
RHODE ISLAND LOTTERY

(AN ENTERPRISE FUND OF THE
STATE OF RHODE ISLAND)

FISCAL YEAR ENDED JUNE 30, 2017

Dennis E. Hoyle, CPA
Auditor General

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



Office of the Auditor General

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

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33 Broad Street • Suite 201 • Providence, RI • 02903-4177
tel: 401.222.2435 • fax: 401.222.2111

September 29, 2017

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

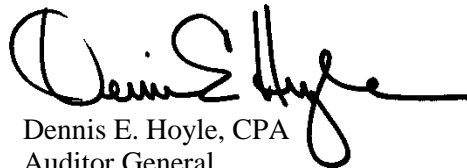
SPEAKER Nicholas A. Mattiello, Chairman

Senator Dominick J. Ruggerio
Senator Dennis L. Algieri
Representative K. Joseph Shekarchi
Representative Patricia L. Morgan

We have completed our audit of the financial statements of the Rhode Island Lottery for the year ended June 30, 2017 and have issued our *Independent Auditor's Report* thereon.

Section III of this report 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 IV contains two management comments which include recommendations intended to enhance internal control or result in other operational efficiencies.

Sincerely,



Dennis E. Hoyle, CPA
Auditor General

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

FISCAL YEAR ENDED JUNE 30, 2017

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RHODE ISLAND LOTTERY

Section I

Independent Auditor's Report

Management's Discussion and Analysis

Basic Financial Statements

Required Supplementary Information



Office of the Auditor General

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

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INDEPENDENT AUDITOR'S REPORT

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, 2017, 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 from 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.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the Lottery as of June 30, 2017, and the respective changes in financial position and its cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

As discussed in Note 13(b), the Lottery's ability to generate income for transfer to the State's General Fund could be adversely impacted by current or planned gaming activities of competitors in neighboring states.

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, 2017, 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 13, Schedule of the Lottery's Proportionate Share of the Net Pension Liability – Employees' Retirement System Plan on page 42, and the Schedule of the Lottery's Contributions – Employees' Retirement System Plan on page 43 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

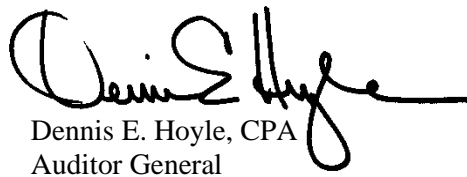
Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Lottery's basic financial statements. The supplementary information included in Schedule 1 is presented for purposes of additional analysis and is not a required part of the basic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

financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, 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, 2017 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 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, 2017

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, 2017. 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 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 for a particular game, the related 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 current liabilities represent 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 \$17.8 million reported at June 30, 2017 relates to the Lottery's previous sale of its exclusive rights to operate its gaming systems and the Lottery's proportionate share of the net pension liability as a participating employer in the Employees' Retirement System Plan. In fiscal 2003, the Lottery sold the exclusive right to operate its current gaming systems 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 recognizes the revenue related to this transaction over the 20 year life of the contract. The deficit net position at June 30, 2017 includes the remaining balance of \$3.8 million representing unearned contract revenue. The remaining net position (deficit) of \$14.0 million represents the Lottery's recognition of its proportionate share of the net pension liability (inclusive of related deferred inflows and outflows) as of June 30, 2017, as a participating employer of the Employees' Retirement System of RI. Further details of the Lottery's net pension liability can be found in the notes to the financial statements.

Financial Highlights

- The Lottery transferred \$362.7 million to the State's General Fund in fiscal 2017. The transfer amount is \$7.1 million or 1.9% less than fiscal year 2016.
- Video lottery net revenue decreased by \$6.3 million during fiscal 2017 for several reasons including competition from nearby State casinos.

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

- Table games operations generated \$140.1 million in net revenue during fiscal 2017, an increase of \$14.3 million or 11.3% over fiscal 2016. This resulted in net income of \$17.8 million for the Lottery from operations after the payment of related commissions and Lottery operating expenses. The addition of 5 gaming tables in November 2016 and enhanced marketing efforts increased net table game revenue.
- PowerBall® and instant ticket sales decreased by \$6.9 million and \$2.1 million, respectively in fiscal 2017 after increases in the prior year which resulted from historic jackpots.

Analysis of Comparative Financial Position

The Lottery's net position (deficit) at June 30, 2017 and June 30, 2016 is summarized below:

	June 30, 2017	June 30, 2016
Assets:		
Current assets		
Cash and cash equivalents	\$ 21,680,893	\$ 20,964,715
Accounts receivable, net	5,612,009	5,500,685
Due from RI Capital Plan Fund	-	444,458
Other	1,152,287	1,317,151
Total current assets	28,445,189	28,227,009
Long-term assets		
Capital assets, net	421,514	368,149
Total assets	28,866,703	28,595,158
Deferred outflows of resources	2,728,140	1,398,829
Liabilities:		
Current liabilities		
Due to State's General Fund - net income from operations	\$ 1,910,826	\$ 1,408,964
Due to State's General Fund - operating expenses	225,840	269,596
Accounts payable	12,355,941	12,123,494
Prize obligations	7,282,732	7,308,112
Compensated absences	252,532	233,053
Other liabilities	7,143,828	7,544,737
Total current liabilities	29,171,699	28,887,956
Long-term liabilities		
Compensated absences	320,005	332,203
Net pension liability	16,260,567	15,073,593
Unearned contract revenue	3,125,000	3,750,000
Total long-term liabilities	19,705,572	19,155,796
Total liabilities	48,877,271	48,043,752
Deferred inflows of resources	511,338	300,202
Net position (deficit):		
Net investment in capital assets	421,514	368,149
Unrestricted	(18,215,280)	(18,718,116)
Total net position (deficit)	\$ (17,793,766)	\$ (18,349,967)

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

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. At June 30, 2017, the Lottery's assets included \$21.7 million in cash and cash equivalents as compared with \$21.0 million at June 30, 2016. The Lottery's accounts receivable approximated \$5.6 and \$5.5 million, respectively, at June 30, 2017 and 2016.

The Lottery's current liabilities 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 \$1.9 million at June 30, 2017 and \$1.4 million at June 30, 2016. At June 30, 2017, vendor payables, made up largely of commissions due to video lottery participants, and prize obligations, attributable mostly to instant ticket games were \$12.4 million and \$7.3 million, respectively. In comparison, vendor payables and prize obligations at June 30, 2016 were \$12.1 million and \$7.3 million, respectively.

The deficit in net position reported at June 30, 2017, 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. At June 30, 2017, a deficit balance of \$3.8 million remains relating to deferred contract revenue to be recognized proportionately over the remaining term of the Master Contract with its gaming systems provider. Additionally, the Lottery recognizes its proportionate share of the net pension liability as a participating employer in the cost-sharing multiple employer Employees' Retirement System plan. As required by RI General Laws, the Lottery's transfer to the State's General Fund is based on net income reflecting the actuarially determined employer contribution to the Employees' Retirement System. Net income reported in the Lottery's financial statements reflects the recognition of pension expense in accordance with generally accepted accounting principles.

Lottery Operations

	<u>June 30, 2017</u>	<u>June 30, 2016</u>
Revenue:		
On-line games	\$ 155,656,091	\$ 164,552,117
Instant games	94,225,863	96,281,087
Video lottery, Net	482,404,252	488,690,835
Table games	140,090,213	125,837,949
Other income	1,178,978	1,101,861
Total revenue	<u>873,555,397</u>	<u>876,463,849</u>
Expenses:		
Cost of gaming operations	(499,426,404)	(495,603,519)
Operating expenses	<u>(10,876,164)</u>	<u>(11,595,766)</u>
Total expenses	<u>(510,302,568)</u>	<u>(507,199,285)</u>
Income before transfers	363,252,829	369,264,564
Transfers to State's General Fund	(362,696,628)	(369,760,880)
Transfers from RI Capital Plan Fund	<u>-</u>	<u>444,458</u>
Increase (decrease) in net position	556,201	(51,858)
Total net position (deficit), beginning of year	<u>(18,349,967)</u>	<u>(18,298,109)</u>
Total net position (deficit), end of year	<u>\$ (17,793,766)</u>	<u>\$ (18,349,967)</u>

RHODE ISLAND LOTTERY

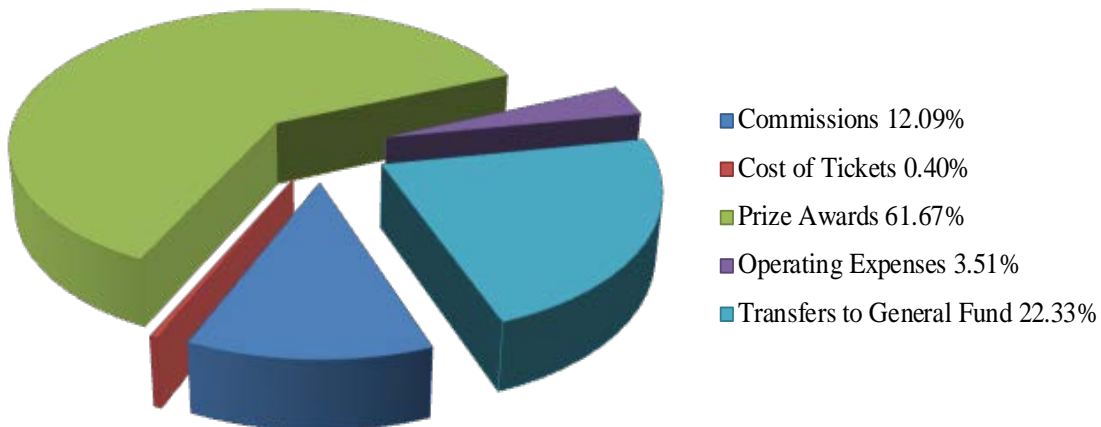
Management's Discussion and Analysis

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®, Mega Millions®, Keno, Bingo, Daily Numbers, Wild Money and Lucky for Life® during fiscal 2017. In total, on-line revenue decreased by \$8.9 million. Significant changes in on-line game revenue from the prior year included:

- Revenue from Powerball® decreased \$6.9 million for fiscal 2017 from the prior year. A \$1.6 billion jackpot won in January 2016 significantly increased revenue in fiscal 2016. The lack of an extraordinary jackpot in fiscal 2017 contributed to the revenue reduction in 2017.

Revenue from Keno, Mega Millions®, and other on-line games generally experienced minor decreases over the prior year.

- Instant ticket revenue for fiscal 2017 decreased \$2.1 million after significant revenue increases in fiscal 2015 and 2016. During fiscal year 2017, the Lottery continued with the successful family of games offering “X” times the prize money and its holiday games. The Lottery also introduced another high price point ticket with a significant dollar top prize amount with the release of \$50,000 Fortune, Lucky Times 20, and the all new, \$3 Mega Bingo.

