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**RHODE ISLAND LOTTERY**

(AN ENTERPRISE FUND OF THE  
STATE OF RHODE ISLAND)

**FISCAL YEAR ENDED JUNE 30, 2013**

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 1, 2013

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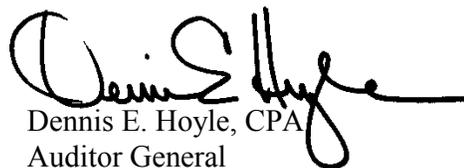
Representative Nicholas A. Mattiello

Representative Brian C. Newberry

We have completed our audit of the financial statements of the Rhode Island Lottery for the year ended June 30, 2013. 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*.

*Section VI* of our report includes three management comments which are intended to enhance the Lottery's operations or its compliance with applicable laws and regulations.

Sincerely,



Dennis E. Hoyle, CPA  
Auditor General

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

*FISCAL YEAR ENDED JUNE 30, 2013*

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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:

### ***Report on the Financial Statements***

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, 2013, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements as listed in the table of contents.

### ***Management's Responsibility for the Financial Statements***

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

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 involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Lottery as of June 30, 2013, and the changes in financial position and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

***Emphasis of Matter***

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.

As discussed in Note 2(b), the financial statements present only the Lottery enterprise fund 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, 2013, 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.

Our opinion is not modified with respect to these matters.

***Other Matters***

*Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 4 through 12 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.

*Other Information*

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Lottery's basic financial statements. The supplementary information included in Schedule 1 is presented for purposes of additional analysis and is not a required part of the basic financial statements.

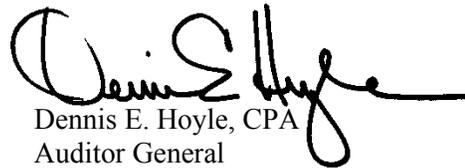
Schedule 1 is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements

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

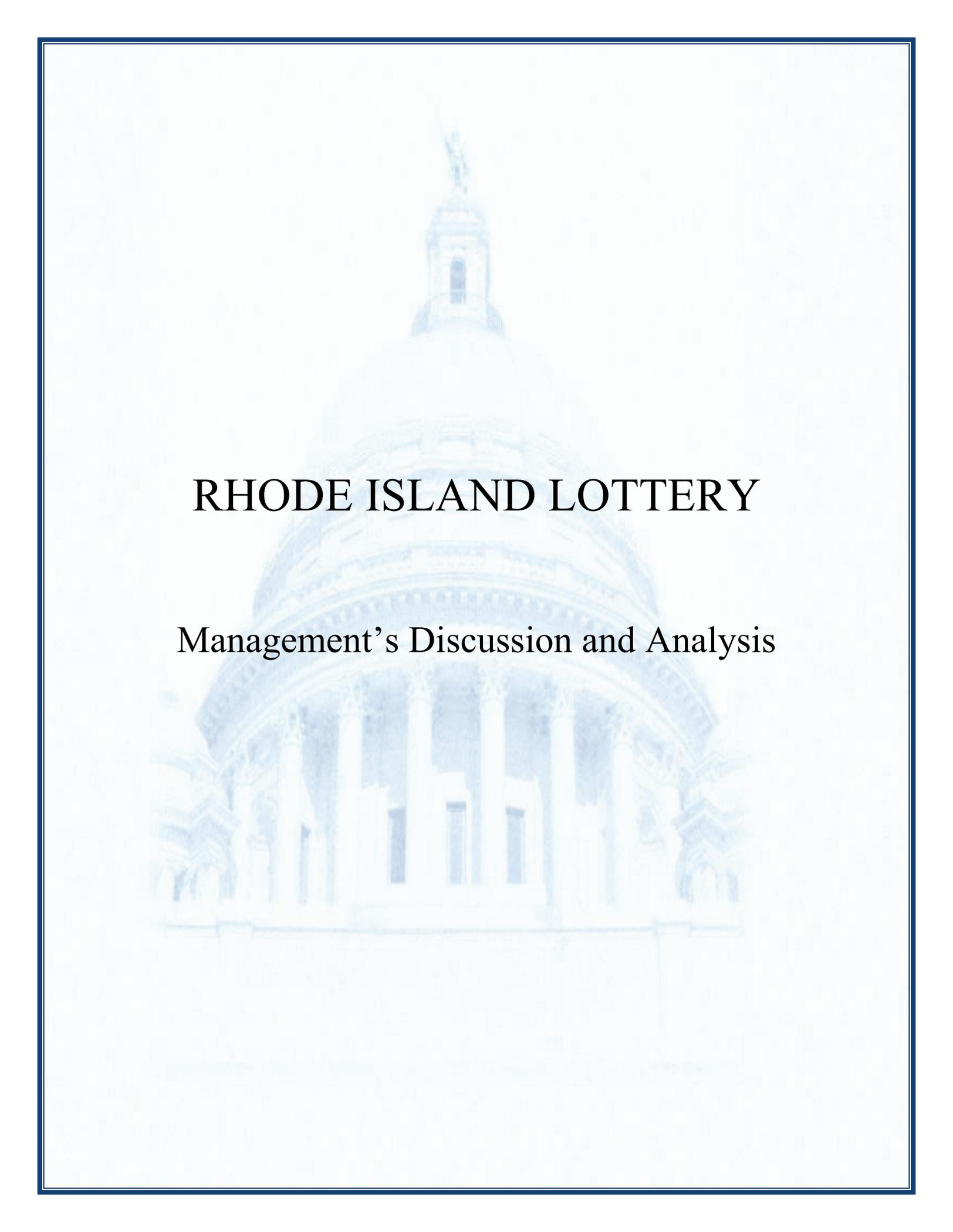
themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, Schedule 1 is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

**Other Reporting Required by *Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated September 27, 2013 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* in considering the Lottery's internal control over financial reporting and compliance.

  
Dennis E. Hoyle, CPA  
Auditor General

September 27, 2013



# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

# 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, 2013. 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 position and changes in net position 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 position 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 Position 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 deficit in net position of \$6.3 million reported at June 30, 2013 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 \$379.2 million to the State's General Fund for the fiscal year ended June 30, 2013, an increase of \$1.5 million in net income transfers over the prior fiscal year.
- Due largely to two record breaking jackpots of \$587.5 million in November 2012 and \$590.5 million in May 2013, Powerball sales increased by \$8.1 million or 24.63% in fiscal 2013.

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

- The Lottery implemented casino-style table gaming at Twin River, its largest video lottery facility, in June 2013. The Lottery successfully developed and implemented comprehensive policies and procedures to ensure the integrity of these games and trained a new regulatory division to oversee table game operations and ensure compliance with these adopted policies and procedures.

### Assets and Liabilities

	June 30, 2013	June 30, 2012
<b>Assets:</b>		
Current assets		
Cash and cash equivalents	\$ 18,914,619	\$ 21,027,311
Accounts receivable, net	7,325,858	7,569,217
Other	740,426	818,932
Total current assets	26,980,903	29,415,460
Long-term assets		
Capital assets, net	402,288	266,828
Total assets	27,383,191	29,682,288
<b>Liabilities:</b>		
Current liabilities		
Due to State's General Fund - net income from operations	\$ 847,359	\$ 2,533,343
Due to State's General Fund - operating expenses	353,432	341,713
Accounts payable	13,941,559	14,063,264
Prize obligations	7,178,210	8,128,698
Compensated absences	166,774	171,770
Other liabilities	5,297,629	4,840,845
Total current liabilities	27,784,963	30,079,633
Long-term liabilities		
Compensated absences	223,228	227,655
Unearned contract revenue	5,625,000	6,250,000
Total long-term liabilities	5,848,228	6,477,655
Total liabilities	33,633,191	36,557,288
<b>Net Position:</b>		
Net investment in capital assets	402,288	266,828
Unrestricted	(6,652,288)	(7,141,828)
Total net position (deficit)	\$ (6,250,000)	\$ (6,875,000)

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, 2013, the Lottery's assets included \$18.9 million in cash and cash equivalents as compared with \$21 million at June

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

30, 2012. The Lottery's accounts receivable approximated \$7.3 and \$7.6 million, respectively, at June 30, 2013 and 2012.

