and regulations relating to state-operated table gaming and set policy for these table games by March 31, 2013. The State sought voter approval of casino-style table games to minimize the impact of casino gaming now approved for nearby Massachusetts.

### 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, 2012

### Assets

**Current assets:**

|  |                |
|--|----------------|
| Cash and cash equivalents (note 3)                                       | \$ 21,027,311  |
| Accounts receivable-less allowance for doubtful accounts<br>of \$107,383 | 7,569,217      |
| Deposits with Multi-State Lottery Association (MUSL) (note 1)            | 4,107          |
| Ticket inventory   | <u>814,825</u> |
| <br>Total current assets   | 29,415,460     |
| <br>Capital assets, net (note 4)   | <u>266,828</u> |
| <br>Total assets   | 29,682,288     |

### Liabilities

**Current liabilities:**

|   |                |
|---|----------------|
| Due to State's General Fund (note 5)                      | \$ 2,533,343   |
| Due to State's General Fund - Operating Expenses (note 5) | 341,713        |
| Accounts payable  | 14,063,264     |
| Obligation for unpaid prize awards                        | 8,128,698      |
| Accrued expenses  | 4,023,636      |
| Compensated absences (note 7)                             | 171,770        |
| Deferred revenue  | 192,209        |
| Unearned contract revenue (note 8)                        | <u>625,000</u> |
| <br>Total current liabilities                             | 30,079,633     |

**Long-term liabilities:**

|                                    |                  |
|------------------------------------|------------------|
| Compensated absences (note 7)      | 227,655          |
| Unearned contract revenue (note 8) | <u>6,250,000</u> |
| <br>Total long-term liabilities    | 6,477,655        |
| <br>Total liabilities              | 36,557,288       |

### Net Assets

|                                     |                    |
|-------------------------------------|--------------------|
| Invested in capital assets (note 8) | 266,828            |
| Unrestricted (note 8)               | <u>(7,141,828)</u> |
| <br>Total net assets (deficiency)   | \$ (6,875,000)     |

See accompanying notes to financial statements.

# RHODE ISLAND LOTTERY

## Statement of Revenue, Expenses and Changes in Net Assets

Year Ended June 30, 2012

### Operating Revenue (schedule 1):

|                             |                           |
|-----------------------------|---------------------------|
| On-line games               | \$ 165,531,966            |
| Instant games               | 83,950,804                |
| Video lottery, net (note 2) | <u>527,323,124</u>        |
| <b>Total revenue</b>        | <b><u>776,805,894</u></b> |

### Cost of gaming operations:

|  |                           |
|--|---------------------------|
| Commissions (note 6)                   | 233,141,645               |
| Prize awards, online and instant games | 155,108,308               |
| Incentive programs, video lottery      | 4,003,153                 |
| Advertising                            | 2,281,816                 |
| Unclaimed prize recovery               | (2,619,903)               |
| Cost of tickets                        | <u>1,299,406</u>          |
| <b>Total cost of gaming operations</b> | <b><u>393,214,425</u></b> |
| <b>Gross profit</b>                    | <b><u>383,591,469</u></b> |

### Operating expenses:

|                                 |                           |
|---------------------------------|---------------------------|
| Personal services               | 5,178,848                 |
| Contract services               | 133,469                   |
| Depreciation                    | 220,856                   |
| Other                           | <u>672,676</u>            |
| <b>Total operating expenses</b> | <b><u>6,205,849</u></b>   |
| <b>Operating income</b>         | <b><u>377,385,620</u></b> |

### Non-operating income (expenses):

|                                |                           |
|--------------------------------|---------------------------|
| Investment income              | 92,061                    |
| Other income                   | <u>853,714</u>            |
| <b>Income before transfers</b> | <b><u>378,331,395</u></b> |

|   |                             |
|---|-----------------------------|
| <b>Transfers to State's General Fund (note 5)</b> | <b><u>(377,706,395)</u></b> |
|---|-----------------------------|

|  |                              |
|--|------------------------------|
| <b>Change in net assets</b>                                | <b>625,000</b>               |
| <b>Total net assets (deficiency), beginning of year</b>    | <b><u>(7,500,000)</u></b>    |
| <b>Total net assets (deficiency), end of year (note 8)</b> | <b><u>\$ (6,875,000)</u></b> |

See accompanying notes to financial statements.

# RHODE ISLAND LOTTERY

## Statement of Cash Flows

Year Ended June 30, 2012

Cash flows from operating activities:

|  |                    |
|--|--------------------|
| Receipts from lottery sales, online and instant games    | \$ 246,010,593     |
| Receipts from video lottery operations, net              | 527,323,124        |
| Receipts from MUSL for grand prize winners               | 249,359,349        |
| Receipts from sale of other tickets                      | 96,476             |
| Other receipts   | 204,397            |
| Payments for on-line and instant ticket prizes           | (149,317,420)      |
| Payments to MUSL grand prize winners                     | (249,359,349)      |
| Payments for commissions - retailers                     | (8,931,584)        |
| Payments for commissions - video lottery                 | (200,322,843)      |
| Payments to facilities - video lottery incentive program | (2,199,328)        |
| Payments for commissions - on-line games contractor      | (22,427,886)       |
| Payments to suppliers for goods and services             | (4,592,414)        |
| Payments to employees for services                       | <u>(5,213,577)</u> |
| Net cash provided by operating activities                | <u>380,629,538</u> |