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, 2017 and 2016.

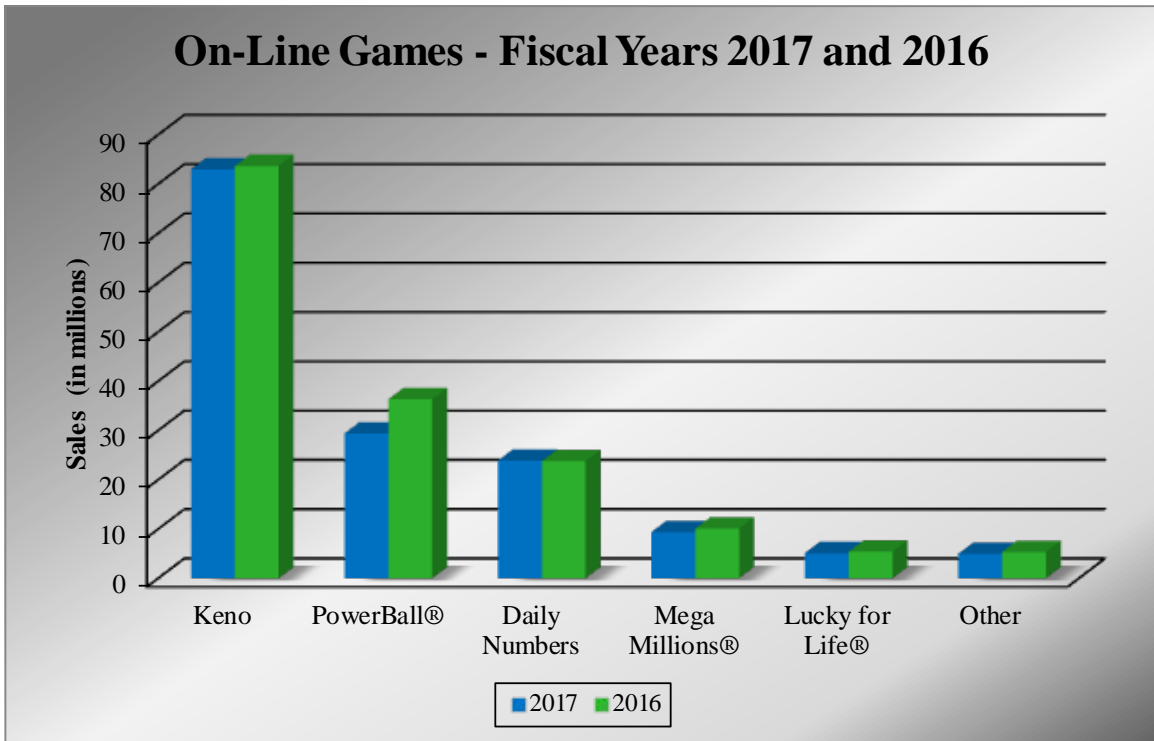
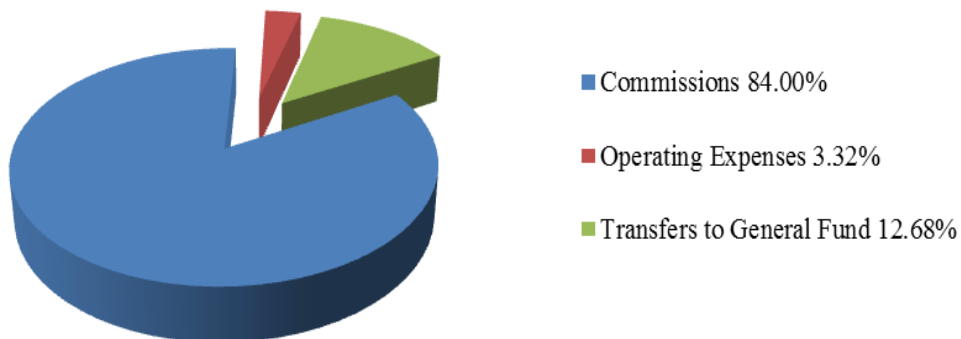


Table Games

For the fiscal year ending June 30, 2017, net table game revenue was \$140.1 million, an increase of 11.3%. During the fiscal year ended June 30, 2017, the number of available gaming tables increased from 108 to 113. The addition of 5 tables in November 2016 in conjunction with continuing targeted marketing efforts resulted in increased net table game revenue.

Distribution of the year's net table game revenue was as follows:

Table Games - Net Revenue Distribution



RHODE ISLAND LOTTERY

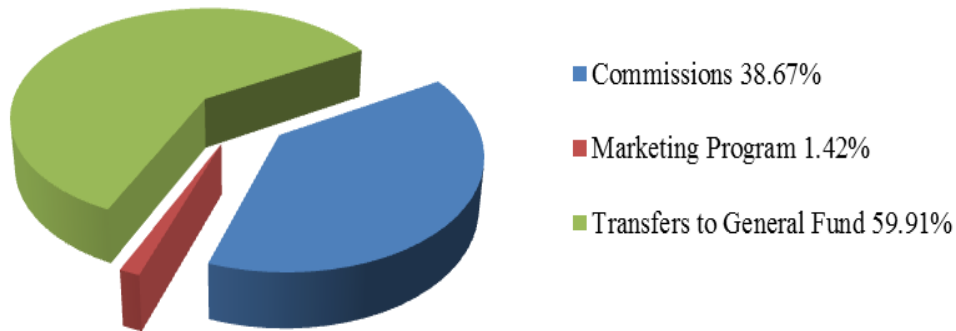
Management's Discussion and Analysis

Video Lottery

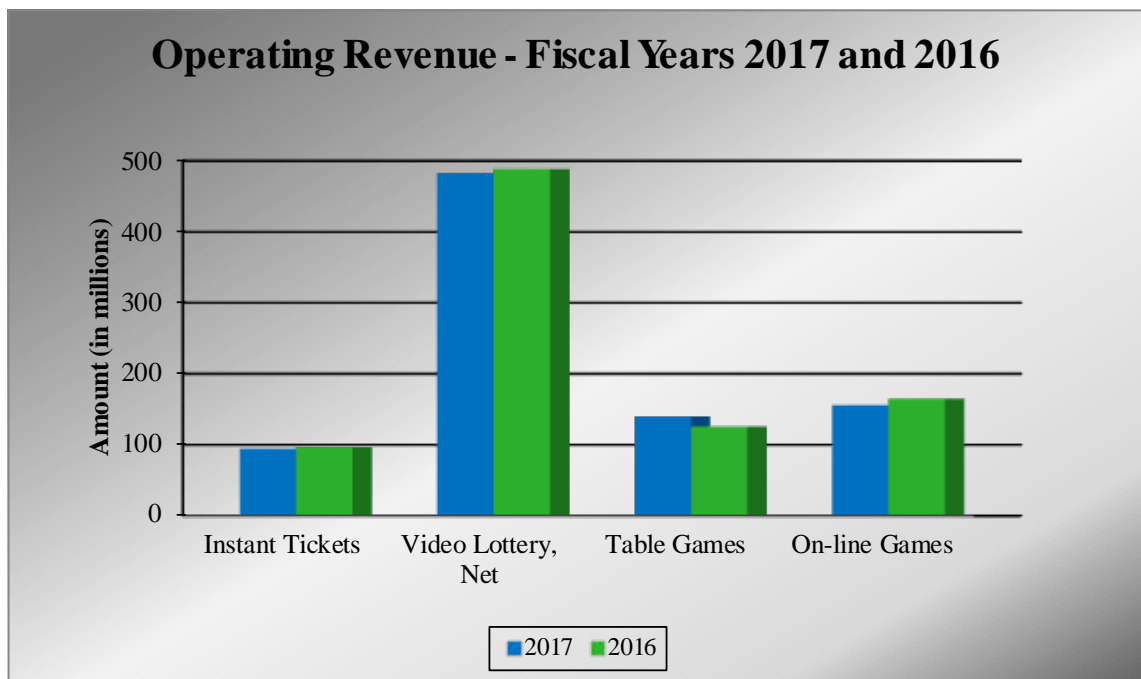
Video lottery net revenue decreased \$6.3 million or 1.3% from the prior fiscal year. Net terminal income at Twin River totaled \$436.3 million, a 1.7% decrease compared to fiscal 2016. Net terminal income at Newport Grand totaled \$46.1 million, a 2.7% increase compared to fiscal 2016. The total net terminal income decrease over the prior fiscal year was due to increased competition from a nearby Massachusetts casino; however the loss in net terminal income was less than anticipated. Increased marketing and promotional efforts continue to minimize the impact of gaming competition on the Lottery's operations.

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

Video Lottery - Net Revenue Distribution



The following graph depicts the Lottery's operating revenue for instant tickets, video lottery, table games, and on-line games for the fiscal year ended June 30, 2017 in comparison to fiscal year ended June 30, 2016.