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 net operations and operating expenses. The amount owed to the General Fund for June net operations approximated \$0.8 million at June 30, 2013 and \$2.5 million at June 30, 2012. At June 30, 2013, vendor payables, made up largely of commissions due to video lottery participants, and prize obligations, attributable mostly to instant ticket games were \$13.9 million and \$7.2 million, respectively. In comparison, vendor payables and prize obligations at June 30, 2012 were \$14.1 million and \$8.1 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 deficit in net position reported at June 30, 2013, as previously explained, relates to the Lottery's immediate transfer, in a prior fiscal year, to the State's General Fund, of all proceeds received from the sale of its exclusive rights over the operation of its gaming systems.

### Lottery Operations

	<u>June 30, 2013</u>	<u>June 30, 2012</u>
Revenue:		
On-line games	\$ 168,360,807	\$ 165,531,966
Instant games	85,003,754	83,950,804
Video lottery	520,747,106	527,323,124
Table games	1,881,238	-
Other income	1,209,985	945,775
Total revenue	<u>777,202,890</u>	<u>777,751,669</u>
Expenses:		
Cost of gaming operations	(390,103,599)	(393,214,425)
Operating expenses	<u>(7,521,824)</u>	<u>(6,205,849)</u>
Total expenses	<u>(397,625,423)</u>	<u>(399,420,274)</u>
Income before transfers	379,577,467	378,331,395
Transfers to State's General Fund	(379,224,717)	(377,706,395)
Transfers from RI Capital Plan Fund	<u>272,250</u>	<u>-</u>
Increase in net position	625,000	625,000
Total net position (deficit), beginning of year	(6,875,000)	(7,500,000)
Total net position (deficit), end of year	<u>\$ (6,250,000)</u>	<u>\$ (6,875,000)</u>

# RHODE ISLAND LOTTERY

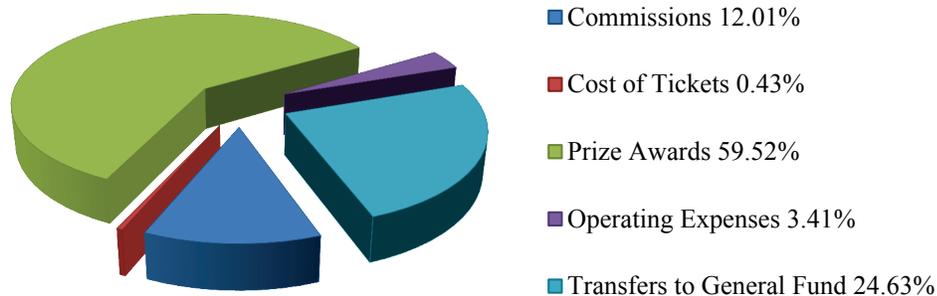
## Management's Discussion and Analysis

### 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:

### **Traditional Lottery**

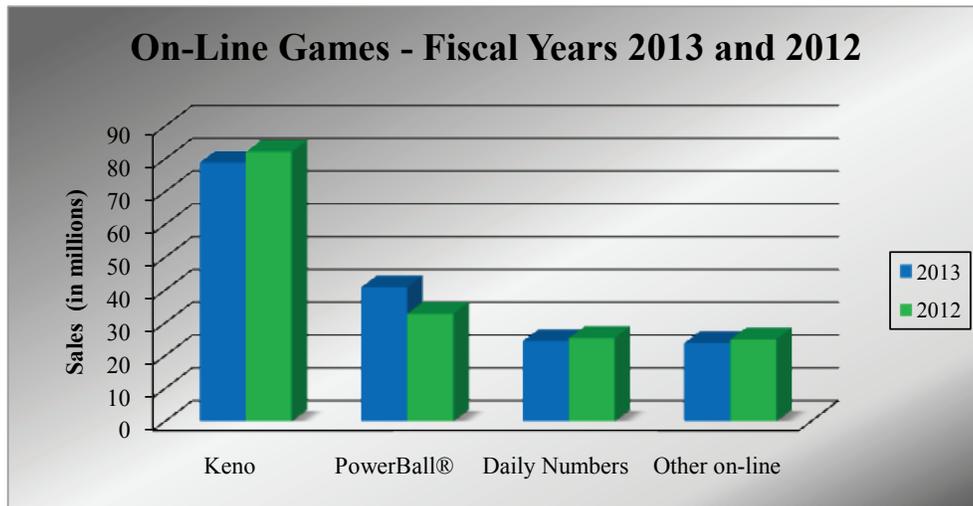


- On-line games offered were PowerBall<sup>®</sup>, Mega Millions<sup>®</sup>, Keno, Bingo, Daily Numbers, Raffle, Wild Money and Lucky for Life at June 30, 2013. In total, on-line revenue increased by \$2.8 million. Significant changes in on-line game revenue from the prior year included:
  - Revenue from Powerball increased \$8.1 million for fiscal 2013 over the prior year mostly due to the two large jackpots previously described.
  - Revenue from Mega Millions decreased \$6.0 million for fiscal 2013 over the prior year in large part to competition from the record Powerball jackpots during the year.
  - Revenue from Lucky for Life totaled \$8.7 million in its first full year of sales, an increase of \$5.0 million over the prior fiscal year which included less than four months of ticket sales.
  - Revenue from Keno decreased by 4% (\$3.3 million) for fiscal 2013 over the prior fiscal year.
- Instant ticket revenue for the fiscal year ended June 30, 2013 increased \$1.1 million or 1.25% from the preceding fiscal year.

# 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, 2013 and 2012.



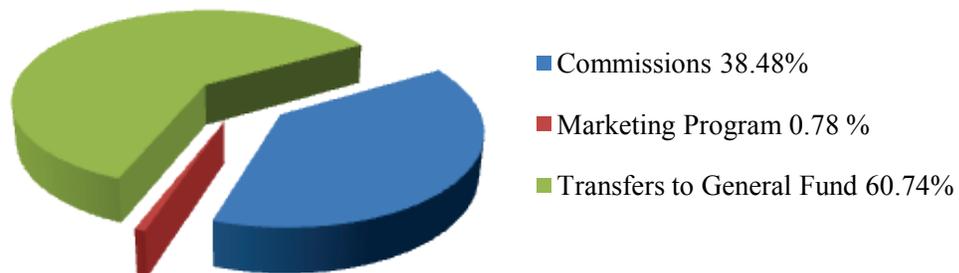
### Video Lottery

- Video lottery net revenue decreased \$6.6 million over the prior fiscal year. During fiscal year 2013, video terminal inputs (cash and credits transferred) increased by \$162 million; however, patrons cashed out (terminal outputs) \$6.6 million more (\$169 million) as compared to the prior year.

The higher prizes are partly attributable to the increased promotional play credits awarded to patrons enrolled in player reward programs. The free play credits, which approximated \$37.6 million in fiscal 2013 (an increase of \$15.9 million over fiscal 2012), are part of continued marketing efforts to increase video lottery revenues. Bonus play credits are designed to entice more frequent visits by patrons to the facility. Although the amount of bonus play redeemed at each video lottery facility is known, the exact impact of redeemed bonus play on video lottery net revenue is unknown because patrons often combine bonus credits and purchased credits during their period of play.