Cash flows from noncapital financing activities:

|   |                      |
|---|----------------------|
| Transfers to State's General Fund                 | <u>(377,904,813)</u> |
| Net cash used for noncapital financing activities | <u>(377,904,813)</u> |

Cash flows from capital and related financing activities:

|  |                 |
|--|-----------------|
| Purchase of capital assets                                 | <u>(18,188)</u> |
| Net cash used for capital and related financing activities | <u>(18,188)</u> |

Cash flows from investing activities:

|  |                      |
|--|----------------------|
| Interest income                            | <u>92,061</u>        |
| Net cash provided by investing activities  | <u>92,061</u>        |
| Net increase in cash and cash equivalents  | 2,798,598            |
| Cash and cash equivalents at July 1, 2011  | <u>18,228,713</u>    |
| Cash and cash equivalents at June 30, 2012 | <u>\$ 21,027,311</u> |

See accompanying notes to financial statements.

Continued.

# RHODE ISLAND LOTTERY

## Statement of Cash Flows (continued)

Year Ended June 30, 2012

Reconciliation of operating income to net cash provided by

operating activities:

|                  |                       |
|------------------|-----------------------|
| Operating income | <u>\$ 377,385,620</u> |
|------------------|-----------------------|

Adjustments to reconcile operating income to net cash

provided by (used for) operating activities:

|   |                              |
|---|------------------------------|
| Depreciation  | 220,856                      |
| Miscellaneous receipts classified as operating activities | 71,540                       |
| Rental income and other receipts                          | 157,171                      |
| (Increase) decrease in assets:                            |                              |
| Accounts receivable                                       | (3,443,552)                  |
| Inventory   | 176,983                      |
| Deposits with MUSL  | 47,226                       |
| Increase (decrease) in liabilities:                       |                              |
| Obligation for unpaid prize awards                        | 3,170,986                    |
| Accounts payable  | 2,111,835                    |
| Due to State's General Fund - Operating expenses          | 6,150                        |
| Accrued expenses and other                                | 758,998                      |
| Deferred revenue  | <u>(34,275)</u>              |
| Total adjustments   | <u>3,243,918</u>             |
| Net cash provided by operating activities                 | <u><u>\$ 380,629,538</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 the following games to the public:

(A) On-line (lottery drawing) games that include:

- i) Traditional in-state drawing games including Daily Numbers, Keno, Wild Money, and Raffle. The drawings for these games are administered by the Rhode Island Lottery and offer patrons set prize amounts or smaller progressive jackpots. Keno is considered a monitor game where drawings are held every 4 minutes on "monitors" in sales locations across the State.
- ii) Multi-state games, which include Powerball® and Mega Millions®, which are operated in accordance with rules and agreements established by the Multi-State Lottery Association (MUSL). These games offer jackpot prize awards to patrons in participating states. Specific details regarding the operation of these games are as follows:
  - (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 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, 2012, the prize reserve funds for the PowerBall® game reported a balance of \$95.7 million of which the Lottery's share was \$1.4 million. The Lottery has charged amounts placed into the prize reserve funds to prize awards expense as the related sales have occurred.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

#### (1) Organization - (Continued)

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 2012, MUSL reduced the Lottery's unreserved account by \$47,226 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 \$4,107 at June 30, 2012 on the Statement of Net Assets in "Deposits with MUSL".

#### (b) *Mega Millions*<sup>®</sup>

MUSL participates as a member (or party) lottery of the Mega Millions<sup>®</sup> Product Group (a group of lotteries participating under an agreement between the Mega Millions<sup>®</sup> lotteries and MUSL to offer the Mega Millions<sup>®</sup> 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<sup>®</sup> lottery game. As such, the Lottery sells Mega Millions<sup>®</sup> 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.

- iii) Lucky for Life, a regional game operates under an agreement between the six New England states ("Party Lotteries") to offer a game with a top prize of \$1,000 per day for life. The Lottery sells Lucky for Life tickets, collects all revenues, and pays prizes based on its share of total sales, as a party lottery operating the regional game. The party lotteries have entered into an agreement with MUSL to administer certain aspects of the game. MUSL communicates and collects the share of prize amounts owed by each party lottery. The top prize is paid in accordance with official game rules and is shared based on each state's percentage of sales in proportion to the total top prize liability. Total low-tier prizes are shared based on a percentage of sales in proportion to the total low-tier prize liability.

All top prizes are funded through the purchase of insurance annuities. Top prizes are based on a \$365,000 deferred annuity paid annually based on the winner's natural life with a minimum payment period of 20 years. If there is more than one top prize winner, up to 14 winners, the annuitized prize will be split equally with a minimum value of \$500 per week. If more than 14 winners, the top prize will be split equally and paid in one lump sum. For top prizes claimed in Rhode Island, the Lottery will utilize MUSL to purchase insurance annuities to satisfy the prize liability. The Lottery has adopted the following minimum qualification requirements for insurance companies providing insurance annuities for top prize winners:

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

#### (1) Organization - (Continued)

- An AM Best rating of A or better;
- At least \$100 million in capital and surplus;
- At least \$1 billion in assets per the balance sheet of the company's most recently audited financial statements prepared by an independent certified public accountant; and
- A National Association of Insurance Commissioners' (NAIC) risk based capital (RBC) ratio of 200% or greater.