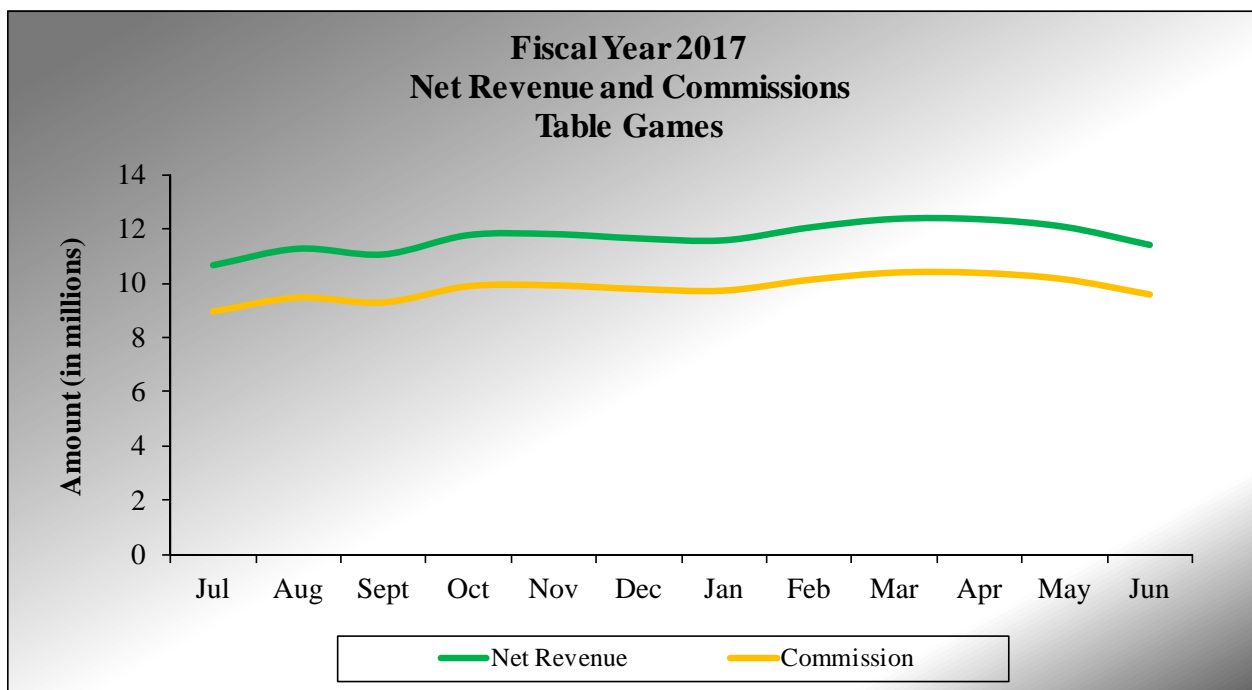
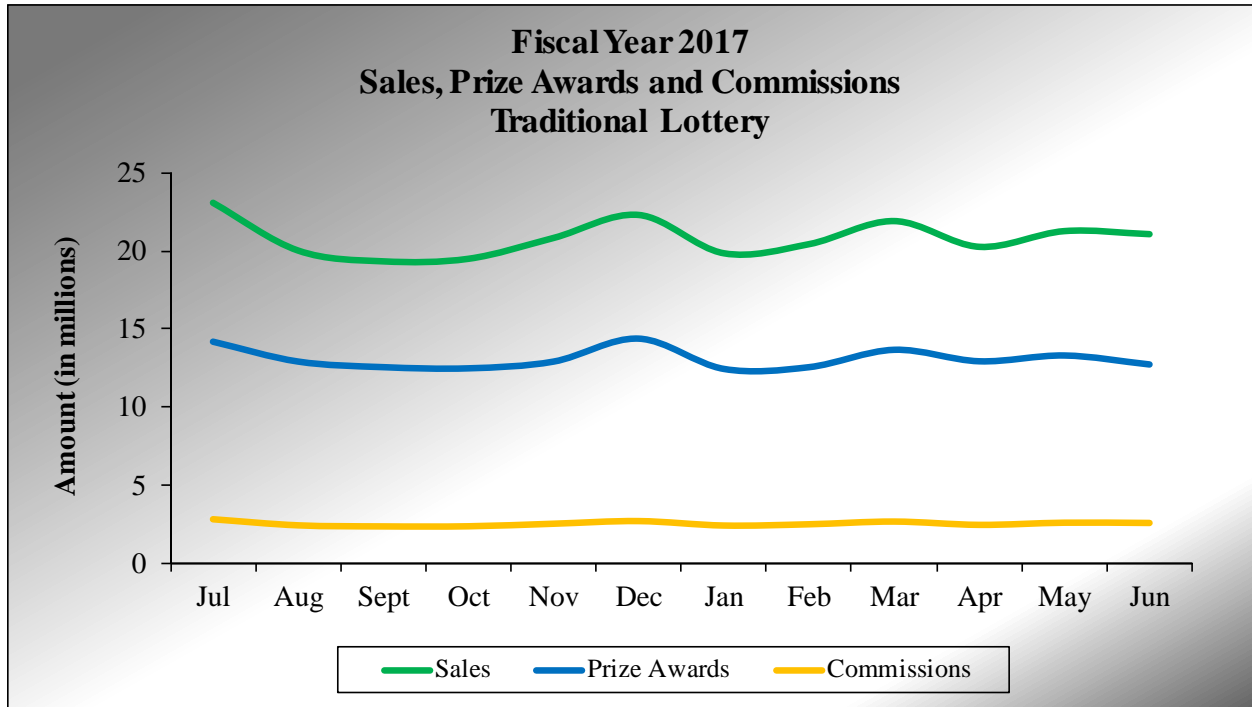


RHODE ISLAND LOTTERY

Management's Discussion and Analysis

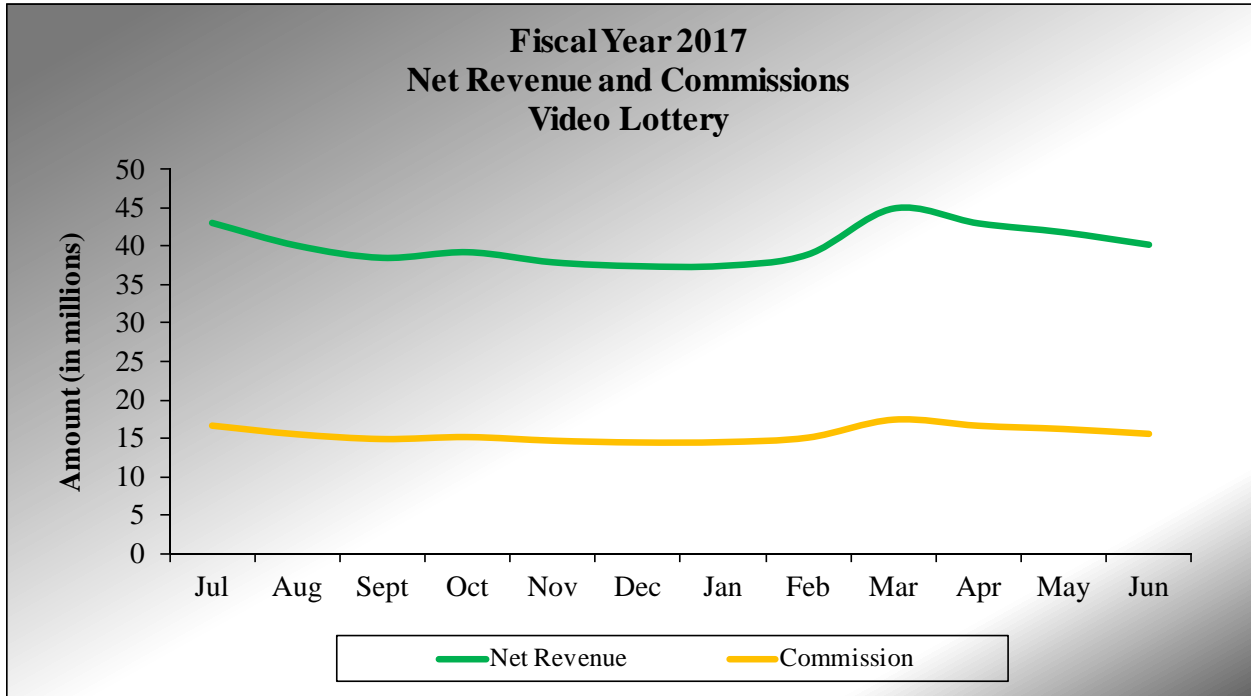
Commissions and Prize Awards Expense

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 and third graphs compare table game net revenue and video lottery net revenue to their related commissions.



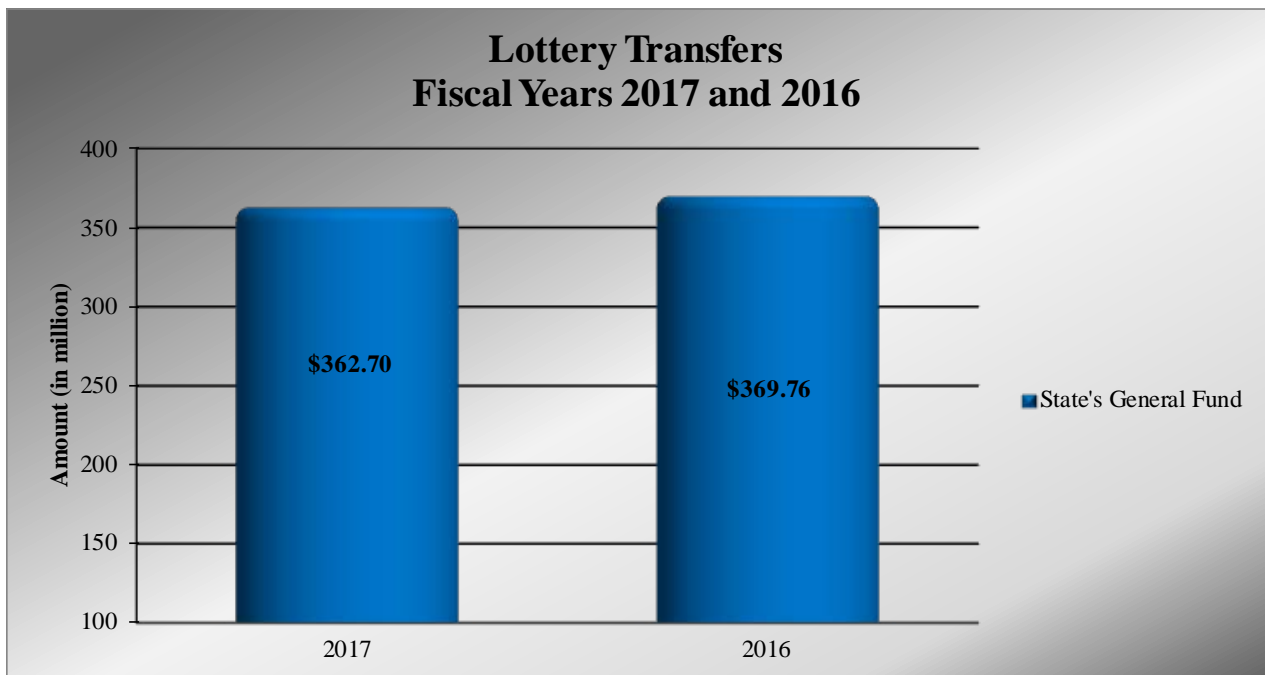
RHODE ISLAND LOTTERY

Management's Discussion and Analysis



Lottery Transfers

Net income transferred by the Lottery for the fiscal years ended June 30, 2017 and June 30, 2016 was \$362.70 million and \$369.76 million, respectively. All fiscal 2017 transfers were made by the Lottery directly to the State's General Fund, as required by the General Laws.



RHODE ISLAND LOTTERY

Management's Discussion and Analysis

Debt Administration

Jackpot prizes awarded under PowerBall® and Mega Millions® are satisfied through investments purchased by the Multi-State Lottery Association (MUSL). MUSL purchases 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 PowerBall® and Mega Millions® jackpot awards which are payable in installments from funds provided by MUSL.