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

### Video Lottery



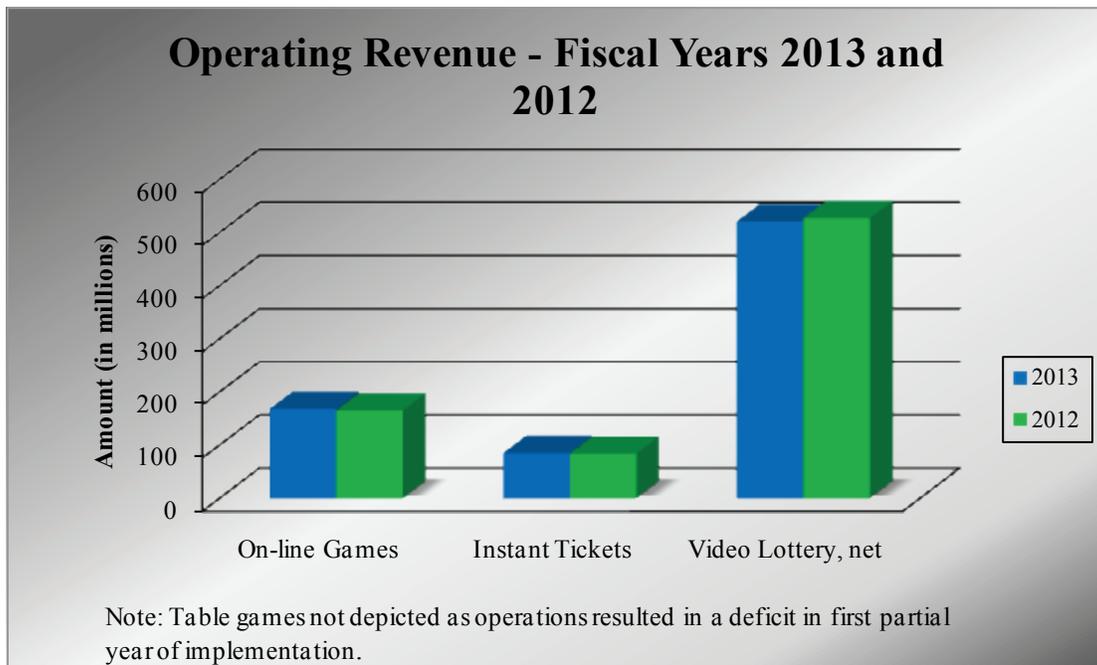
# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

### Table Games

- Table games were introduced at Twin River in Lincoln, Rhode Island in mid-June 2013. For the fiscal year ending June 30, 2013, net table game revenue was \$1.88 million. Commissions paid were \$1.54 million. The Lottery incurred administrative and operating expenses during the fiscal year to establish the rules, regulations, and minimum internal controls necessary to operate table games. Total administrative and operating expenses were \$.91 million. Commissions and administrative and operating expenses reduced the State's share of net table game revenue of \$.34 million, which resulted in a net loss of \$.57 million for 2013, the first year of implementation.

The following graph depicts the Lottery's on-line, instant, and video lottery operating revenue for the fiscal year ended June 30, 2013 in comparison to fiscal year ended June 30, 2012.

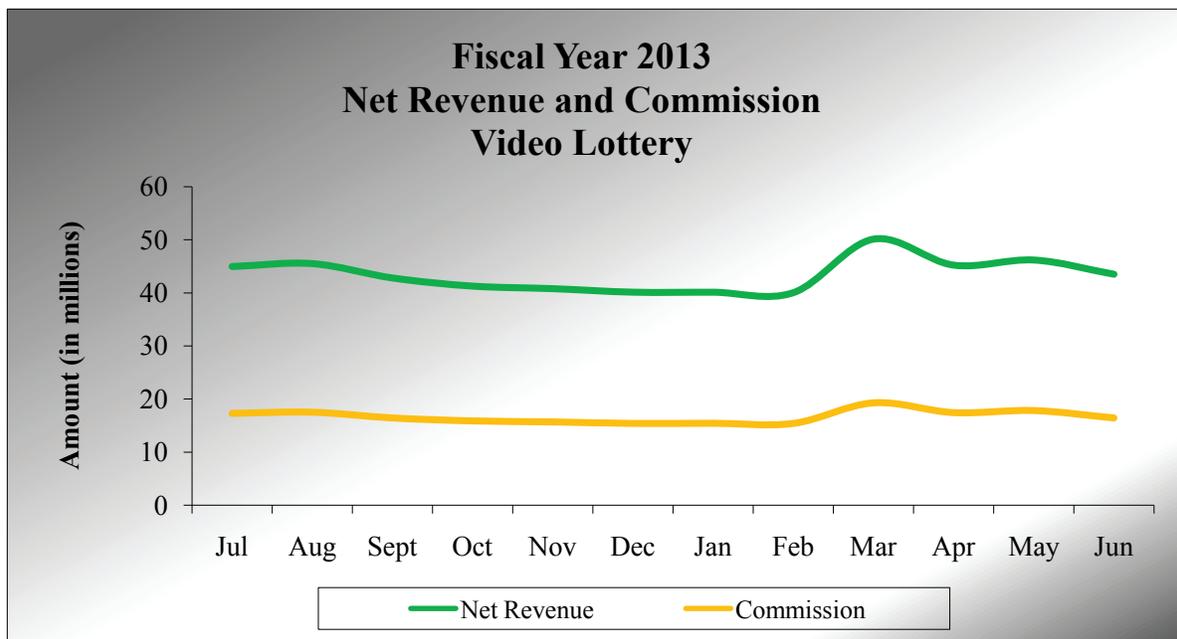
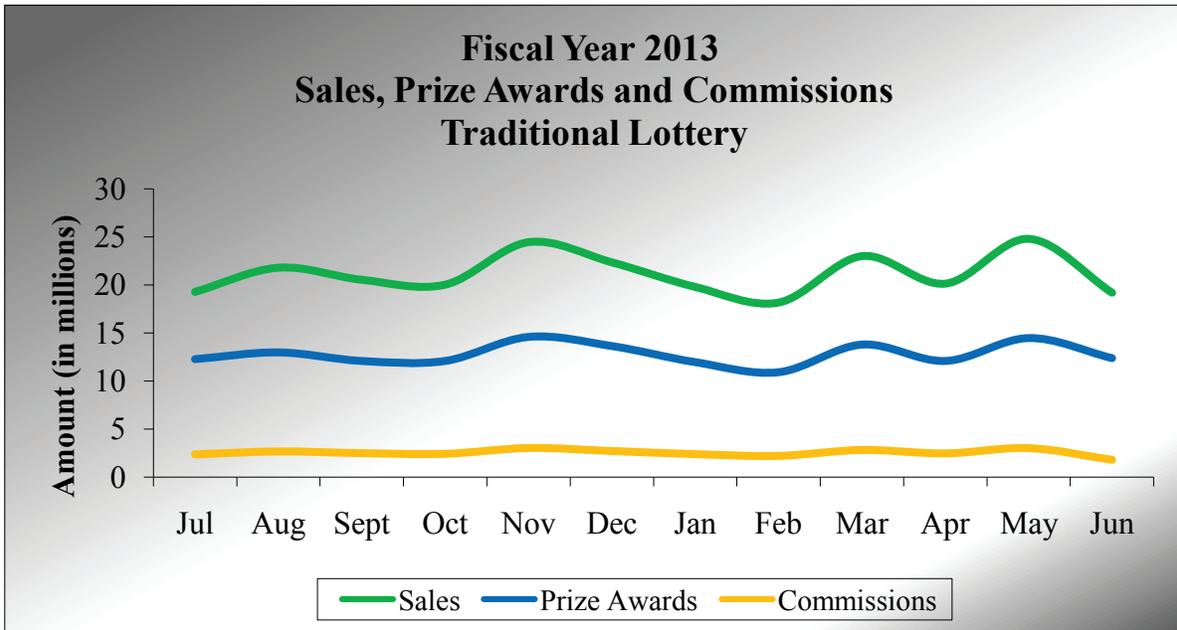


### Commissions and Prize Awards Expense

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, 2013 and June 30, 2012 was \$379.2 million and \$377.7 million, respectively. The increase in transfers to the General Fund is mostly attributable to an increase in revenue from on-line games. All fiscal 2013 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<sup>®</sup> and Mega Millions<sup>®</sup> 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<sup>®</sup> 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 purchase its annuities for any future top prize winners through MUSL with an insurance company with an AM Best rating of A or better.