In the event of default on an insurance annuity for a Rhode Island winner, the Lottery may be contingently liable for any remaining prize amounts due the winner.

Second and third level prizes are set at \$25,000 and \$2,000 respectively. If there are more than a specified number of winners at each level, the total prize liability is set and split equally among the winners. All low-tier prizes (all levels except the top prize) are paid in one lump sum cash payment through the Selling Lottery. There is a reconciliation by the Game Administrator for both low-tier and unclaimed expired prizes (prize levels 2-10) when a party lottery varies from its projected prize liabilities and its unclaimed expired prizes.

(B) Instant tickets sold through licensed lottery retailers. Instant (or scratch) ticket offerings include a wide array of themed games where patrons must match two or three of a kind, get like symbols or wild features, or meet other game requirements to win the prize shown.

(C) Video lottery games which are located at two licensed facilities, Twin River and Newport Grand. There are a total of 5,845 video lottery terminals (VLTs) located in the State's two facilities offering various virtual and multi-layer display games, hosting a wide array of card and theme games to the public.

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.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

#### (1) Organization - (Continued)

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<br>Raffle<br>Instant Ticket Games<br>PowerBall®<br>Mega Millions®<br>Wild Money<br>Lucky for Life | 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. |

#### (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.

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 effective GASB Statements in the preparation of these financial statements.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

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

(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. For the Mega Millions® and Powerball® games, prize awards expense is recorded equal to the required contributions to the jackpot pool and low-tier prizes won. For the Lucky for Life game, prize awards expense is recorded equal to the estimated cost of actual prizes won. Prize awards expense is subsequently adjusted based on the Lottery's share of purchased annuities for the top prize and a settlement for actual low tier prizes won in all participating states.
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 - are reported on a net basis. 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).

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (2) Summary of Significant Accounting Policies - (Continued)

The gross video lottery terminal inputs and outputs for fiscal 2012 and reported video lottery net revenue are detailed in the following schedule:

| <b>Schedule of Video Lottery Net Revenue<br/>For the Fiscal Year Ended June 30, 2012</b> |                      |  |
|--|----------------------|--|
| <b>Video Terminal Cash-In (Gross Terminal Inputs):</b>                                   |                      |  |
| Cash collected from video lottery terminals  | \$ 1,518,868,545     |  |
| Plus: Credit vouchers redeemed for play in video lottery terminals                       | <u>1,763,826,859</u> |  |
| Total cash in reported by video lottery terminals  | 3,282,695,404        |  |
| <b>Less:</b>   |                      |  |
| <b>Video Terminal Cash-out (Gross Terminal Outputs):</b>                                 |                      |  |
| Video lottery credit vouchers issued by video lottery terminals                          | 2,755,068,935        |  |
| Plus: Contributions to progressive video jackpots from patron play                       | <u>303,345</u>       |  |
| Total cash-out amounts reported by video lottery terminals                               | <u>2,755,372,280</u> |  |
| Video lottery revenue, net   | \$ 527,323,124       |  |

### (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 Lottery*

The Lottery reimburses 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.

(3) Deposits and Investment Risk

(a) *Deposits*

The Lottery's cash deposit balances at June 30, 2012 totaled \$1,175,521, with corresponding bank balances totaling \$1,231,080. The bank balances consisted of \$158,119 in demand deposit accounts and \$1,072,961 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.

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, 2012 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 \$1,231,080 at year end, the entire amount was either covered by federal depository insurance or collateralized by securities held by an independent third party custodian.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

(3) Deposits and Investment Risk - (Continued)

(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, 2012, the Lottery had investments consisting of \$19,851,790 in the Ocean State Investment Pool Trust (OSIP), an investment pool established by the State General Treasurer. The Lottery's investment accounted for 6% of the total investment in OSIP at June 30, 2012. Funds of agencies, authorities, commissions, boards, municipalities, political subdivisions, and other public units of the State are eligible to invest in OSIP. OSIP operates in a manner consistent with SEC Rule 2a-7 like pool and thus, reports all investments at amortized cost rather than fair value. The OSIP is not rated and the weighted average maturity of investments held in the pool, by policy, is not to exceed 60 days. OSIP issues a publicly available financial report that can be obtained by writing to the Office of the General Treasurer, Finance Department, 50 Service Avenue - 2<sup>nd</sup> Floor, Warwick, RI 02886.

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.

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.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(3) *Deposits and Investment Risk* - (Continued)

(c) *Cash and Cash Equivalents*

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

|  |                             |
|--|-----------------------------|
| Cash deposit balance per books             | \$ 1,175,521                |
| Investments classified as cash equivalents | <u>19,851,790</u>           |
| Cash and cash equivalents                  | <u><u>\$ 21,027,311</u></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.