The Lucky for Life® game offers top and second prize winners an annuity or cash option payment. If selected by the winner, the Lucky for Life® game requires each selling lottery to purchase an insurance annuity to fully fund the top and second prizes won in that state. All participating lotteries share in the cost of the insurance annuity or cash option, however, the selling lottery is responsible for settling the top and second prize liabilities. 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 from an insurance company with an AM Best rating of A or better. Rhode Island has purchased its second prize winners' annuities through MUSL in accordance with insurance company rating requirements.

Capital Assets

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

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

Potential Factors Impacting Future Operations

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

- Of the total \$362.7 million fiscal year 2017 Lottery transfer to the State of Rhode Island General Fund, \$289.0 million and \$17.8 million from video lottery and table games, respectively, were from the two licensed facilities. Both the Twin River licensed facility in Lincoln, RI and the Newport Grand licensed facility in Newport, RI are principally owned by the Twin River Management Group. Upon completion of the Twin River - Tiverton, LLC casino in the fall of 2018, the license for Newport Grand will transfer to Twin River – Tiverton, LLC also principally owned by the Twin River Management Group. The casino in Tiverton, situated on the border of Massachusetts is strategically located to compete with nearby gaming facilities. The construction of a hotel at the Twin River – Lincoln location is also expected to better position that facility to compete with its nearby competitors. The hotel is expected to open in August 2018.

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

- The facilities face increased competition from surrounding casinos including Massachusetts casinos expanding in the region. Plainridge Park Casino in Plainville, MA has been operating since June 2015. The MGM Casino in Springfield, MA is a \$950 million project scheduled to open in 2018. The Wynn Casino in Everett, MA is a \$2.4 billion project scheduled to open by June 2019. In Connecticut, the Mashantucket Pequot and Mohegan tribal nations are federally recognized tribes that operate nearby casinos. The two sovereign nations have formed a commercial gaming company in a joint venture called MMCT to create a third casino. This project is being contested by a private casino organization. The Lottery and the State continually monitor the risk to gaming operations and assess and expand important revenue generating marketing and promotional programs to best enable competitive positions.
- 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. Legislation enacted for fiscal year 2018 increased the amount of promotional play for each facility subject to authorization 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, in conjunction with their gaming partners, continuously explores new games and modifications to existing games to maximize revenue. Recent and future initiatives planned include the following:
 - In April 2018, the PowerBall® game will be enhanced with a \$1 add-on game offering on Mondays and Thursdays. Such changes are designed to generate an increase in game play and overall sales.
 - In October 2017, changes to an enhanced, newer Mega Millions® game will increase to a \$2 price point, offer larger starting jackpots, bigger average jackpots with faster rolls, and improved odds of winning the second level prize of \$1 million. A new wager "Just the Jackpot" will also be an option for playing the game.
 - PlaySpot™, a tethered wagering pilot program, began in December 2016 at one retailer location. Utilizing smartphone technology, a player may purchase certain Lottery products via Bluetooth connectivity at a licensed retailer location and also receive prize payments. The pilot program extends into fiscal 2018 with the potential to include up to 15 retailers during the pilot program.

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, 2017

Assets

Current assets:

Cash and cash equivalents (note 3)	\$	21,680,893
Accounts receivable-less allowance for doubtful accounts of \$98,374		5,612,009
Deposits with Multi-State Lottery Association (MUSL) (note 1)		42,642
Ticket inventory		<u>1,109,645</u>
Total current assets		28,445,189

Capital assets, net (note 4)		<u>421,514</u>
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Total assets		<u>28,866,703</u>
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Deferred outflows of resources (note 9)		<u>2,728,140</u>
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Liabilities

Current liabilities:

Due to State's General Fund - net income from operations (note 5)	\$	1,910,826
Due to State's General Fund - operating expenses (note 5)		225,840
Accounts payable		12,355,941
Obligation for unpaid prize awards		7,282,732
Accrued expenses		6,242,699
Compensated absences (note 7)		252,532
Advances for future drawings		241,596
Unearned contract revenue (note 8)		625,000
Other current liabilities		<u>34,533</u>
Total current liabilities		<u>29,171,699</u>

Long-term liabilities:

Compensated absences (note 7)		320,005
Net pension liability (note 9)		16,260,567
Unearned contract revenue (note 8)		<u>3,125,000</u>
Total long-term liabilities		<u>19,705,572</u>

Total liabilities		<u>48,877,271</u>
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Deferred inflows of resources (note 9)		<u>511,338</u>
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Net position (deficit)

Net position, net investment in capital assets (note 8)		421,514
Unrestricted (deficit) (note 8)		<u>(18,215,280)</u>
Total net position (deficit)	\$	<u>(17,793,766)</u>

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Revenue, Expenses and Changes in Net Position

Year Ended June 30, 2017

Operating Revenue (schedule 1):

On-line games	\$ 155,656,091
Instant games	94,225,863
Video lottery (note 2)	482,404,252
Table games (note 2)	<u>140,090,213</u>
Total operating revenue	<u>872,376,419</u>

Cost of gaming operations (schedule 1):

Commissions (note 6)	334,736,611
Prize awards, online and instant games	157,023,937
Incentive programs, video lottery	6,857,127
Advertising	2,622,021
Unclaimed prize recovery	(2,808,577)
Cost of tickets	<u>995,285</u>
Total cost of gaming operations	<u>499,426,404</u>
Gross profit	<u>372,950,015</u>

Operating expenses:

Personal services	9,948,138
Contract services	36,154
Depreciation and amortization	131,982
Other	<u>759,890</u>
Total operating expenses	<u>10,876,164</u>
Operating income	362,073,851

Non-operating income (expenses):

Investment income	305,420
Other income (expenses) - net	<u>873,558</u>
Income before transfers	363,252,829

Transfer to State's General Fund (note 5)

(362,696,628)

Increase in net position 556,201

Total net position (deficit), beginning of year (18,349,967)

Total net position (deficit), end of year (note 8) \$ (17,793,766)

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Cash Flows

Year Ended June 30, 2017

Cash flows from operating activities:	
Receipts from lottery sales, online and instant games	\$ 249,704,373
Receipts from video lottery operations	482,404,252
Receipts from table games	140,090,213
Receipts from MUSL for grand prize winners	2,778,254
Receipts from problem gambling program	100,000
Receipts from sale of other tickets	56,335
Other receipts	205,868
Payments for on-line and instant ticket prizes	(154,240,739)
Payments to MUSL grand prize winners	(2,778,254)
Payments for commissions - retailers	(10,057,345)
Payments for commissions - video lottery	(186,245,129)
Payments for commissions - table games	(119,313,361)
Payments to facilities - video lottery incentive program	(6,827,370)
Payments for commissions - on-line games contractor	(19,150,948)
Payments to suppliers for goods and services	(4,253,305)
Payments to employees for services	(10,126,431)
	<hr/>
Net cash provided by operating activities	362,346,413
Cash flows from noncapital financing activities:	
Transfers to State's General Fund	(362,194,766)
Transfers from RI Capital Plan Fund	444,458
	<hr/>
Net cash used for noncapital financing activities	(361,750,308)
Cash flows from capital and related financing activities:	
Purchase of capital assets	(185,347)
	<hr/>
Net cash used for capital and related financing activities	(185,347)
Cash flows from investing activities:	
Interest income	305,420
	<hr/>
Net cash provided by investing activities	305,420
	<hr/>
Net increase in cash and cash equivalents	716,178
Cash and cash equivalents at July 1, 2016	20,964,715
	<hr/>
Cash and cash equivalents at June 30, 2017	\$ 21,680,893
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See accompanying notes to financial statements.

Continued.

RHODE ISLAND LOTTERY

Statements of Cash Flows (Continued)

Year Ended June 30, 2017

Reconciliation of operating income to net cash provided by operating activities:	
Operating income	\$ 362,073,851
Adjustments to reconcile operating income to net cash provided by (used for) operating activities:	
Depreciation and amortization	131,982
Miscellaneous receipts classified as operating activities	42,442
Rental income and other receipts	206,117
(Increase) decrease in assets and deferred outflows of resources:	
Accounts receivable	(111,324)
Deposits with MUSL	(249)
Inventory	165,113
Deferred outflows of resources	(1,329,311)
Increase (decrease) in liabilities and deferred inflows of resources:	
Due to State's General Fund - operating expenses	(43,756)
Accounts payable	232,443
Obligation for unpaid prize awards	(25,380)
Accrued expenses and other	(321,968)
Net pension liability	1,186,974
Advances for future drawings	(71,657)
Deferred inflows of resources	211,136
Total adjustments	<u>272,562</u>
Net cash provided by operating activities	<u>\$ 362,346,413</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 – Midday and Evening, Keno, Bingo, and Wild Money. 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 and 8 minutes, respectively, on "monitors" in sales locations across the State.
- ii) Multi-state games, which include Powerball[®] and Mega Millions[®], 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*[®]

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

The prize pool for PowerBall[®] is 50% of each drawing period's ticket sales. MUSL may place up to 5% of each drawing period's ticket sales for PowerBall[®], included as part of each member's prize liability, in prize reserve funds. The prize reserve deduction begins at 2% when an annuity jackpot exceeds \$120 million and 4% when an annuity jackpot exceeds \$250 million. The maximum balance on the prize reserve funds for PowerBall[®] is \$140 million. Once the prize reserve funds exceed this designated amount, 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 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.

Effective with the drawing held on July 2, 2016, at any time that the Grand Prize Carry Forward Pool (GPCFP) is below forty-five million dollars (\$45,000,000) prior to a drawing, the GPCFP deduction from a Party Lottery's Grand Prize Pool (GPP) contribution for that drawing shall be equal to a maximum of four percent (4%) of a Party Lottery's sales when the annuity Grand Prize exceeds one hundred twenty million dollars (\$120,000,000). The GPCFP percentage shall be reduced by the percentage of sales being actually contributed to the Set-Aside Pool (SAP), Set Prize Reserve Account (SPRA) or the Prize Reserve Account (PRA). At any time that the GPCFP exceeds forty-five million dollars (\$45,000,000) prior to a drawing, there shall be no GPCFP deduction for that drawing.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization - (Continued)

At June 30, 2017, the prize reserve funds for the PowerBall® game reported a balance of \$117.9 million of which the Lottery's share was \$1.3 million. The Lottery records amounts, which are placed into the prize reserve funds, as prize awards expense when the related sales occur.

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 \$42,642 at June 30, 2017 on the Statement of Net Position as "Deposits with MUSL".

(b) *Mega Millions*®

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

The prize pool for Mega Millions® shall consist of up to 51% of each drawing period's ticket sales. An amount of up to 1% of each drawing period's ticket sales may be placed in one or more prize pool reserve accounts. The maximum prize reserve account is \$45 million.

At June 30, 2017, the prize reserve account for the Mega Millions® game reported a balance of \$38.0 million of which the Lottery's share was \$432,299.