### 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

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

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:

- Master Video Lottery Contracts and amendments thereto with its video lottery facilities, Twin River and Newport Grand include provisions for the continued operation of promotional play programs where the facilities reward patrons with free video terminal play up to an amount authorized by the Lottery. These agreements also require the Lottery to reimburse the facilities for its net terminal income share of certain qualified marketing and promotional expenses. These agreements provide significant incentives for the facilities to continue to invest appropriately in the promotion of their facilities and the Lottery's video and table games activities. See Note 12 to the financial statements for details regarding these agreements.
- 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 during spring 2014. It is anticipated that there could be an adverse effect on the amount of revenue derived from video lottery facilities in Rhode Island. The Lottery and the State continually monitor the risk to gaming operations resulting from competition in nearby states.
- The General Laws delineate the allocation of net table game revenue between Twin River and the State. The statute includes provisions to modify the commission percentage for Twin River and the Town of Lincoln in the event video lottery net terminal income decreases upon the implementation of table games. This provision could reduce the Lottery's share of net table game revenue from 18% currently to 16% in future years if the aforementioned conditions exist.
- Legislation was recently enacted to increase commissions to Newport Grand, one of the Lottery's video lottery facilities, by an additional 2.25% of Net Terminal Income beginning in fiscal 2014. This legislation is designed to provide additional compensation to this facility which has struggled financially in recent years. This legislation authorizes the increase through fiscal 2015.
- Revenue from table games operations in fiscal 2014, the first full year of operations, coupled with the addition of more tables at Twin River, is expected to approximate \$60 million. The State's share in fiscal 2014 is expected to approximate \$10.8 million with a residual transfer to the General Fund of approximately \$6.5 million after related operating expenses.

### 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, RI, 02920.

# RHODE ISLAND LOTTERY

## Statement of Net Position

June 30, 2013

### Assets

Current assets:

Cash and cash equivalents (note 3)	\$	18,914,619
Accounts receivable-less allowance for doubtful accounts of \$100,363		7,325,858
Deposits with Multi-State Lottery Association (MUSL) (note 1)		41,828
Ticket inventory		698,598
Total current assets		26,980,903
Capital assets, net (note 4)		402,288
Total assets		27,383,191

### Liabilities

Current liabilities:

Due to State's General Fund - net income from operations (note 6)	\$	847,359
Due to State's General Fund - operating expenses (note 6)		353,432
Accounts payable		13,941,559
Obligation for unpaid prize awards		7,178,210
Accrued expenses		4,408,358
Compensated absences (note 7)		166,774
Advances for future drawings		217,939
Unearned contract revenue (note 8)		625,000
Other current liabilities		46,332
Total current liabilities		27,784,963

Long-term liabilities:

Compensated absences (note 7)		223,228
Unearned contract revenue (note 8)		5,625,000
Total long-term liabilities		5,848,228
Total liabilities		33,633,191

### Net Position

Net investment in capital assets (note 8)		402,288
Unrestricted (note 8)		(6,652,288)
Total net position (deficit)	\$	(6,250,000)

See accompanying notes to financial statements.

# RHODE ISLAND LOTTERY

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

Year Ended June 30, 2013

Operating Revenue (schedule 1):	
On-line games	\$ 168,360,807
Instant games	85,003,754
Video lottery (note 2)	520,747,106
Table games (note 2)	1,881,238
Total revenue	775,992,905
Cost of gaming operations (schedule 1):	
Commissions (note 6)	232,891,499
Prize awards, online and instant games	153,205,932
Incentive programs, video lottery	4,076,294
Advertising	2,159,542
Unclaimed prize recovery	(3,328,183)
Cost of tickets	1,098,515
Total cost of gaming operations	390,103,599
Gross profit	385,889,306
Operating expenses:	
Personal services	6,212,132
Contract services	61,413
Depreciation and amortization	136,599
Other	1,111,680
Total operating expenses	7,521,824
Operating income	378,367,482
Non-operating income (expenses):	
Investment income	114,980
Other income (expenses)	1,095,005
Income before transfers	379,577,467
Transfers to State's General Fund (note 5)	(379,224,717)
Transfers from RI Capital Plan Fund	272,250
Increase in net position	625,000
Total net position (deficit), beginning of year	(6,875,000)
Total net position (deficit), end of year (note 8)	\$ (6,250,000)

See accompanying notes to financial statements.

# RHODE ISLAND LOTTERY

## Statement of Cash Flows

Year Ended June 30, 2013

Cash flows from operating activities:	
Receipts from lottery sales, online and instant games	\$ 253,639,499
Receipts from video lottery operations	520,747,106
Receipts from table games	1,881,238
Receipts from MUSL for grand prize winners	2,333,000
Receipts from sale of other tickets	92,835
Other receipts	409,444
Payments for on-line and instant ticket prizes	(150,828,237)
Payments to MUSL grand prize winners	(2,333,000)
Payments for commissions - retailers	(9,035,425)
Payments for commissions - video lottery	(202,426,041)
Payments to facilities - video lottery incentive program	(4,007,075)
Payments for commissions - on-line games contractor	(21,883,748)
Payments to suppliers for goods and services	(3,670,584)
Payments to employees for services	(6,221,555)
	<hr/>
Net cash provided by operating activities	378,697,457
Cash flows from noncapital financing activities:	
Transfers to State's General Fund	(380,910,701)
Transfers from RI Capital Plan Fund	272,250
	<hr/>
Net cash used for noncapital financing activities	(380,638,451)
Cash flows from capital and related financing activities:	
Purchase of capital assets	(294,330)
Proceeds from sale of capital assets	7,652
	<hr/>
Net cash used for capital and related financing activities	(286,678)
Cash flows from investing activities:	
Interest income	114,980
	<hr/>
Net cash provided by investing activities	114,980
Net decrease in cash and cash equivalents	(2,112,692)
Cash and cash equivalents at July 1, 2012	21,027,311
Cash and cash equivalents at June 30, 2013	<hr/> <hr/>
	\$ 18,914,619

See accompanying notes to financial statements.

Continued.

RHODE ISLAND LOTTERY  
Statement of Cash Flows (continued)  
Year Ended June 30, 2013

Reconciliation of operating income to net cash provided by operating activities:	
Operating income	<u>\$ 378,367,482</u>
Adjustments to reconcile operating income to net cash provided by (used for) operating activities:	
Depreciation and amortization	151,218
Miscellaneous receipts classified as operating activities	69,172
Rental income and other receipts	400,833
(Increase) decrease in assets:	
Accounts receivable	243,359
Inventory	116,229
Deposits with MUSL	(37,721)
Increase (decrease) in liabilities:	
Obligation for unpaid prize awards	(950,488)
Accounts payable	(121,706)
Due to State's General Fund - operating expenses	11,719
Accrued expenses and other	421,631
Advances for future drawings	<u>25,729</u>
Total adjustments	<u>329,975</u>
Net cash provided by operating activities	<u><u>\$ 378,697,457</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, Bingo, 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 and Bingo are considered monitor games where drawings are held every 4 or 8 minutes, respectively, on "monitors" in sales locations across the State.
- ii) Multi-state games, which include PowerBall<sup>®</sup> and Mega Millions<sup>®</sup>, 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 operations of these games are as follows:

##### (a) *PowerBall*<sup>®</sup>

The Lottery sells PowerBall<sup>®</sup> 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<sup>®</sup> is 50% of each drawing period's ticket sales. MUSL has placed 2% of each drawing period's ticket sales for PowerBall<sup>®</sup>, included as part of each member's prize liability, in prize reserve funds. The maximum balance on the prize reserve funds for PowerBall<sup>®</sup> 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, 2013, the prize reserve funds for the PowerBall<sup>®</sup> game reported a balance of \$78.9 million of which the Lottery's share was \$1.2 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. The Lottery has recorded all income and operating expenses related to its unreserved account and has reported the balance of \$41,828 at June 30, 2013 on the Statement of Net Position 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) ration 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 (or scratch) ticket offerings sold through licensed lottery retailers 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 are operated through 5,635 video lottery terminals (VLTs) at two licensed facilities, Twin River and Newport Grand. Video lottery offers 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.