A summary of capital assets follows:

| <u><u>Cost</u></u>                           | Estimated<br>Useful Life | Balance at<br>June 30, 2011 | 2012<br>Additions          | 2012<br>Disposals         | Balance at<br>June 30, 2012 |
|--|--------------------------|-----------------------------|----------------------------|---------------------------|-----------------------------|
| Building                                     | 20                       | \$ 1,468,983                | \$ -                       | \$ -                      | \$ 1,468,983                |
| Building improvements                        | 10                       | 1,947,226                   | -                          | (33,696)                  | 1,913,530                   |
| Ticket production equipment                  | 10                       | 14,938                      | -                          | (3,452)                   | 11,486                      |
| Office equipment                             | 10                       | 103,836                     | -                          | (2,288)                   | 101,548                     |
| Furniture and fixtures                       | 10                       | 92,332                      | -                          | (1,120)                   | 91,212                      |
| Lottery drawing equipment                    | 3                        | 99,402                      | -                          | -                         | 99,402                      |
| Automobiles                                  | 3                        | 271,044                     | 18,188                     | (14,393)                  | 274,839                     |
| Computer equipment                           | 3                        | 231,460                     | -                          | (40,920)                  | 190,540                     |
| Trucks                                       | 3                        | 22,445                      | -                          | -                         | 22,445                      |
| Total  |                          | <u><u>\$ 4,251,666</u></u>  | <u><u>\$ 18,188</u></u>    | <u><u>\$ (95,869)</u></u> | <u><u>\$ 4,173,985</u></u>  |
| <u><u>Less: Accumulated Depreciation</u></u> |                          |                             |                            |                           |                             |
| Building                                     |                          | \$ 1,453,006                | \$ 1,557                   | \$ -                      | \$ 1,454,563                |
| Building improvements                        |                          | 1,593,641                   | 187,596                    | (33,696)                  | 1,747,541                   |
| Ticket production equipment                  |                          | 14,939                      | -                          | (3,452)                   | 11,487                      |
| Office equipment                             |                          | 37,713                      | 8,548                      | (2,288)                   | 43,973                      |
| Furniture and fixtures                       |                          | 80,011                      | 7,367                      | (1,120)                   | 86,258                      |
| Lottery drawing equipment                    |                          | 89,273                      | 4,341                      | -                         | 93,614                      |
| Automobiles                                  |                          | 262,517                     | 9,540                      | (14,393)                  | 257,664                     |
| Computer equipment                           |                          | 228,625                     | 1,907                      | (40,920)                  | 189,612                     |
| Trucks                                       |                          | 22,445                      | -                          | -                         | 22,445                      |
| Total  |                          | <u><u>\$ 3,782,170</u></u>  | <u><u>\$ 220,856</u></u>   | <u><u>\$ (95,869)</u></u> | <u><u>\$ 3,907,157</u></u>  |
| Capital assets, net                          |                          | <u><u>\$ 469,496</u></u>    | <u><u>\$ (202,668)</u></u> | <u><u>\$ -</u></u>        | <u><u>\$ 266,828</u></u>    |

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

#### (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 2012 are reported as follows in the Lottery's financial statements:

|  |                      |
|--|----------------------|
| Due to State's General Fund, beginning of year | \$ 2,731,761         |
| Transfers to State's General Fund              | 377,706,395          |
| Cash paid during fiscal year                   | <u>(377,904,813)</u> |
| Due to State's General Fund, end of year       | <u>\$ 2,533,343</u>  |

- (a) The Lottery also reimburses the State's General Fund for a variety of operating expenses associated with personnel costs, information technology resources, utilities, etc. Amounts owed the General Fund at year-end for operating expenses totaled \$341,713. This amount is reported on the Statement of Net Assets separate of amounts due to the general fund as residual income transfers.

#### (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 \$399,425 and \$434,154 as of June 30, 2012 and 2011, respectively, and is recorded as a liability in the Statement of Net Assets. The current portion of \$171,770 as reported was estimated based on a three year average of employee utilization experience.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

(7) Compensated Absences - (Continued)

Changes in the reported liability for compensated absences for fiscal 2012 are as follows:

|                                    | Balance at<br>July 1, 2011 | Increase  | Decrease  | Balance at<br>June 30, 2012 |
|------------------------------------|----------------------------|-----------|-----------|-----------------------------|
| Liability for Compensated Absences | \$ 434,154                 | \$231,614 | \$266,343 | \$ 399,425                  |

(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, 2012 of \$6.875 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, 2012.

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, 2012.

(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 (COLAs), 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 of Rhode Island, 50 Service Avenue, Warwick, RI 02886.

*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 22.98% of annual covered payroll for the fiscal year ended June 30, 2012. The Lottery contributed \$728,878, \$595,558, and \$582,513 for the fiscal years ended June 30, 2012, 2011 and 2010, respectively, equal to 100% of the required contributions for each year.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

(9) Retirement Plan - (Continued)

*Pension Reform Impacting Future Periods:*

In November 2011, the Rhode Island General Assembly enacted a comprehensive pension reform legislation which included implementing a supplemental defined contribution plan and other benefit and eligibility changes including suspending COLAs. The above changes and other provisions of the reform enacted are effective July 1, 2012.

(10) Postemployment Healthcare Plan

*Plan Description:*

The Lottery contributes to the State's 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 has been established to accumulate assets and pay benefits and other costs associated with the system.

The OPEB system issues a stand-alone, publicly available financial report that includes the financial statements and required supplementary information. A copy of the report can be obtained from the State Controller's Office, 1 Capitol Hill, Providence, RI 02903

*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% 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.