- iii) Lucky for Life®, which expanded to twenty-four lotteries in fiscal year 2017, operates under an agreement between the six New England states ("New England Lotteries") and the Arkansas Scholarship Lottery, the Colorado Lottery Commission, the Delaware Lottery, the Office of Lottery & Charitable Games, the Idaho Lottery, the Iowa Lottery Authority, the Kansas Lottery, the Kentucky Lottery Corporation, the Michigan Lottery, the Minnesota State Lottery, the Missouri Lottery, the Montana Lottery, the North Carolina Lottery, the North Dakota Lottery, the Ohio Lottery Commission, the South Carolina Education Lottery, the South Dakota Lottery, and the Wyoming Lottery Corporation (collectively referred to as the "Licensee Lotteries") to offer the Lucky for Life® 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 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 and second 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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization - (Continued)

Top Prize Settlement

All top prizes are funded through the purchase of insurance annuities with an alternative cash option. For the annuity option, 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, including the number of top prize winners exercising the cash option, with a minimum value of \$500 per week to each winner exercising the annuity option.

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:

- 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) rating 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.

As an alternative to the annuitized payment option, the top prize winner may request the top prize cash option payment of \$5,750,000. If there is more than one top prize winner, the top prize cash option will be divided by the total number of prize winners, including top prize winners selecting the annuitized payment option.

If more than 14 top prize winners, the top prize liability will be split equally among all top prize winners and paid in one lump sum cash payment, without an annuitized option.

Second Tier Prize Settlement

For up to 20 second prize winners, including those who exercise the cash option, the annuity payment option will be \$25,000 per year for life to second prize winners exercising the annuity option. For up to 20 second prize winners, including those who exercise the annuity option, the cash option will be \$390,000 to each second prize winner exercising the cash option.

If more than 20 second prize winners, the second prize liability is capped and will be split equally among all second prize winners and paid in one lump sum cash payment, without an annuitized option.

All low-tier prizes (all levels except the top prize and second prizes) 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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization - (Continued)

- (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 bonus features, or meet other game requirements to win the prize shown.
- (C) Video lottery games are operated through 5,319 video lottery terminals (VLTs) at two licensed facilities, Twin River Casino 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.
- (D) Table games are operated at 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, the Town of Lincoln, RI, and the balance being remitted to the General Fund. During fiscal 2017, commissions to Twin River and the Town of Lincoln were 83% and 1%, respectively.
- (E) 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.

Game	Prize Payout	Mandated Payments to the State
Daily Numbers 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 – net of prizes, commissions, administrative and operating expenses.
Keno	Not less than 45% or more than 72% of sales	Payments to the General Fund – net of prizes, commissions, administrative and operating expenses.
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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(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.

(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[®], prize awards expense is recorded equal to the required contributions to the jackpot pool and low-tier prizes won. For the Lucky for Life[®] game, prize awards expense is recorded equal to the estimated cost of actual prizes won. Prize awards expense is subsequently adjusted based on the Lottery's share of purchased annuities for the top prize and a settlement for actual low tier prizes won in all participating states.
2. Instant ticket lottery games - when ticket packets are charged to retailers. Prize expense is recognized in proportion to the number of tickets sold based on the stated prize structure for a specific instant ticket game.
3. Video lottery games - are reported on a net basis. Gross revenue is recognized when game credits are purchased via cash or credit redemption at the terminal (gross terminal inputs). Related prizes are recognized when game credits are issued by a video lottery terminal making them redeemable as credits in another video terminal or for cash by a patron (gross terminal outputs).

RHODE ISLAND LOTTERY

Notes to Financial Statements

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

The gross video lottery terminal inputs and outputs for fiscal 2017 and reported video lottery net revenue are detailed in the following schedule:

Schedule of Video Lottery Net Revenue For the Fiscal Year Ended June 30, 2017	
Video Terminal Cash-In (Gross Terminal Inputs):	
Cash collected from video lottery terminals	\$ 1,453,452,266
Plus: Credit vouchers redeemed for play in video lottery terminals	<u>1,818,192,647</u>
Total cash in reported by video lottery terminals	3,271,644,913
Less:	
Video Terminal Cash-out (Gross Terminal Outputs):	
Video lottery credit vouchers issued by video lottery terminals	2,789,099,085
Plus: Contributions to progressive video jackpots from patron play	<u>141,576</u>
Total cash-out amounts reported by video lottery terminals	<u>2,789,240,661</u>
Video lottery revenue, net	<u><u>\$ 482,404,252</u></u>

4. Table games, with the exception of poker, 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), plus markers (credit extended at a table to patrons in exchange for chips), less fills, plus credits, less beginning chip inventory, plus ending chip inventory, plus one-half of match play and free bet coupons redeemed. Poker games revenue is reported on a gross fee basis, referred to as poker rake, from the Twin River Facility. Poker rake calculated daily at each table is based upon a percentage of each poker pot or a direct fee charged to each player in proportion to the time spent playing at the poker table.

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 table 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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

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

All expenses directly attributable to providing or promoting lottery games to the public are considered costs of gaming operations and are reported as such on the Lottery's Statement of Revenue, Expenses, and Changes in Net Position. These expenses predominantly include commissions to lottery retailers, gaming facilities, video lottery terminal providers, gaming system operators, and the cities/towns that host the Lottery's gaming facilities, in addition to advertising, marketing and promotional expenses.

All other expenses directly attributable to the Lottery's support and oversight of gaming activities are reported as operating expenses. Operating expenses mostly consist of personnel costs, contract services, depreciation/amortization expenses, and other expenses associated with the maintenance of the Lottery's headquarters and internal computer network.

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), rental income, and refunds from the Multi-State Lottery Association.

(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. The Lottery adheres to the State's capitalization thresholds and estimated useful lives for capital asset categories.

(e) *Cash Equivalents*

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

(f) *Investments*

Investments are recorded at fair value except for certain money market investments that have a remaining maturity at the time of purchase of one year or less, which are recorded at a net asset value reflective of amortized cost which approximates fair market value.

(g) *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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

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

(h) *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.

(i) *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.

(j) *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.

(k) *Compulsive and Problem Gambling Program*

Pursuant to section 42-61.2-14 of the Rhode Island General Laws, the Lottery is required to establish a program for compulsive and problem gamblers in conjunction with Twin River and Newport Grand to include awareness, player self-exclusion, and promotion of a problem gambling hotline. The program is funded through aggregate reimbursements made by Twin River and Newport Grand totaling not less than \$100,000 annually. The Lottery received \$100,000 from gaming facility providers toward the operation of its compulsive and problem gambling program. At June 30, 2017, the Lottery included \$34,533 in other current liabilities representing the unexpended portion of the annual reimbursements from the facilities for the compulsive and problem gambling program.

(l) *Pensions*

For purposes of measuring the net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the fiduciary net position of the Employees' Retirement System ("ERS") and the additions to/deductions from ERS' fiduciary net position have been determined on the same basis as they are reported by ERS. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

(m) *Use of Estimates*

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

(n) *New Accounting Pronouncements*

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

RHODE ISLAND LOTTERY

Notes to Financial Statements

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

GASB Statement No. 75, Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions, will be implemented in fiscal 2018. As a participant in the State's cost-sharing Other Postemployment Benefits (OPEB) plan, the Lottery will recognize its proportionate share of the State's Net OPEB liability in fiscal 2018 and restate net position at July 1, 2017.

(3) Deposits and Investment Risk

(a) *Deposits*

The Lottery's cash deposit balances at June 30, 2017 totaled \$1,804,596, with corresponding bank balances totaling \$1,853,221. The bank balances consisted of \$606,161 in demand deposit accounts and \$1,247,060 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, 2017 pursuant to Chapter 35-10.1 of the General Laws. However, the State Investment Commission has adopted a collateralization requirement for institutions holding the State's deposits. Financial institutions are required to pledge collateral equal to 102% of the uninsured deposit amounts. Of the total bank deposit balance totaling \$1,853,221 at year end, the entire amount was either covered by federal depository insurance or collateralized by securities held by an independent third party custodian.

(b) *Investments - Fair Value Measurements*

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."

The Lottery categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. GASB Statement No. 72, *Fair Value Measurement and Application*, defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The hierarchy is based on the valuation inputs used to measure the fair value of the assets. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(3) Deposits and Investment Risk– (Continued)

At June 30, 2017, the Lottery had a single investment consisting of \$19,876,297 in the Ocean State Investment Pool Trust (OSIP), an investment pool established by the State General Treasurer. The Lottery's investment accounted for less than 2% of the total investment in OSIP at June 30, 2017. Agencies, authorities, commissions, boards, municipalities, political subdivisions, and other public units of the State may invest in OSIP. 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 - 2nd Floor, Warwick, RI 02886.

OSIP has met the criteria outlined in GASB Statement No. 79 – *Certain External Investment Pools and Pool Participants* to permit election to report its investments at amortized cost which approximates 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 transacts with its participants at a stable net asset value (NAV) per share. Investments reported at the NAV are not subject to the leveling categorization as described above. There are no participant withdrawal limitations.

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.

Cash deposits, including interest-bearing investment deposit accounts	\$ 1,804,596
Investments classified as cash equivalents	<u>19,876,297</u>
Cash and cash equivalents	<u>\$ 21,680,893</u>

RHODE ISLAND LOTTERY

Notes to Financial Statements

(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:

	Estimated Useful Life	Balance at June 30, 2016	2017 Additions	2017 Disposals	Balance at June 30, 2017
<u>Cost</u>					
Building	50	\$ 1,437,912			\$ 1,437,912
Building improvements	20	1,944,601		(7,373)	1,937,228
Ticket production equipment	5	11,486			11,486
Office equipment	5	101,237	8,908	(14,412)	95,733
Furniture and fixtures	5	90,856	32,963	(14,726)	109,093
Lottery drawing equipment	5	117,352		(20,417)	96,935
Automobiles	5	410,228	130,299	(108,701)	431,826
Computer equipment	5	211,380	13,802	(140,637)	84,545
Trucks	5	22,445			22,445
Intangible Assets	7	175,424			175,424
Total		\$ 4,522,921	\$ 185,972	\$(306,266)	\$ 4,402,627
 <u>Less: Accumulated Depreciation and Amortization</u>					
Building		\$ 1,437,912			\$ 1,437,912
Building improvements		1,858,954	7,933	(7,350)	1,859,537
Ticket production equipment		11,486			11,486
Office equipment		101,235	883	(14,412)	87,706
Furniture and fixtures		90,856	3,267	(14,726)	79,397
Lottery drawing equipment		104,778	3,588	(20,416)	87,950
Automobiles		260,472	79,289	(108,100)	231,661
Computer equipment		176,833	11,963	(140,637)	48,159
Trucks		22,445			22,445
Intangible Assets		89,801	25,059		114,860
Total		\$ 4,154,772	\$ 131,982	\$(305,641)	\$ 3,981,113
Capital assets, net		\$ 368,149	\$ 53,990	\$ (625)	\$ 421,514