- (D) Table games are operated at the Twin River Casino in Lincoln, Rhode Island. Chapter 42-61.2 of the General Laws authorizes the State to operate casino gaming, and the Lottery Division to promulgate rules and regulations and set policy for table gaming. This chapter stipulates the allocation of net table game revenue. Consistent with the General Laws, net table game revenue derived from Twin River is deposited in the State Lottery Fund for administrative purposes with commissions distributed to Twin River (82% of net table game revenue for fiscal year 2013), and the balance being remitted to the 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 Raffle Instant Ticket Games PowerBall® Mega Millions® Wild Money Lucky for Life Bingo	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.
Table Games	Prize payout not established by law	Payments to the General Fund - net table game revenue minus commission payments and table game administrative and operating expenses.

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting

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

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

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

#### (b) *Reporting Entity*

The Lottery, a division of the Department of Revenue of the State of Rhode Island and Providence Plantations (State), is accounted for as an enterprise fund for financial reporting purposes.

Accordingly, its annual financial statements are included in the State's Comprehensive Annual Financial Report (CAFR). The accompanying financial statements are not intended to present the financial position and results of operations of the State.

#### (c) *Revenues and Expenses*

The Lottery defines all revenues and expenses deriving from on-line, instant ticket, video lottery, and table games as 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, video lottery, and table games 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).

The gross video lottery terminal inputs and outputs for fiscal 2013 and reported video lottery net revenue are detailed in the following schedule:

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

<b>Schedule of Video Lottery Net Revenue For the Fiscal Year Ended June 30, 2013</b>	
<b>Video Terminal Cash-In (Gross Terminal Inputs):</b>	
Cash collected from video lottery terminals	\$ 1,522,994,600
Plus: Credit vouchers redeemed for play in video lottery terminals	1,922,321,733
Total cash-in reported by video lottery terminals	3,445,316,333
<b>Less:</b>	
<b>Video Terminal Cash-out (Gross Terminal Outputs):</b>	
Video lottery credit vouchers issued by video lottery terminals	2,924,295,816
Plus: Contributions to progressive video jackpots from patron play	273,411
Total cash-out amounts reported by video lottery terminals	2,924,569,227
Video lottery revenue, net	\$ 520,747,106

4. Table games are reported on a net table game (win) basis from the Twin River facility. Net table game revenue, calculated daily at each table, is cash in the drop box, plus front money (patron funds left on deposit with the facility that are drawn for chips at a table), less fills, plus credits, less beginning chip inventory, and plus ending chip inventory.

The State, through the Division of State Lottery, has operational control and regulating authority to collect casino gaming gross receipts, allocate receipts according to statute, define and limit the rules of play and odds of authorized games including minimum and maximum wagers and payouts for each game. Amounts required by statute to be paid to Twin River are reported as commissions. The statute further stipulates that the Division of State Lottery establish rules and regulations and set policy for table games. These policies, and regulations (promulgated in accordance with the Lottery's established minimum control standards and federal and State statute) stipulate that the tables games retailer (Twin River) be responsible for obtaining approved equipment (tables, dice, cards, etc.) and bearing all risk for the management, security, and monitoring of authorized table games. Twin River is also responsible for marketing table games and all related expenses. The Lottery Division incurs operating and administrative costs relating to the oversight and regulation of casino operations which are netted against the State's statutory share of net table game revenue prior to transferring the balance to the State's General Fund.

All other revenues and expenses are defined as non-operating. Non-operating revenues include income from pull tab tickets (the Lottery is not responsible for prizes won), video facility contributions for the Lottery's problem gaming program, rental income, and refunds from the Multi-state Lottery Association. Non-operating expenses include the costs of operating the Lottery's problem gambling program.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

#### (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. Asset and useful lives are as follows:

<u>Asset Category</u>	<u>Useful Life</u>	<u>Threshold</u>
Buildings	50 years	\$1,000,000
Building Improvements	20 years	\$1,000,000
Computer Equipment	5 years	\$ 5,000
Furniture and Equipment	5 years	\$ 5,000
Automobiles	5 years	\$ 5,000

In addition, the Lottery capitalizes certain intangible assets and amortizes those assets over their expected benefit period.

#### (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) *Advances for Future Drawings*

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.

#### (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

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual amounts could differ from those amounts.

#### (k) *Changes in Accounting Estimate and Presentation*

In fiscal year 2013, the Lottery changed its asset capitalization policy to mirror the policies adopted by the State. This change resulted in higher capitalization thresholds for most capital asset categories and increased the useful lives for buildings from 20 to 50 years. This change did not have a material effect on the Lottery's financial statements for fiscal 2013 and is not expected to materially impact future periods.

The Lottery implemented GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, in fiscal 2013. While the Lottery did not have any deferred inflows or outflows of resources, as defined by GASB 63, the implementation did result in certain changes in terminology utilized within the Lottery's financial statements.

### (3) Deposits and Investment Risk

#### (a) *Deposits*

The Lottery's cash deposit balances at June 30, 2013 totaled \$11,138,467, with corresponding bank balances totaling \$11,190,668. The bank balances consisted of \$327,090 in demand deposit accounts and \$10,863,578 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, 2013 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 \$11,190,668 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, 2013, the Lottery had investments consisting of \$7,776,152 in the Ocean State Investment Pool Trust (OSIP), an investment pool established by the State General Treasurer. The Lottery’s investment accounted for 3% of the total investment in OSIP at June 30, 2013. Agencies, authorities, commissions, boards, municipalities, political subdivisions, and other public units of the State may 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 Position consist of the following:

Cash deposit balance per books	\$ 11,138,467
Investments classified as cash equivalents	<u>7,776,152</u>
 Cash and cash equivalents	 <u>\$ 18,914,619</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 position.

A summary of capital assets follows:

	<u>Estimated Useful Life</u>	<u>Balance at June 30, 2012</u>	<u>2013 Additions</u>	<u>2013 Disposals</u>	<u>Balance at June 30, 2013</u>
<u>Cost</u>					
Building	50	\$ 1,468,983	\$ -	\$ (31,071)	\$ 1,437,912
Building improvements	20	1,913,530	32,936	(1,865)	1,944,601
Ticket production equipment	5	11,486	-	-	11,486
Office equipment	5	101,548	-	(311)	101,237
Furniture and fixtures	5	91,212	-	(356)	90,856
Lottery drawing equipment	5	99,402	-	-	99,402
Automobiles	5	274,839	100,245	(59,411)	315,673
Computer equipment	5	190,540	16,796	(27,644)	179,692
Trucks	5	22,445	-	-	22,445
Intangible Assets	7	-	175,424	-	175,424
Total		<u>\$ 4,173,985</u>	<u>\$ 325,401</u>	<u>\$ (120,658)</u>	<u>\$ 4,378,728</u>
<u>Less: Accumulated Depreciation and Amortization</u>					
Building		\$ 1,454,563	\$ 1,423	\$ (18,074)	\$ 1,437,912
Building improvements		1,747,542	91,253	-	1,838,795
Ticket production equipment		11,486	-	-	11,486
Office equipment		43,973	12,725	(311)	56,387
Furniture and fixtures		86,258	4,954	(356)	90,856
Lottery drawing equipment		93,614	4,030	-	97,644
Automobiles		257,664	36,150	(59,411)	234,403
Computer equipment		189,612	4,138	(21,857)	171,893
Trucks		22,445	-	-	22,445
Intangible Assets		-	14,619	-	14,619
Total		<u>\$ 3,907,157</u>	<u>\$ 169,292</u>	<u>\$ (100,009)</u>	<u>\$ 3,976,440</u>
Capital assets, net		<u>\$ 266,828</u>	<u>\$ 156,109</u>	<u>\$ (20,649)</u>	<u>\$ 402,288</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 2013 are reported as follows in the Lottery's financial statements:

Due to State's General Fund, beginning of year	\$ 2,533,343
Transfers to State's General Fund	379,224,717
Cash paid during fiscal year	<u>(380,910,701)</u>
Due to State's General Fund, end of year	\$ <u>847,359</u>

- (b) 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 \$353,432. This amount is reported on the Statement of Net Position separate of amounts due to the State's General Fund - net income from operations.