All participating employers are required by law to fund the actuarially determined annual required contribution (ARC), which for fiscal year 2012 was 6.86% 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 years ended June 30, 2011 and June 30, 2012 were \$193,447 and \$218,485 respectively, which represents 100% of the ARC.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

#### (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.

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

| Commission Percentages                 |                 |
|--|-----------------|
| <b>On-Line and Instant Tickets</b>     |                 |
| 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%           |
| <b>Video Lottery Central System</b>    |                 |
| 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.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

#### (12) Commitments - (Continued)

##### (b) Video Lottery Facility – 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 Master Contract has been amended in recent years to reflect the statutory authorization of the operation of a promotional points program at Twin River. In fiscal 2012, Twin River was authorized and issued approximately \$18.7 million in promotional points to facility patrons. Recently enacted legislation has authorized an additional expansion of Twin River's promotional play program effective July 1, 2012.

The Master Contract has also been amended to reflect the statutory requirement that the Lottery reimburse UTGR for allowable marketing expenses at an amount not to exceed \$6 million multiplied by the Lottery's percentage of net terminal income (61.16% and 61.08% for fiscal years 2012 and 2011, respectively). 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).

##### (c) Video Lottery Facility – 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 contract, as amended, entitles Newport Grand to compensation equal in percentage of net terminal income to that of Twin River.

The Master Contract has been amended in recent years to reflect the statutory authorization of the operation of a promotional points program at Newport Grand. In fiscal 2012, Newport Grand was authorized and issued approximately \$2.9 million in promotional points to facility patrons. Recently enacted legislation has authorized an additional expansion of Newport Grand's promotional play program effective July 1, 2012.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

(12) Commitments - (Continued)

The Master Contract has also been amended to reflect the statutory requirement that the Lottery 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 (61.76% and 61.69% for fiscal years 2012 and 2011, respectively). 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).

(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 gaming at two licensed video lottery facilities. Newport Grand, one of those video lottery facilities is subject to certain financing agreement restrictions. 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 2012, a subsequent loan amendment required continued deposits and a new loan covenant requirement.
- (c) The Lottery's video lottery operations could be adversely impacted by enacted legislation in Massachusetts allowing three casinos and one slot parlor in that State. Massachusetts has developed a two-phase application process for potential operators and developers. The Massachusetts Gaming Commission could award casino licenses during fiscal 2014 based on their current timeline. Depending on the resulting location of the facilities within Massachusetts, video lottery revenues in Rhode Island could decrease.

In response to above, the Rhode Island General Assembly enacted legislation that calls for a statewide referendum in November 2012 to allow casino-style gaming at Twin River and Newport Grand. If the referendum passes both statewide and locally in the communities that currently host Twin River (Town of Lincoln) and/or Newport Grand (City of Newport), the Lottery Division shall promulgate rules and regulations relating to state-operated table gaming at these facilities by March 31, 2013. While the Narragansett Indian Tribe filed a complaint against the State of Rhode Island in the Superior Court on or about September 28, 2011, inter alia, challenging the constitutionality of the casino gaming act on the grounds that it would not be "state-operated" and the act "delegates unconstitutional authority to a private corporation", on or about June 29, 2012, the Superior Court found that the Narragansett Indian Tribe had not sustained their burden of proof that the act violates the state or United States constitution. The Narragansett Indian Tribe filed a notice of appeal of that decision. The remaining issues in the case which are still pending in the Superior Court relate to whether the state "operates" Twin River and Newport Grand.

## RHODE ISLAND LOTTERY

### Notes to Financial Statements

(13) Contingencies - (Continued)

(d) In the event of default on an insurance annuity contract for a Rhode Island winner of the Lucky for Life jackpot prize award, the Lottery may be contingently liable for any remaining prize amounts due the winner.

(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 2012, the Lottery maintained its amount of purchased insurance coverage. Claims and settlements incurred for fiscal years 2012, 2011 and 2010 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, 2012