RHODE ISLAND LOTTERY

Notes to Financial Statements

(5) *Transfers to the State*

- (a) 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. Transfers to the State's General Fund for fiscal 2017 are reported as follows in the Lottery's financial statements:

Due to State's General Fund, beginning of year	\$	1,408,964
Transfers to State's General Fund		362,696,628
Cash paid during fiscal year		(362,194,766)
Due to State's General Fund, end of year	\$	<u>1,910,826</u>

The Lottery transfers net income to the State's General Fund based on the Lottery's actual pension contributions (which is the actuarially determined contribution required to be made by law) to the State Employees' pension plan. Pension expense reported in the Lottery's financial statements in accordance with GASB Statement No. 68, *Accounting and Financial Reporting for Pensions* is a different amount reflecting the change in the net pension liability during the fiscal year. The table below details the amount transferred to the General Fund as required by RI General Laws:

<u>Description</u>	<u>Amount</u>
Income before Transfers	\$ 363,252,829
Add: Pension expense in accordance with GASB Statement No. 68	1,382,915
Less: Pension contributions made subsequent to measurement date	(1,314,116)
Less: Contract revenue recognized in 2017 transferred to the General Fund in prior period	(625,000)
Transfers to State's General Fund	<u>\$ 362,696,628</u>

- (b) The Lottery also reimburses the State's General Fund for certain operating expenses associated with personnel costs, information technology resources, utilities, etc. Amounts owed to the General Fund at year-end for operating expenses totaled \$225,840. This amount is reported on the Statement of Net Position separate of amounts due to the State's General Fund - net income from operations.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(6) Commissions

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

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 \$572,537 as of June 30, 2017 and is recorded as a liability in the Statement of Net Position. The current portion of \$252,532, as reported, was estimated based on a four year average of employee utilization.

Changes in the reported liability for compensated absences for fiscal 2017 are as follows:

	Balance at July 1, 2016	Increase	Decrease	Balance at June 30, 2017
Liability for Compensated Absences	\$565,256	\$387,712	\$380,431	\$ 572,537

RHODE ISLAND LOTTERY

Notes to Financial Statements

(8) Net Position - (Deficit)

Components of Unrestricted (Deficit):

- *Balance of prior year advance to the General Fund prior to contract revenue recognition* - On May 12, 2003, the Lottery entered into a 20-year contract, effective July 1, 2003, with its 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, 2017 of \$3.8 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, 2017.
- *Proportionate share of Net Pension Liability in accordance with GASB Statement No. 68, Accounting and Financial Reporting for Pensions* – the Lottery recognizes its proportionate share of the State's net pension liability for the Employees' Retirement System Plan of RI. The Lottery's net pension liability at June 30, 2017 was \$16,260,567, which constitutes a significant portion of the unrestricted deficit reported on the Statement of Net Position at June 30, 2017. As required by RI General Laws, the Lottery's transfer to the State's General Fund is based on net income reflecting the actuarially determined employer contribution to the Employees' Retirement System. Net income reported in the Lottery's financial statements reflects the recognition of pension expense in accordance with generally accepted accounting principles.

Net investment in capital assets:

- The Lottery's net position (deficit) at June 30, 2017 also includes its net investment in capital assets. The Lottery had no debt related to capital assets at June 30, 2017.

(9) Retirement Plans

General Information about the Pension Plan

Plan description - Employees of the Lottery participate in a cost-sharing multiple-employer defined benefit pension plan – the Employees' Retirement System Plan - administered by the Employees' Retirement System of the State of Rhode Island (the "System"). Under a cost sharing plan, pension obligations for employees of all employers are pooled and plan assets are available to pay the benefits of the employees of any participating employer providing pension benefits through the plan, regardless of the status of the employers' payment of its pension obligation to the plan. The plan provides retirement and disability benefits and death benefits to plan members and beneficiaries.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(9) *Retirement Plans*- (Continued)

The System issues a publicly available financial report that includes financial statements and required supplementary information for the plans. The report may be obtained at <http://www.ersri.org>.

Benefit provisions - The level of benefits provided to participants is established by Chapter 36-10 of the General Laws, which is subject to amendment by the General Assembly. Member benefit provisions vary based on service credits accumulated at dates specified in various amendments to the General Laws outlining minimum retirement age, benefit accrual rates and maximum benefit provisions. In general, members accumulate service credits for each year of service subject to maximum benefit accruals of 80% or 75%. For those hired after June 30, 2012, the benefit accrual rate is 1% per year with a maximum benefit accrual of 40%. Members eligible to retire at September 30, 2009 may retire with 10 years of service at age 60 or after 28 years of service at any age. The retirement eligibility age increases proportionately for other members reflecting years of service and other factors until it aligns with the Social Security Normal Retirement Age, which applies to any member with less than 5 years of service as of July 1, 2012. Members are vested after 5 years of service.

The plan provides for survivor's benefits for service connected death and certain lump sum death benefits. Joint and survivor benefit provision options are available to members.

Cost of living adjustments are provided but are currently suspended until the collective plans covering state employees and teachers reach a funded status of 80%. Until the plans reach an 80% funded status, interim cost of living adjustments are provided at four-year intervals.

The plan also provides nonservice-connected disability benefits after five years of service, and service-connected disability benefits with no minimum service requirement.

Contributions – The funding policy, as set forth in the General Laws, Section 36-10-2, provides for actuarially determined periodic contributions to the plan. For fiscal 2017, Lottery employees, with less than 20 years of service as of 7/1/2015, were required to contribute 3.75% of their annual covered salary. Employees with more than 20 years of service as of 7/1/2015 were required to contribute 11% of their annual covered salary. The Lottery is required to contribute at an actuarially determined rate; the rate was 25.34% of annual covered payroll for the fiscal year ended June 30, 2017. The Lottery contributed \$1,314,116, \$1,219,209 and \$1,183,029 for the fiscal years ended June 30, 2017, 2016 and 2015, respectively, equal to 100% of the required contributions for each year.

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources

At June 30, 2017, the Lottery reported a liability of \$16,260,567 for its proportionate share of the net pension liability related to its participation in ERS. The net pension liability was measured as of June 30, 2016, the measurement date, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of June 30, 2015 rolled forward to June 30, 2016. The Lottery's proportion of the net pension liability was based on its share of contributions to the ERS for fiscal year 2016 relative to the total contributions of all participating employers for that fiscal year. At June 30, 2016, the Lottery's proportion was 0.76619002%.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(9) Retirement Plans - (Continued)

For the year ended June 30, 2017, the Lottery recognized pension expense of \$1,382,915. At June 30, 2017, the Lottery reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

Deferred Outflows of Resources

Changes in proportion and differences between employer contributions and proportionate share of contributions	\$	253,323
Net difference between projected and actual investment earnings		1,160,701
Contributions subsequent to measurement date		1,314,116
Total Deferred Outflows of Resources	\$	<u>2,728,140</u>

Deferred Inflows of Resources

Difference between expected and actual experience	\$	430,604
Change of assumptions		80,734
Total Deferred Inflows of Resources	\$	<u>511,338</u>

Contributions of \$1,314,116 are reported as deferred outflows of resources related to pensions resulting from the Lottery's contributions in fiscal year 2017 subsequent to the measurement date, and will be recognized as a reduction of the net pension liability determined at the June 30, 2017 measurement date. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

<u>Year ended June 30:</u>	<u>Net Deferred Outflows (Inflows) of Resources:</u>
2018	\$ 128,425
2019	128,425
2020	410,830
2021	235,006
2022	-
Thereafter	-
Total	<u>\$ 902,686</u>

RHODE ISLAND LOTTERY

Notes to Financial Statements

(9) Retirement Plans - (Continued)

Actuarial Assumptions

The total pension liability was determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	2.75%
Salary increases	3.50% to 6.50%
Investment rate of return	7.50%

Mortality rates were based on 115% (males) and 95% (females) of the RP-2000 combined healthy mortality tables with white collar adjustments projected with scale AA from 2000.

The actuarial assumptions used in the June 30, 2015 valuations rolled forward to June 30, 2016 and the calculation of the total pension liability at June 30, 2016 were consistent with the results of an actuarial experience study performed as of June 30, 2013.

The long-term expected rate of return best-estimate on pension plan investments was determined by the actuary using a building-block method. The actuary started by calculating best-estimate future expected real rates of return (expected returns net of pension plan investment expense and inflation) for each major asset class, based on a collective summary of capital market expectations from 35 sources. The June 30, 2016 expected arithmetic returns over the long-term (20 years) by asset class are summarized in the following table:

<u>Type of Investment</u>	<u>Target Allocation</u>	<u>Long-Term Expected Real Rate of Return</u>
Global Equity:	38.00%	
U.S. Equity		6.98%
International Developed		7.26%
International Emerging Markets		9.57%
Equity Hedge Funds	8.00%	4.10%
Private Equity	7.00%	10.15%
Core Fixed Income	15.00%	2.37%
Absolute Return Hedge Funds	7.00%	4.10%
Infrastructure	3.00%	5.58%
Real Estate	8.00%	5.33%
Other Real Return Assets:	11.00%	
Master Limited Partnerships		4.97%
Credit		4.97%
Inflation Linked Bonds		1.76%
Cash, Overlay and Money Market	3.00%	0.82%
	100.00%	

RHODE ISLAND LOTTERY

Notes to Financial Statements

(9) *Retirement Plans* - (Continued)

These return assumptions are then weighted by the target asset allocation percentage, factoring in correlation effects, to develop the overall long-term expected rate of return best-estimate on an arithmetic basis.

Discount rate

The discount rate used to measure the total pension liability was 7.5 percent. The projection of cash flows used to determine the discount rate assumed that contributions from plan members will be made at the current contribution rate and that contributions from the employers will be made at statutorily required rates, actuarially determined. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

In May 2017, the Employees' Retirement System of Rhode Island Board voted to lower the investment rate of return assumption from 7.5% to 7% which will be reflected in the determination of the net pension liability (asset) for the various plans administered by the System beginning with the June 30, 2017 measurement date valuations.

Sensitivity of the net pension liability (asset) to changes in the discount rate

The following presents the net pension liability (asset) calculated using the discount rate of 7.5 percent as well as what the net pension liability (asset) would be if it were calculated using a discount rate that is 1-percentage-point lower or 1-percentage-point higher than the current rate.