(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). Table games commissions, as specified in the General Laws, are paid to Twin River.

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 \$390,002 as of June 30, 2013 and is recorded as a liability in the Statement of Net Position. The current portion of \$166,774 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 2013 are as follows:

	Balance at July 1, 2012	Increase	Decrease	Balance at June 30, 2013
Liability for Compensated Absences	\$399,425	\$246,469	\$255,892	\$ 390,002

(8) Net Position - (Deficit)

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 deficit in net position at June 30, 2013 of \$6.25 million. As the contract revenue is recognized over the twenty-year life of the contract, the deficit in net position 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, 2013.

Net position reported by the Lottery also includes its net investment in capital assets. The Lottery had no debt related to capital assets at June 30, 2013.

(9) Retirement Plan

Effective July 1, 2012, the State administered retirement system was modified to include both defined benefit and defined contribution plan components.

*Defined Benefit Plan Description:*

All Lottery employees 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 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.

*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 3.75% of their annual covered salary. The Lottery is required to contribute at an actuarially determined rate; the rate was 21.18% of annual covered payroll for the fiscal year ended June 30, 2013. The Lottery contributed \$730,252, \$728,878, and \$595,558 for the fiscal years ended June 30, 2013, 2012 and 2011, respectively, equal to 100% of the required contributions for each year.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(9) Retirement Plan - (Continued)

*Defined Contribution Plan Description:*

Employees participating in the defined benefit plan, as described above, also participate in a defined contribution plan of the Employees' Retirement System as authorized by General Law Chapter 36-10.3. The defined contribution plan is established under IRS section 401(a) and is administered by TIAA-CREF. Employees may choose among various investment options available to plan participants. Employees contribute 5% of their annual covered salary and employers contribute 1% of annual covered salary. Employee contributions are immediately vested while employer contributions are vested after three years of contributory service. Contributions required under the plan by both the employee and employer are established by the General Laws, which are subject to amendment by the General Assembly.

Amounts in the defined contribution plan are available to participants in accordance with Internal Revenue Service guidelines for such plans.

The Lottery contributed \$34,479 for the fiscal year ended June 30, 2013 (which was the first year of the defined contribution plan), equal to 100% of the required contributions for that year.

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.

(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. A copy of the report can be obtained from the State Controller's Office, 1 Capitol Hill, Providence, RI 02903.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(10) Postemployment Healthcare Plan - (Continued)

*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 2013 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, 2013, June 30, 2012 and June 30, 2011 were \$236,522, \$218,485, and \$193,447 respectively, which represents 100% of the ARC.

(11) Deferred Compensation

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

(12) Commitments

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

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

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

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(12) Commitments - (Continued)

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

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

The Lottery also leases to the vendor a portion of its headquarters to house the computer hardware and office space necessary for the operation of the Lottery's games. The term of the lease is five (5) years, commencing October 19, 2012 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 one (1) four (4) year term renewal option. The base rate for the renewal options will be an increase of four percent (4%) per annum unless a mutually acceptable rate is negotiated.

(b) Video Lottery Facility – 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 a promotional points program at Twin River. In fiscal 2013, Twin River was authorized and issued approximately \$31.8 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, 2013.

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 (61.12% and 61.16% for fiscal years 2013 and 2012, 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).

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (12) Commitments - (Continued)

#### (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. Recent legislation increased the percentage of net terminal income by 2.25% effective July 1, 2013, and expiring June 30, 2015.

The Master Contract has been amended in recent years to reflect the statutory authorization of a promotional points program at Newport Grand. In fiscal 2013, Newport Grand was authorized and issued approximately \$5.8 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, 2013.

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 (61.67% and 61.76% for fiscal years 2013 and 2012, 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 2013, 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

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (13) Contingencies - (Continued)

their current timeline. Depending on the resulting location of the facilities within Massachusetts, lottery revenues in Rhode Island could decrease.

- (d) 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.
- (e) 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

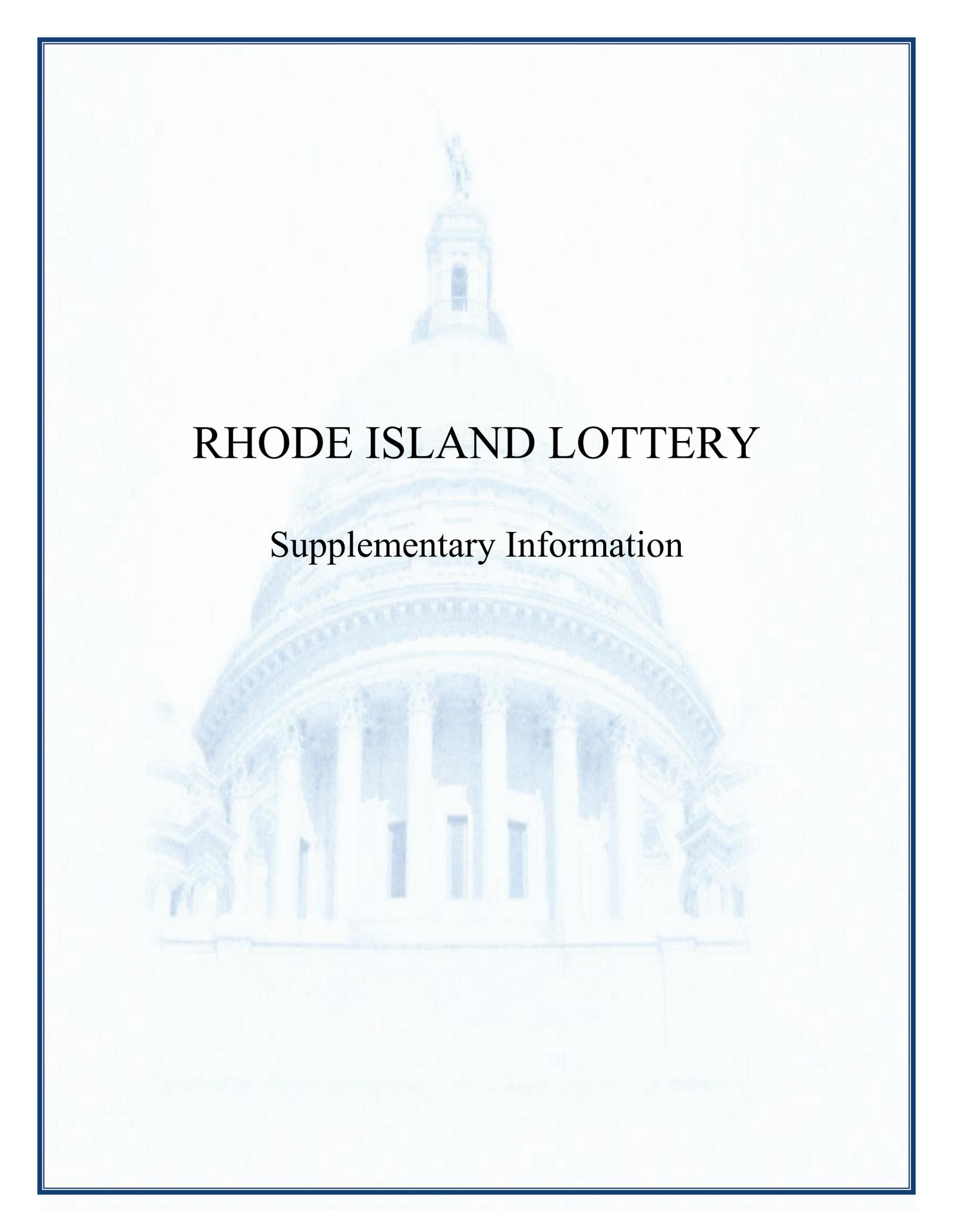
The Lottery is exposed to various types of risk related to its operations. These risks can result in losses incurred from property damage or destruction, inability to operate gaming activities and worker compensation claims. The Lottery manages these risks through the purchase of commercial insurance. During fiscal 2013, the Lottery maintained its amount of purchased insurance coverage. Claims and settlements incurred for fiscal years 2013, 2012 and 2011 have not exceeded the Lottery's insurance coverage.