### **Schedule 1**

|   | Revenue or<br>Net Terminal<br>Income | Commissions           | Prize<br>Awards<br>Expense | Unclaimed<br>Prize<br>Recovery | Cost of<br>Tickets  | Advertising         | Incentive<br>Programs | Cost of<br>Gaming<br>Operations | Gross<br>Profit/(Loss) |
|---|--------------------------------------|-----------------------|----------------------------|--------------------------------|---------------------|---------------------|-----------------------|---------------------------------|------------------------|
| <b>Lottery games:</b>                     |                                      |                       |                            |                                |                     |                     |                       |                                 |                        |
| On-line games                             |                                      |                       |                            |                                |                     |                     |                       |                                 |                        |
| Keno                                      | \$ 82,251,847                        | \$ 10,687,440         | \$ 53,676,191              | \$ (308,706)                   | \$ -                | \$ 385,195          | \$ -                  | \$ 64,440,120                   | \$ 17,811,727          |
| PowerBall®                                | 32,858,107                           | 4,269,436             | 16,432,084                 | (755,972)                      | -                   | 556,881             | -                     | 20,502,429                      | 12,355,678             |
| Daily Numbers                             | 25,412,018                           | 3,301,925             | 13,305,825                 | (163,225)                      | -                   | 87,432              | -                     | 16,531,957                      | 8,880,061              |
| Mega Millions®                            | 13,943,638                           | 1,811,774             | 7,182,038                  | (116,019)                      | -                   | 302,573             | -                     | 9,180,366                       | 4,763,272              |
| Wild Money                                | 4,891,994                            | 635,644               | 2,673,202                  | (58,795)                       | -                   | 33,204              | -                     | 3,283,255                       | 1,608,739              |
| Lucky for Life                            | 3,774,422                            | 490,432               | 4,525,267                  | -                              | -                   | 108,621             | -                     | 5,124,320                       | (1,349,898)            |
| Raffle                                    | 2,399,940                            | 311,838               | 1,200,000                  | (17,000)                       | -                   | 325,888             | -                     | 1,820,726                       | 579,214                |
|   | 165,531,966                          | 21,508,489            | 98,994,607                 | (1,419,717)                    | -                   | 1,799,794           | -                     | 120,883,173                     | 44,648,793             |
| Instant tickets                           | 83,950,804                           | 8,931,584             | 56,113,701                 | (1,069,949)                    | 1,299,406           | 482,022             | -                     | 65,756,764                      | 18,194,040             |
| Video Lottery, net*                       | 527,323,124                          | 202,701,572           | -                          | (130,237)                      | -                   | -                   | 4,003,153             | 206,574,488                     | 320,748,636            |
| <b>Totals</b>                             | <b>\$ 776,805,894</b>                | <b>\$ 233,141,645</b> | <b>\$ 155,108,308</b>      | <b>\$ (2,619,903)</b>          | <b>\$ 1,299,406</b> | <b>\$ 2,281,816</b> | <b>\$ 4,003,153</b>   | <b>\$ 393,214,425</b>           | <b>\$ 383,591,469</b>  |
| <b>Video Lottery Commissions - Detail</b> |                                      |                       |                            |                                |                     |                     |                       |                                 |                        |
| Facilities                                |                                      |                       | 145,415,204                |                                |                     |                     |                       |                                 |                        |
| Technology Providers                      |                                      |                       | 36,283,881                 |                                |                     |                     |                       |                                 |                        |
| Central Communications Provider           |                                      |                       | 12,773,222                 |                                |                     |                     |                       |                                 |                        |
| City/Town                                 |                                      |                       | 7,420,148                  |                                |                     |                     |                       |                                 |                        |
| Narragansett Indian Tribe                 |                                      |                       | 809,117                    |                                |                     |                     |                       |                                 |                        |
| <b>Total</b>                              | <b>\$ 202,701,572</b>                |                       |                            |                                |                     |                     |                       |                                 |                        |

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



# Office of the Auditor General

State of Rhode Island and Providence Plantations - General Assembly

Dennis E. Hoyle, CPA - Auditor General

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## 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, 2012, and have issued our report thereon dated October 1, 2012. 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 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 previously.

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

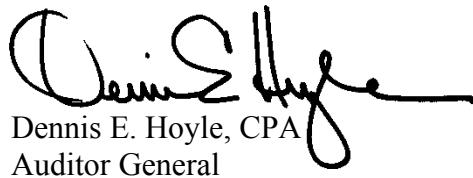
### **Compliance and Other Matters**

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 or other matters that are required to be reported under *Government Auditing Standards*.

However, we noted an instance of immaterial noncompliance and two matters designed to enhance the Lottery's operations and internal control that are described in Findings 2012-1, 2012-2, and 2012-3, respectively, in the accompanying Schedule of Findings and Responses.

The Lottery's responses (auditee views) to the findings identified in our audit are included in the accompanying Schedule of Findings and Responses. We did not audit the Lottery's responses, and accordingly, we express no opinion on the responses.

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  
Auditor General

October 1, 2012

## **SCHEDULE OF FINDINGS AND RESPONSES**

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### **FINDING 2012-1**

#### **COMPLIANCE WITH GENERAL FUND TRANSFER REQUIREMENTS**

Section 42-61-15 of the Rhode Island General Laws (General Laws) mandates that the Lottery transfer an amount equal to no less than 25% of the total revenue received from on-line and instant lottery games (except for the on-line game, Keno which has a minimum transfer percentage of 15% of total revenue). For fiscal 2012, the Lottery transferred 23.55% of on-line games and instant ticket revenue (plus other non-operating revenue) to the General Fund after payment of prize awards, commissions, and operating expenses (all Lottery operating expenses not just those relating to on-line and instant tickets as more fully described below) resulting in non-compliance with the 25% transfer requirement for those games.

The Lottery transferred 100% of its net earnings to the General Fund in fiscal 2012. Such transfers included significantly more than the 15% minimum requirement for the Keno game - \$5.9 million more. The transfer “shortfall” to meet just the specific 25% transfer requirement defined above approximates \$2.4 million or 0.6% of total fiscal 2012 transfers of \$377 million.

The structure of the General Law requirements regarding minimum transfer amounts to the State’s General Fund should be reassessed and amended to reflect the current mix of game offerings, designed prize payouts and an equitable distribution of the Lottery’s operating costs to the different game types. This is particularly relevant in light of the potential implementation of table games which require an entirely different regulatory oversight process and thus higher Lottery operating costs. Further, certain games have a less consistent or predictable payout experience (e.g., the recently implemented *Lucky for Life* game and anticipated casino-style table games). As more fully discussed in Finding 2012-2, actual prize award expense for the *Lucky for Life* game was not consistent with the designed game payout for the initial partial year implementation period. This did, and could subsequently, impact strict compliance with the minimum mandated transfer percentage as currently included in the General Laws.