1.00% Decrease (6.50%)	Current Discount Rate (7.50%)	1.00% Increase (8.50%)
\$ 19,911,714	\$ 16,260,567	\$ 13,271,527

Pension Plan Fiduciary Net Position:

As noted earlier, ERS issues a publicly available financial report that includes financial statements and required supplementary information for the plans. The report may be obtained at <http://www.ersri.org>. The report contains detailed information about the pension plan's fiduciary net position.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(9) Retirement Plans - (Continued)

Defined Contribution Plan:

Plan Description – Certain employees participating in the defined benefit plan (those with less than 20 years of service as of 7/1/2015), 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. The Retirement Board is the plan administrator and plan trustee. The Employees may choose among various investment options available to plan participants. The State Investment Commission is responsible for implementing the investment policy of the plan and selecting the investment options available to members.

Plan contributions – Certain employees (those with less than 20 years of service as of 7/1/2015) contribute 5% of their annual covered salary and employers contribute at the following percentages of annual covered salary for these employees based on their years of service as of July 1, 2015:

<u>Years of Service</u> <u>As of 7/1/2015</u>	<u>Employer</u> <u>Contribution Rate</u>
15 - 20 Years	1.50%
10 - 15 Years	1.25%
0 - 10 Years	1.00%

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 of the State of Rhode Island, which are subject to amendment by the General Assembly.

The Lottery contributed and recognized as pension expense \$52,176 for the fiscal year ended June 30, 2017, equal to 100% of the required contributions for the fiscal year.

Plan vesting and contribution forfeiture provisions – The total amount contributed by the member, including associated investment gains and losses, shall immediately vest in the member's account and is non-forfeitable. The total amount contributed by the employer, including associated investment gains and losses, vests with the member and is non-forfeitable upon completion of three (3) years of contributory service. Non-vested employer contributions are forfeited upon termination of employment. Such forfeitures can be used by employers to offset future remittances to the plan.

Retirement benefits – Benefits may be paid to a member after severance from employment, death, plan termination, or upon a deemed severance from employment for participants performing qualified military service. At a minimum, retirement benefits must begin no later than April 1 of the calendar year following the year in which the member attains age 70½ or terminates employment, if later.

The System 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 at <http://www.ersri.org>.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(10) Postemployment Healthcare Plan

Plan Description:

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

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 financial report. A copy can be obtained from the State Controller's Office, 1 Capitol Hill, Providence, RI 02908.

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.

For fiscal 2017, employers were required to contribute 5.97% of covered payroll. The employer required contribution rate is determined on an actuarially determined basis consistent with a funding approach outlined in the General Laws and as adopted by the OPEB System Board. The Lottery fully funded its required contribution to the plan for the years ended June 30, 2017, 2016 and 2015 which were \$309,600, \$307,993 and \$342,283 respectively.

(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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments

(a) Gaming Systems Provider – International Game Technology (IGT)

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 (\$3.8 million at June 30, 2017).

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 \$117,000 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.

On July 1, 2016, the Lottery entered into a Sixth Amendment to the Master Contract with IGT. Under this amendment, IGT will provide instant ticket printing services under the same terms and conditions as the Lottery’s most recent contract, including pricing, through June 30, 2023. In addition, IGT will provide a redesigned, enhanced website. By mutual agreement, IGT will provide courier service for the delivery of instant ticket products, four licensed instant ticket games, and the new website at no cost to the Lottery (total value of \$2,691,000); and the Lottery will waive IGT’s obligations under Section 6.3 of the Master Contract (minimum employment mandates) through December 31, 2017. The first amendment to the IGT instant ticket agreement dated May 2017 requires IGT to implement the sales force management system known as OnePlace by December 31, 2017. OnePlace combines web and mobile applications to provide sales representatives in the field information on the most important retailer issues and opportunities. These include specific individual retailer issues, project tasks, various alerts, sales trends, and more detailed information in order to optimize the mix of instant games and increase sales.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments - (Continued)

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

On July 18, 2005, the Lottery entered into a five (5) year Master Video Lottery Terminal Contract with UTGR, Inc. (UTGR), the owners of Twin River, to manage one of the State's licensed video lottery facilities. The contract entitles UTGR to compensation ranging from 26% to 28.85% of video lottery net terminal income at the facility. UTGR and the Lottery extended the contract and signed the first five-year extension term commencing on July 18, 2010. The second term commenced 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 2017, Twin River was authorized and issued approximately \$45 million in promotional points to facility patrons. Recent legislation authorizes increases in promotional points from 10% of prior year net terminal income plus \$750,000 to 20% prior year net terminal income plus \$750,000, subject to approval from the Lottery Director.

The Master Contract has also been amended to reflect the statutory requirement that the Lottery reimburse UTGR for certain allowable marketing expenses. The Lottery is currently obligated to reimburse UTGR for allowable marketing expenses as follows:

<u>Marketing Expense Level</u>	<u>Lottery Reimbursement Percentage</u>
\$1 up to \$4,000,000	0%
\$4,000,001 up to \$10,000,000	State Share of NTI
\$10,000,001 up to \$14,000,000	0%
\$14,000,001 up to \$17,000,000	State Share of NTI

Most recent statute and contract amendments require the Lottery to reimburse UTGR for allowable marketing expenses incurred between \$4 million and \$10 million and between \$14 million and \$17 million at the same percentage as the Lottery's share of net terminal income for the fiscal year (60.86% for 2017). The Lottery reimbursed UTGR for \$5,477,400 in marketing expenses for fiscal 2017.

On May 2, 2017, the Lottery entered into a fifth amendment to the Master Contract with UTGR, Inc. (UTGR) authorizing UTGR to construct and operate a hotel at Twin River Casino in Lincoln, RI.

On May 3, 2017, the Lottery entered into a sixth amendment to the Master Contract with UTGR, Inc. (UTGR) providing the option to extend the agreement for two additional five (5) year terms commencing on July 18, 2020 and July 17, 2025 and continuing until July 17, 2030. Certain extensions are contingent on UTGR's compliance with full-time employment mandates. The agreement also effectuates the legislation authorizing and directing the Lottery to operate casino gaming at Twin River-Tiverton and to implement statutory changes regarding the allocation of video lottery net terminal income and net table game revenue at Twin River Casino in Lincoln, RI and Twin River – Tiverton in Tiverton, RI.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments - (Continued)

(c) Video Lottery Facility – Premier Entertainment II, 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 commenced 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. In addition, Newport Grand is entitled to an increased percentage of net terminal income of 1.9% to be used for approved marketing expenses at Newport Grand.

The Master Contract has been amended in recent years to reflect the statutory authorization of a promotional points program at Newport Grand. In fiscal 2017, Newport Grand was authorized and issued approximately \$5.2 million in promotional points to facility patrons. Recent legislation authorizes increases in promotional points from 10% of prior year net terminal income plus \$750,000 to 20% prior year net terminal income plus \$750,000, subject to approval from the Lottery Director.

The Master Contract has also been amended to reflect the statutory requirement that the Lottery reimburse Newport Grand for certain allowable marketing expenses. The Lottery is currently obligated to reimburse Newport Grand for allowable marketing expenses as follows:

<u>Marketing Expense Level</u>	<u>Lottery Reimbursement Percentage</u>
\$1 up to \$560,000	0%
\$560,001 up to \$1,400,000	State Share of NTI

Most recent statute and contract amendments require the Lottery to reimburse Newport Grand for allowable marketing expenses incurred between \$560,000 and \$1.4 million at the same percentage as the Lottery’s share of net terminal income for the fiscal year (61.40% for 2017). The Lottery reimbursed Premier Entertainment II, LLC. for \$504,212 in marketing expenses for fiscal 2017.

(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) The Lottery’s gaming operations currently compete with casinos in nearby Connecticut and Massachusetts. In addition, both neighboring States have already approved or are considering additional casino expansion likely to increase gaming competition in New England. The Lottery and the State continually monitor the risk to gaming operations resulting from competition in nearby states. In 2016, having passed statewide and local referenda, authorizing a new gaming facility located in Tiverton, RI, owned by Twin River – Tiverton will offer state-operated casino gaming which is currently under construction and is expected to commence operations in the fall of 2018.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(13) Contingencies – (Continued)

The Narragansett Indian Tribe filed a complaint against the State of Rhode Island in the Rhode Island Superior Court on or about September 28, 2011, challenging, *inter alia*, the constitutionality of the Rhode Island Casino Gaming Act (“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 Rhode Island Superior Court found that the Narragansett Indian Tribe had not sustained their burden of proof beyond a reasonable doubt that the Act is facially unconstitutional. The Narragansett Indian Tribe filed a notice of appeal of that decision with the Rhode Island Supreme Court. On or about March 4, 2015, the Rhode Island Supreme Court issued a decision upholding the Superior Court’s decision. The remaining issues in the case relating to whether the State “operates” Twin River and Newport Grand facilities remain pending in the Superior Court.

- (c) 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 2017, the Lottery maintained its amount of purchased insurance coverage. Claims and settlements incurred for fiscal years 2017, 2016 and 2015 have not exceeded the Lottery’s insurance coverage.

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

The Lottery also manages a variety of operational risks which could impact the continuity of business operations. These include the risk of cyber-attacks, property damages, or employee strikes which could adversely impact Lottery operations and have an effect on the State’s share of net revenues. To mitigate these risks, Lottery contractors and facility operators procure business interruption insurance, cyber liability insurance, and other property insurance, in conjunction with managing employment issues in a manner that safeguards the continuity of the Lottery’s business operations.

RHODE ISLAND LOTTERY

Required Supplementary Information

RHODE ISLAND LOTTERY
Schedule of the Lottery's Proportionate Share of the Net Pension Liability
Employees' Retirement System Plan

Year Ended	June 30, 2017	June 30, 2016	June 30, 2015
Measurement Date	June 30, 2016	June 30, 2015	June 30, 2014
Lottery's proportion of the net pension liability	0.76619002%	0.75882896%	0.74724193%
Lottery's proportionate share of the net pension liability	\$16,260,567	\$15,073,593	\$13,315,141
Lottery's covered-employee payroll	\$5,155,796	\$5,070,849	\$4,891,380
Lottery's proportionate share of the net pension liability as a percentage of its covered - employee payroll	315.38%	297.26%	272.22%
Plan fiduciary net position as a percentage of the total pension liability	51.88%	55.03%	58.58%

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Notes:

1.) The amounts presented for each fiscal year were determined as of June 30 measurement date prior to the fiscal year-end.

2.) Schedule is intended to show information for 10 years - additional years will be displayed as they become available.