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

### (15) Subsequent Event

Lottery management has evaluated subsequent events through September 27, 2013, the date for which the financial statements were available for issuance.

Subsequent to June 30, 2013, legislation was enacted in the State of Rhode Island that increased the percentage of net terminal income payable to Newport Grand LLC under the Newport Grand Master Contract discussed in Note 12(c). The commission payable to Newport Grand was increased by 2.25% for the period July 1, 2013 through June 30, 2015.



# RHODE ISLAND LOTTERY

## Supplementary Information

# RHODE ISLAND LOTTERY

## Operating Revenue and Cost of Gaming Operations

Year Ended June 30, 2013

### Schedule 1

	Revenue <sup>(3)</sup>	Commissions	Prize Awards Expense	Unclaimed Prize Recovery	Cost of Tickets	Advertising	Incentive Programs	Cost of Gaming Operations	Gross Profit/(Loss)
Lottery games:									
On-line games									
Keno	\$ 78,964,759	\$ 10,265,306	\$ 51,122,847	\$ (261,600)	\$ -	\$ 299,456	\$ -	\$ 61,426,009	\$ 17,538,750
Bingo	1,381,565	179,601	883,833	-	-	12,829	-	1,076,263	305,302
PowerBall®	40,949,997	5,323,441	20,478,826	(424,524)	-	486,780	-	25,864,523	15,085,474
Daily Numbers	24,522,578	3,187,900	12,194,206	(189,477)	-	53,456	-	15,246,085	9,276,493
Mega Millions®	7,930,357	1,030,935	4,069,652	(182,476)	-	212,651	-	5,130,762	2,799,595
Wild Money	3,583,753	465,883	2,010,545	(100,732)	-	6,712	-	2,382,408	1,201,345
Lucky for Life	8,726,218	1,134,396	4,192,093	(836,766)	-	146,478	-	4,636,201	4,090,017
Raffle	2,301,580	299,202	1,200,000	(32,000)	-	353,664	-	1,820,866	480,714
	168,360,807	21,886,664	96,152,002	(2,027,575)	-	1,572,026	-	117,583,117	50,777,690
Instant tickets	85,003,754	9,032,509	57,053,930	(1,133,174)	1,098,515	587,516	-	66,639,296	18,364,458
Video Lottery <sup>(1)</sup>	520,747,106	200,429,711	-	(167,434)	-	-	4,076,294	204,338,571	316,408,535
Table Games <sup>(2)</sup>	1,881,238	1,542,615	-	-	-	-	-	1,542,615	338,623
Totals	\$ 775,992,905	\$ 232,891,499	\$ 153,205,932	\$ (3,328,183)	\$ 1,098,515	\$ 2,159,542	\$ 4,076,294	\$ 390,103,599	\$ 385,889,306

Video Lottery Commissions - Detail

Facilities	\$ 143,716,420
Technology Providers	35,863,253
Central Communications Provider	12,707,471
City/Town	7,339,102
Narragansett Indian Tribe	803,465
Total	\$ 200,429,711

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

(2) Table Games commenced June 14, 2013.

(3) See note 2 (c) for details of revenue accounting policy.

See accompanying notes to financial statements.



# Office of the Auditor General

State of Rhode Island and Providence Plantations - General Assembly  
Dennis E. Hoyle, CPA - Auditor General

[oag.ri.gov](http://oag.ri.gov)

86 Weybosset Street • Providence, RI • 02903-2800  
tel: 401.222.2435 • fax: 401.222.2111

## **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, 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, 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, 2013, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements, and have issued our report thereon dated September 27, 2013.

### **Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered the Lottery's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purposes of expressing our opinion on the financial statements, but not for the purpose of expressing our opinion on the effectiveness of the Lottery's internal control. Accordingly, we do not express an opinion on the effectiveness of the Lottery's internal control.

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

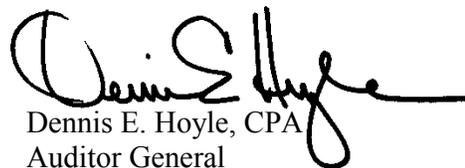
Joint Committee on Legislative Services, General Assembly  
State of Rhode Island and Providence Plantations:

### **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*.

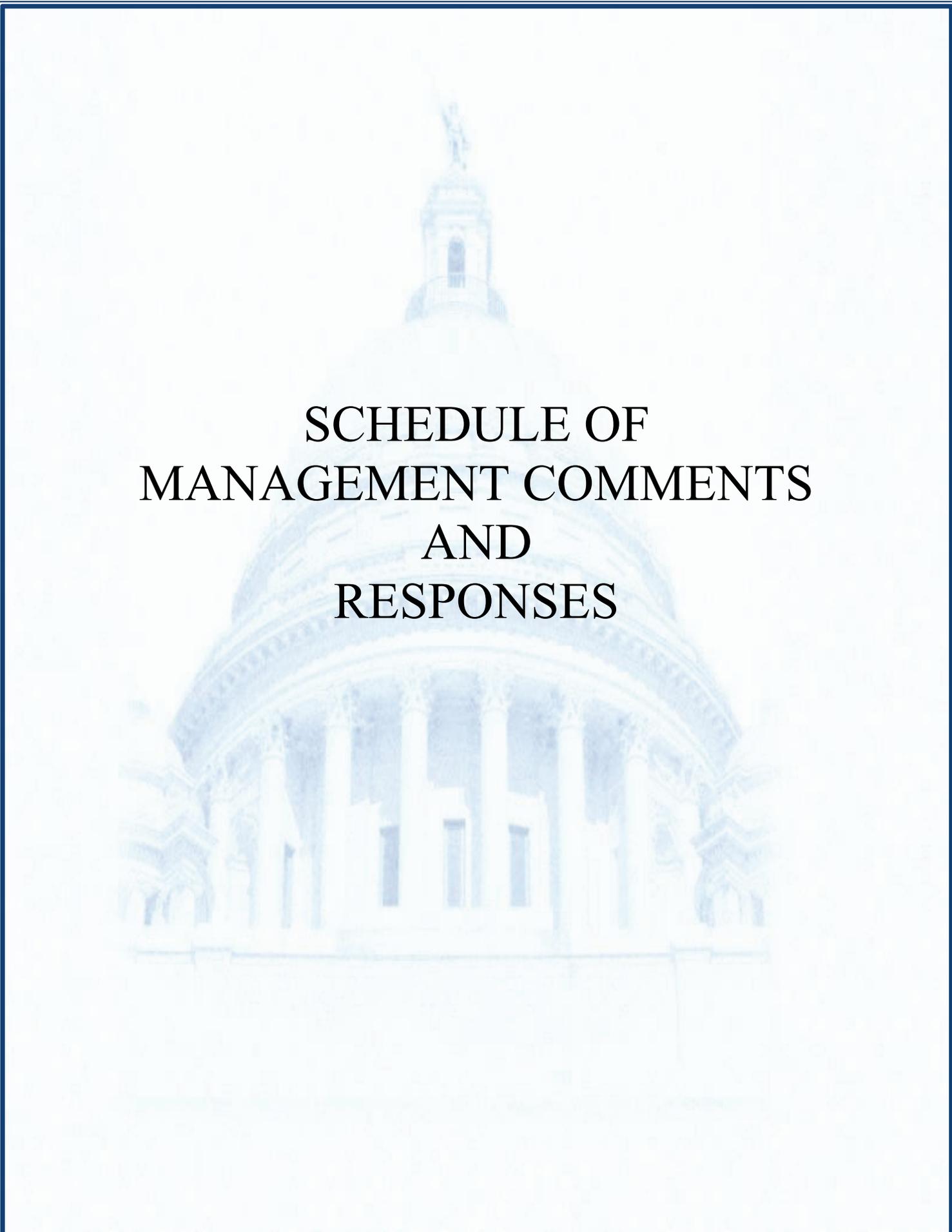
### **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Lottery's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Dennis E. Hoyle, CPA  
Auditor General