The General Laws regarding the Lottery have been amended since the initial enabling legislation to reflect new game offerings (e.g., Keno, video lottery, and most recently casino style table games). The General Laws do not specify an aggregate minimum transfer amount from all Lottery games but instead are specific to online and instant, Keno, and video games. However, the General Laws do not provide for allocation of the Lottery’s operating expenses to the different categories of games. Consequently, all Lottery operating expenses are included in the calculation of the 25% minimum transfer amount for online and instant games. The calculation as provided in the General Laws includes 100% of the Lottery’s operating costs (excluding video lottery incentive expenses) in determining compliance with the 25% minimum General Fund transfer amount; yet these games contribute only 11% of the total amount transferred to the General Fund on an annual basis.

The General Law requirements that outline the division of revenue for video lottery are outlined separately from on-line and instant ticket games. Laws for video lottery allocate 100% of net terminal income without an express allocation for Lottery operating costs. Recently

## **SCHEDULE OF FINDINGS AND RESPONSES**

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enacted General Law provisions regarding casino-style table games provide for “deposit (of net proceeds) into the state lottery fund for administrative purposes and then the balance remaining into the general fund”. Whether such administrative purposes would be limited to the oversight and monitoring of just table games is not specifically stated.

The Lottery and Department of Revenue should review the existing statutes and propose recommended amendments to address the existing and future compliance concerns. A desirable balance should be maintained by providing an overall statutory compliance structure yet allow the Lottery an appropriate amount of flexibility to maximize the overall generation of income and transfers to the State’s General Fund.

### **RECOMMENDATION**

- 2012-1      Review the current law and propose modifications to the General Laws to better align minimum transfer requirements with current game prize structures and provide for a proportionate allocation of operating costs to on-line, instant, video lottery and table games.

#### *Auditee Views:*

*The Lottery concurs with this Recommendation. As noted in this report, the Lottery transferred 100% of its net earnings to the General Fund in fiscal 2012. Such transfers included significantly more than the 15% minimum requirement for the Keno game - \$5.9 million more.*

*Current General Laws require that all Lottery operating expenses (excluding video lottery incentive expenses) must be included in the calculation in determining compliance with the 25% minimum General Fund transfer amount. However, the General Laws only allow the revenue from on-line and instant lottery games to be considered for the 25% minimum transfer. The revenue from the on-line and instant lottery games accounts for only 11% of the total amount transferred to the General Fund on an annual basis, whereas the operating expenses also include those expenses associated with Keno and Video Lottery, which account for more than 15% of the overall operating expenses on an annual basis. The current formula for calculating the 25% minimum return is outdated and needs to be revised to provide a more proportionate allocation of operating costs as noted in the Auditors’ Recommendation. The Lottery will propose legislation to clarify the statute to allow for reasonable flexibility in its allocation of expenditures associated to Keno, VLTs and potential Table Game expenses.*

## **SCHEDULE OF FINDINGS AND RESPONSES**

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### **FINDING 2012-2**

#### **LUCKY FOR LIFE – PRIZE AWARDS RECOGNITION AND GAME OPERATIONS**

The Rhode Island Lottery partnered with the other New England states (participating states) to offer the *Lucky for Life* game to the public in March 2012. The *Lucky for Life* game offers a top prize award of \$1,000 per day for life as well as lower tier prizes. The cost of actual prize awards is shared by the participating states pro-rata based on their percentage of total sales for each drawing.

*Lucky for Life* is different from other multi-state jackpot games, such as *Powerball®* and *Mega Millions®*, where prize award expense is consistent and recognized as a percentage of sales based on a fixed percentage contribution to a prize pool. The *Lucky for Life* game has a fixed top prize that is independent of sales volume and therefore, the correlation between sales and prize award expense is less predictable. Further, since annuities are purchased to satisfy the payment of the prize for life, the age of the winner impacts the ultimate prize award cost. Accounting for this game involves estimates for prizes won which are yet unclaimed and/or unsettled (annuity contract has not been purchased). Consequently, actual reported results for any given time period will likely vary.

For the initial four-month period ended June 30, 2012, sales were \$3.8 million with prize award expense of \$4.5 million. After costs for advertising and commissions totaling \$600 thousand, game operations resulted in a net loss of \$1.3 million for the period. These game results contributed to the non-compliance discussed in Finding 2012-1. The Lottery expects that actual results over a longer time period will approximate the designed game prize payout of 60% of sales.

The Lottery should assess whether there are ways the volatility of reported game results could be reduced through implementation of revised operating practices (e.g., establishment of a prize reserve fund). Games that accumulate prize pools charge the participating lotteries for their share of prize awards based on the designed payout percentage for those games regardless of actual prizes won. As sales are recognized, the Lottery records a consistent prize percentage which covers low-tier prizes, contributions to jackpot prize pools, and also allocates a small percentage of prize contributions to a prize reserve fund to insulate lotteries for periods when actual prize experience is greater than the designed percentage. Games with such reserves allow for more even prize recognition and less variability based on the “luck of the draw”.

This game also potentially exposes the Lottery to future risk due to the “for life” aspect of the prize award. The commitment period spans from a minimum of 20 years to potentially 70+ years. Safeguards have been established to ensure annuities are only purchased from highly rated insurance companies; however, the liability could revert to the Lottery in the event of default. The Lottery should assess this potential long-term risk exposure and explore ways that such risk might be mitigated.

## **SCHEDULE OF FINDINGS AND RESPONSES**

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Additionally, operation of the game is more complex since no one entity assumes overall responsibility. In contrast, the Lottery's participation in other multi-state games is administered by the Multi-State Lottery Association.