RHODE ISLAND LOTTERY
Schedule of the Lottery's Contributions
Employees' Retirement System Plan

	<u>2017</u>	<u>2016</u>	<u>2015</u>
Statutorily determined contribution	\$1,314,116	\$1,219,209	\$1,183,029
Contributions in relation to the statutorily	\$1,314,116	1,219,209	1,183,029
Contribution deficiency (excess)	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
Lottery's covered-employee payroll	\$5,185,935	\$5,155,796	\$5,070,849
Contributions as a percentage of covered-employee payroll	25.34%	23.65%	23.33%

Notes:

1.) Employers participating in the State Employee's Retirement System are required by RI General Laws, Section 36-10-2, to contribute an actuarially determined contribution rate each year.

2.) Schedule is intended to show information for 10 years - additional years will be displayed as they become available.

RHODE ISLAND LOTTERY

NOTES TO REQUIRED SUPPLEMENTARY INFORMATION

SCHEDULE OF THE LOTTERY'S PROPORTIONATE SHARE OF THE NET PENSION LIABILITY

Factors affecting trends for amounts related to the net pension liability:

There were no changes in actuarial methods or assumptions or benefits reflected in the calculation of the net pension liability as of the June 30, 2016 measurement date compared to the June 30, 2015 measurement date. Benefits were also unchanged between these measurement dates.

There were no changes in actuarial methods or assumptions reflected in the calculation of the net pension liability as of the June 30, 2015 measurement date compared to the June 30, 2014 measurement date.

Benefit changes, which resulted from the settlement of the pension litigation and the subsequent enactment of those settlement provisions by the General Assembly, are reflected in the calculation of the net pension liability at the June 30, 2015 measurement date. Significant benefit changes are summarized below:

- Employees with more than 20 years of service at July 1, 2012 will increase their employee contribution rates to 11% for state employees and participate solely in the defined benefit plan effective July 1, 2015 – service credit accruals will increase from 1% to 2% per year.
- Members are eligible to retire upon the attainment of: age 65 with 30 years of service, 64 with 31 years of service, or 62 with 33 years of service. Members may retire earlier if their RI Retirement Security Act date is earlier or are eligible under a transition rule.
- The COLA formula was adjusted to 50% of the COLA and is calculated by taking the previous 5-year average investment return, less the discount rate (5-year return – 7.5%, with a max of 4%) and 50% of the previous year's CPI-U (max of 3%) for a total max COLA of 3.5%. The COLA is calculated on the first \$25,855, effective, 01/01/2016, and indexed as of that date as well.
- Other changes included providing interim cost of living increases at four rather than five year intervals, providing a one-time cost of living adjustment of 2% (applied to first \$25,000), two \$500 stipends, and minor adjustments.



RHODE ISLAND LOTTERY

Section II

Supplementary Information

Schedule 1 – Operating Revenue and Cost of Gaming Operations

RHODE ISLAND LOTTERY

Operating Revenue and Cost of Gaming Operations Year Ended June 30, 2017

Schedule 1

	Revenue ⁽²⁾	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	\$ 82,984,608	\$ 10,780,600	\$ 54,276,641	\$ (299,557)	\$ -	\$ 318,975	\$ -	\$ 65,076,659	\$ 17,907,949
Bingo	972,663	125,379	623,059	(4,627)	-	1,130	-	744,941	227,722
PowerBall®	29,378,496	3,818,003	14,693,370	(569,578)	-	903,104	-	18,844,899	10,533,597
Daily Numbers	23,886,086	3,104,149	12,784,546	(246,696)	-	35,602	-	15,677,601	8,208,485
Mega Millions®	9,365,827	1,217,393	4,733,285	(113,237)	-	202,774	-	6,040,215	3,325,612
Wild Money	3,967,038	515,673	2,185,830	(42,255)	-	23,590	-	2,682,838	1,284,200
Lucky for Life®	5,096,898	661,275	3,286,821	(165,352)	-	182,877	-	3,965,621	1,131,277
Other Sales	4,475	89	3,085	-	-	-	-	3,174	1,301
	<u>155,656,091</u>	<u>20,222,561</u>	<u>92,586,637</u>	<u>(1,441,302)</u>	<u>-</u>	<u>1,668,052</u>	<u>-</u>	<u>113,035,948</u>	<u>42,620,143</u>
Instant tickets	94,225,863	10,057,345	64,437,300	(1,127,373)	995,285	953,969	-	75,316,526	18,909,337
Video Lottery ⁽¹⁾	482,404,252	186,780,926	-	(239,902)	-	-	6,857,127	193,398,151	289,006,101
Table Games	140,090,213	117,675,779	-	-	-	-	-	117,675,779	22,414,434
Totals	<u>\$ 872,376,419</u>	<u>\$ 334,736,611</u>	<u>\$ 157,023,937</u>	<u>\$ (2,808,577)</u>	<u>\$ 995,285</u>	<u>\$ 2,622,021</u>	<u>\$ 6,857,127</u>	<u>\$ 499,426,404</u>	<u>\$ 372,950,015</u>
<u>Video Lottery Commissions - Detail</u>									
Facilities		\$ 134,002,267							
Technology Providers		33,185,033							
Central Communications Provider		12,060,106							
City/Town		6,791,864							
Narragansett Indian Tribe		741,656							
Total		<u>\$ 186,780,926</u>							

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

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



RHODE ISLAND LOTTERY

Section III

**Independent Auditor's Report on Internal
Control Over Financial Reporting
and on Compliance**



Office of the Auditor General

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

oag.ri.gov

33 Broad Street • Suite 201 • Providence, RI • 02903-4177
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, 2017, 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, 2017.

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 purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control. 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.

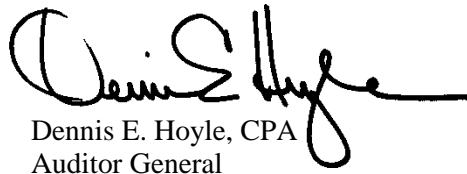
Joint Committee on Legislative Services, General Assembly
State of Rhode Island and Providence Plantations:

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free from 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 Lottery's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Dennis E. Hoyle, CPA
Auditor General

September 27, 2017



RHODE ISLAND LOTTERY

Section IV

Management Comments

MANAGEMENT COMMENTS

Fiscal Year Ended June 30, 2017

Management Comment 2017-1

IT SECURITY OVERSIGHT AND MONITORING

The Lottery has a long-term contract with its gaming systems contractor to support multiple aspects of the Lottery's overall gaming activities including on-line games operation and the central communications network for video lottery as well as other functionalities. All these operational activities are IT dependent and accordingly, the Lottery must ensure that IT security risks have been sufficiently considered and addressed. The Lottery has continually monitored IT security by its vendors by utilizing a combination of contracted IT security reviews as well as internal resources to evaluate the IT security preparedness of systems operated by the gaming systems contractor and others.

While the Lottery has maintained an appropriate level of IT security monitoring and prompted timely corrective action to identified risks or weaknesses, it should enhance its comprehensive evaluation of any risks identified through the monitoring process with specific consideration of how an identified risk could impact Lottery operations. The growing complexity of the overall information network and the inter-connectivity of the various software and hardware utilized to operate the Lottery require an increasingly complex risk evaluation process. More documentation is recommended regarding how the Lottery evaluates risks and the gaming systems contractor's corrective action or risk mitigation response.

The Lottery should seek to strengthen contract language to enhance its ability to ensure continued security over critical Lottery technology supporting its gaming activities. Since the inception of the Lottery, contracts have typically specified system upgrades at defined dates. While the gaming systems contractor is required to maintain and support the systems to the satisfaction of the Lottery, the contract should be amended to incorporate specifications regarding system security. This should facilitate the Lottery's ability to ensure system security particularly when system upgrades are not imminent or are delayed by mutual agreement to coincide with the latest technology development. At times, addressing certain identified IT security issues, can be deferred or is dependent upon the next scheduled system refresh. With the exponentially rapid changes in information technology, contract terms should be strengthened to more directly require that the vendor maintain the systems to meet continually evolving IT security standards and requirements.

RECOMMENDATIONS

- 2017-1(a) Enhance the consideration and documentation of IT security risks identified during ongoing IT security risk assessments including whether risks were appropriately mitigated or whether immediate corrective action was warranted.
- 2017-1(b) Strengthen current contract terms to enhance the Lottery's ability to ensure the gaming systems contractor maintains critical technology supporting its gaming activities to meet evolving IT security standards and requirements.

Auditee Views and Corrective Action Plan:

2017-1(a) - The Lottery has a comprehensive IT security program, which includes performing risk assessments on a regular basis. This program is key in protecting the IT assets of the Lottery from emerging threats and ensures that the Lottery continually has the latest IT security

MANAGEMENT COMMENTS

Fiscal Year Ended June 30, 2017

protective measures in place. The Lottery will incorporate these recommended enhancements into its IT security program to further strengthen its program.

2017-1(b) - The Lottery will strengthen current contract language to ensure the gaming systems contractor maintains critical technology supporting its gaming activities to meet evolving IT security standards and requirements.

Management Comment 2017-2

IMPLEMENTATION OF GASB STATEMENT NO. 75 - ACCOUNTING AND FINANCIAL REPORTING FOR POSTEMPLOYMENT BENEFITS OTHER THAN PENSIONS

The Governmental Accounting Standards Board issued new OPEB accounting standards for employers participating in defined benefit OPEB plans which are effective beginning in fiscal 2018. Upon implementation of the standards, an employer, such as the Lottery, will record OPEB expense equal to the change in the net OPEB liability calculated in accordance with the parameters outlined in the new standard. Since the Lottery participates in a cost sharing OPEB plan - it will record its proportionate share of the net pension liability for all members within the State administered OPEB plan.

The change in the net OPEB liability will include market or fair value changes of the assets held within the OPEB plan. Currently, the Lottery records OPEB expense equal to the actuarially determined annual required contribution for its employees. Beginning in fiscal 2018, the amount required to fund the plan and the pension expense recorded for financial statement purposes will be different.

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). Upon implementation of new pension accounting standards in fiscal 2015, a change was made to the General Laws which provided for the transfer to the General Fund to be based on the actuarially determined contribution amount. A similar change should be sought for the new OPEB expense amount. If OPEB expense for financial reporting purposes was used to determine amounts available for transfer to the State's General Fund, such amounts are likely to be more volatile from year to year due to changes in the market value of assets. For financial reporting purposes the Lottery should report the OPEB expense amount determined in accordance with generally accepted accounting principles.

RECOMMENDATION

2017-2 Seek modification to the General Laws to allow determination of the amount to be transferred to the State's General Fund based on the actuarially determined contribution to the cost-sharing OPEB plan rather than the OPEB expense amount reflecting fiscal 2018 implementation of the new OPEB accounting standard.

Auditee Views and Corrective Action Plan:

The Lottery concurs with this recommendation.