September 27, 2013



**SCHEDULE OF  
MANAGEMENT COMMENTS  
AND  
RESPONSES**

## **SCHEDULE OF MANAGEMENT COMMENTS AND RESPONSES**

### **Management Comment 2013-1**

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

The Rhode Island General Laws (General Laws) governing Lottery operations 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 delineate key game design provisions, shares of net income to various parties, and amounts to be transferred to the State's General Fund. Assessing compliance with these provisions has become more challenging due to the ambiguity regarding how the Lottery's operating expenses should be factored into these calculations and, if included, how such expenses should be allocated to the various game offerings.

The General Laws are specific to online and instant lottery games, Keno, and video lottery regarding minimum amounts to be transferred to the State's General Fund. Section 42-61-15 of the General Laws mandate 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 2013, the Lottery complied by transferring 26.5% 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. However, as was reported in the prior year, the Lottery could not fully comply with the 25% transfer requirement for on-line games for fiscal 2012 even though 100% of net income was transferred to the General Fund.

Technical noncompliance could occur again because the General Laws do not provide for a proportionate allocation of operating expenses to the various game offerings for the purpose of determining compliance with minimum transfer amounts. Consequently, all Lottery operating expenses (with the exception of table games and marketing expense reimbursements to video lottery facilities) are included in the calculation of the 25% minimum transfer amount for online and instant games. The General Laws regarding video lottery allocate 100% of net terminal income without an express allocation for related operating costs. Recently 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 direct oversight and monitoring of table games is not clear.

The lack of authorization to allocate its operating expenses consistently by game type also impacts the Lottery's monthly financial reporting. Currently, the Lottery's monthly financial statements allocate operating expenses (with the exception of table games and marketing expense reimbursements to video lottery facilities) to on-line and instant games. Keno and video lottery (both of which require significant personnel support) receive no allocation of operating expenses. This causes an inconsistent measure of each game's contribution to amounts transferred to the General Fund.

The Lottery and Department of Revenue should review the existing statutes and propose a comprehensive technical amendment regarding how the Lottery's operating costs should be considered in determining compliance with game design and minimum transfer amounts. A balance between providing an appropriate overall statutory compliance structure yet allowing the Lottery an

## **SCHEDULE OF MANAGEMENT COMMENTS AND RESPONSES**

appropriate amount of flexibility to maximize the overall generation of income and transfers to the State's General Fund should be maintained.

### **RECOMMENDATION**

2013-1            Propose a comprehensive technical amendment to the General Laws to allow a proportionate allocation of operating expenses for the purpose of assessing compliance with game design and minimum General Fund transfer amounts.

*Rhode Island Lottery Response:*

*The Lottery concurs with this recommendation and will determine the statutory modifications needed to address the issues highlighted by the Auditor General.*

### **Management Comment 2013-2**

## **FUTURE IMPLEMENTATION OF NEW PENSION ACCOUNTING STANDARDS AND THE IMPACT ON LOTTERY TRANSFERS TO THE GENERAL FUND**

The Governmental Accounting Standards Board issued a new pension accounting standard for employers participating in defined benefit pension plans which is effective beginning in fiscal 2015. Upon implementation of the standard, an employer, such as the Lottery, will record pension expense equal to the change in the net pension liability calculated in accordance with the parameters outlined in the new standard. Since the Lottery participates in a cost sharing pension plan - the Employees' Retirement System (ERS) - it will record its proportionate share of the net pension liability for all members within the ERS.

The change in the net pension liability will include market or fair value changes of the assets held within the pension plan. Currently, the Lottery records pension expense equal to the actuarially determined annual required contribution for its employees. Under current accounting standards, the amount required to fund the plan is consistent with the amount recorded as pension expense; however, beginning in fiscal 2015, these amounts will differ.

Amounts transferred to the State's General Fund resulting from Lottery operations have been determined consistent with the Lottery's net income measured for financial reporting purposes (full accrual accounting in accordance with generally accepted accounting principles). In anticipation of the implementation of the new pension accounting standard, Lottery management should consider how the new recognition of pension expense could affect amounts transferred to the State's General Fund. For example, the amount available for transfer to the General Fund could be based on the actual contribution made on a funding basis or on the accounting recognition of pension expense. If pension expense for financial reporting purposes is used to determine amounts available for transfer to the State's General Fund, such amounts are likely to be more volatile due to changes in the market value of assets which will directly impact such amounts.

Since the transfer of amounts to the State's General Fund is largely governed by the Rhode Island General Laws, part of the analysis of the impact of the changes resulting from the

## **SCHEDULE OF MANAGEMENT COMMENTS AND RESPONSES**

implementation of the new accounting standard should include whether any request for modification of the statute is needed.

### **RECOMMENDATION**

2013-2            Analyze the potential impact of the new pension accounting standard on the Lottery's financial reporting and amounts available for transfer to the General Fund. Consider whether any modification is needed to statutory provisions regarding the determination and transfer of Lottery net income.

*Rhode Island Lottery Response:*

*The Lottery concurs with this recommendation.*

### **Management Comment 2013-3**

#### **GENERAL LAW PROVISIONS REGARDING STATE, CASINO AND LOCAL SHARING OF NET TABLE GAME REVENUE**

The legislation that placed the expansion of table games before the voters delineated the share of net table game revenue to the State and the casino. The State's share starts at 16% of net table game revenue but increases to 18% until there is a reduction in net terminal income (video lottery) for the facility between fiscal years. In that event, the additional 2% is paid instead to Twin River (1%) and the Town of Lincoln (1%). For fiscal 2013, the State received 18% of net table game revenue from Twin River.

While table games have just recently begun at Twin River in June 2013, we observed that some aspects of implementing the provisions of the law may be subject to interpretation and consequently may warrant clarification. For example:

- A reduction of as little as \$1 in net terminal income between fiscal years could trigger a shift in the allocation of net table games revenue.
- The statute includes wording that the trigger for the shift in allocation begins "on the first date that such Table Game Retailer's net terminal income for a full State fiscal year is less than such Table Game Retailer's net terminal income for the prior State fiscal year". That date could be when the Lottery's audited financial statements are available for the fiscal year or when preliminary operating results are available. The allocation shift could be retroactive to the first day of the applicable fiscal year or effective on the date that the information is known.
- Once triggered, it is not clear whether the 2% allocation reverts back to the State in the event that net terminal income from video lottery increases between fiscal years.
- The earliest measurement date for the comparison of net terminal income between fiscal years could be two full fiscal years after the implementation of table games or, since video

## **SCHEDULE OF MANAGEMENT COMMENTS AND RESPONSES**

lottery has already been operational, a look-back of two fiscal years commencing immediately with the implementation of table games.

The Lottery and Department of Revenue should consider whether any clarification is needed to facilitate compliance with the intent of these General Law provisions.

### **RECOMMENDATION**

2013-3            Review the General Law provisions delineating the respective shares of net table game revenue and assess whether modifications are necessary to clarify the intent of changes in the share of net table game revenue upon decreases in video lottery net terminal income.

*Rhode Island Lottery Response:*

*The Lottery concurs with this recommendation and will prepare legislation proposing clarification on the issue of changes in the share of net table game revenue in the event of a decrease in video lottery net terminal income.*