### **RECOMMENDATIONS**

- 2012-2a      Evaluate the current operational procedures for the *Lucky for Life* game to determine if revised operating practices would produce a more consistent and predictable recognition of prize awards.
- 2012-2b      Assess the potential long-term risk exposure associated with prize awards for life and related annuity contracts and explore ways that such risk might be mitigated.
- 2012-2c      Assess whether an entity independent of the participating states could assume full operational responsibility for the game.

#### *Auditee Views:*

*2012-2a – Low-tier prizes are recorded based on game parameters. When a top prize is won, an initial top prize amount is recorded and subject to adjustment when the actual cost of the annuity, as based on the winner's age, becomes known. The additional estimated prize expense cost is recorded at that time, based on the percentage of sales by state. If a top prize is won at the end of a fiscal year, an estimated prize will be recorded based on the information known at the time. When the prize is claimed, any adjustment to that estimate will be made. This is in lieu of establishing reserve contributions for the game to cover total annuity costs.*

*2012-2b – The Lottery utilizes the Multi-State Lottery Association (MUSL) to purchase insurance annuities to cover the prize liabilities, with the following mandatory qualifications of insurance companies:*

- *AM Best rating of A or better,*
- *At least \$100 million in capital and surplus,*
- *At least \$1 billion in assets per the balance sheet of the company's most recently audited financial statements prepared by an independent certified public accountant,*
- *A National Association of Insurance Commissioners' (NAIC) risk-based capital (RBC) ratio of 200% or greater.*

*In addition, selected insurance companies are required to notify the Lottery in writing if said firm no longer meets the conditions as outlined above. Misrepresentation or failure of the firm to notify the Lottery shall be reason for termination of contract and possible*

## **SCHEDULE OF FINDINGS AND RESPONSES**

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*legal action. On an annual basis, the Lottery will perform a solvency review of each company's AM Best Rating and may require a copy of the company's most recent audited financial statements.*

*2012-2c – The Lottery, along with the other five New England states, utilize MUSL as a “clearing house” for the calculation, tracking, and handling of funds amongst the states. Due to varying statutory requirements and restrictions in some of the other five states, full operational responsibility for the game by an independent entity is not feasible.*

### **FINDING 2012-3**

#### **INFORMATION SYSTEMS SECURITY**

Due to the highly computerized nature of the Lottery's gaming activities, the Lottery devotes significant efforts to ensure that all information systems, both internal and those operated by contractors, comply with established system security policies and procedures. Compliance with these policies are key to ensuring the integrity of these computerized systems and data. 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.

As part of these on-going efforts, the Lottery has identified, and we concur that improvements are needed in the following areas to improve overall information systems security:

- *Information systems security resources at the video lottery facilities* – The Lottery has continually focused efforts on ensuring that information systems security at its video lottery facilities complies with established policies and procedures. With the complexity of video lottery operations growing each year, resources devoted to information systems security are still lacking and overly reliant on contractors at one of the State's video lottery facilities. Dedicated information system security is required by the video lottery facilities to ensure that information system security is maintained and operational at all times. A lack of such resources results in a facility that reacts to identified problems instead of preventing threats from materializing.
- *Information systems security - disaster recovery and contingency planning* – Included in the Lottery's comprehensive information systems security policies and procedures are requirements to ensure that disaster recovery and contingency plans exist for all significant information systems. An important part of these policies and procedures is ensuring that these disaster recovery and contingency plans are tested periodically. Periodic testing is vital to ensure the successful recovery of these systems when a real failure ultimately does occur. The Lottery should adopt schedules with their contractors to ensure the periodic testing of their plans and to ensure that any issues noted during the tests are addressed and retested in a timely manner.

## **SCHEDULE OF FINDINGS AND RESPONSES**

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Improvements in the areas noted above will enhance the Lottery's existing efforts in ensuring data integrity and information systems security over all systems that impact the Lottery's operations.

### **RECOMMENDATIONS**

- 2012-3a Continue working with video lottery facilities to ensure that sufficient personnel resources are being dedicated to the maintenance of information systems security.
- 2012-3b Ensure the periodic testing of disaster recovery and contingency plans for all information systems impacting the Lottery's operations.

*Auditee Views:*

*2012-3a – One facility has an outside IT security consulting firm performing information security job functions which is effective in providing the Lottery with an overview of the IT security posture of the facility. The Lottery has been working with this IT security consulting firm and the facility to identify areas within the organization that need immediate attention.*

*The Lottery has required the facility to hire an additional outside IT security firm to perform a review which is scheduled for October 2012 to review the IT Department at the facility to recommend what additional resources are needed and to define the job requirements to address existing IT security issues which require additional staffing at the facility.*

*Once the review is done the IT Security firm will be delivering a recommendation to the Lottery which will include the necessary positions which the facility will have to implement. Once the positions are implemented the Lottery will follow up to ensure that all of the issues are addressed.*

*Another facility has a contractor performing internal IT security review services which has resolved many of the IT security issues from previous reviews.*

*2012-3b – The Lottery, the Lottery's central system provider, and the VLT facilities have current up to date disaster recovery plans in place and have tested various aspects of the plans but the Lottery and its central system provider are both working to perform a full test of the recovery plans, which includes running out of the central system provider's backup data center. Currently, the Lottery is implementing a new video central system, and once the new system is in place, a test of the backup site will be performed on both the video and online system.*