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**RHODE ISLAND LOTTERY**

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*

and

**MANAGEMENT COMMENTS**

**JUNE 30, 2008 AUDIT**

Ernest A. Almonte, CPA, CFF  
Auditor General

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

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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS  
GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

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

ERNEST A. ALMONTE, CPA, CFF  
AUDITOR GENERAL  
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December 16, 2008

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

We have audited the financial statements of the Rhode Island Lottery (the "Lottery") for the year ended June 30, 2008 and have issued our report thereon dated October 2, 2008. The Lottery's financial statements and our independent auditor's report are included in the Lottery's *Comprehensive Annual Financial Report* for the fiscal year ended June 30, 2008.

In accordance with *Government Auditing Standards*, we have also prepared a report, dated October 2, 2008 and included herein, on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations and contracts. Our report on the Lottery's internal control over financial reporting and on compliance and other matters indicated certain issues that we considered to be significant deficiencies in internal control over financial reporting. These control deficiencies are described in the accompanying Schedule of Findings and Responses.

We also noted another matter which is intended to improve internal control and is presented for your consideration.

Sincerely,

Ernest A. Almonte, CPA, CFF  
Auditor General

# **RHODE ISLAND LOTTERY**

**JUNE 30, 2008 AUDIT**

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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS  
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OFFICE of the AUDITOR GENERAL

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

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

We have audited the financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2008 and have issued our report thereon dated October 2, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

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

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be

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

prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying schedule of findings and responses as Findings 2008-1, 2008-2, and 2008-3 to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that none of the significant deficiencies described above is a material weakness.

### **Compliance and Other Matters**

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

We noted a matter that we reported to management of the Lottery which is included herein as Finding 2008-4.

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



Ernest A. Almonte, CPA, CFF  
Auditor General

October 2, 2008

## SCHEDULE OF FINDINGS AND RESPONSES

### Finding 2008-1

#### CONTROLS OVER ACTIVITIES PERFORMED BY THE GAMING SYSTEM CONTRACTOR

The Lottery's gaming systems are designed, operated and maintained by a contractor under a 20-year master contract. As part of the daily operations of these gaming systems, the contractor provides the Lottery with gaming and financial data necessary to meet its financial reporting and monitoring responsibilities. When considering the overall controls over the Lottery's operations, management must have a thorough understanding of the contractor's control structure and some assurance regarding its overall effectiveness.

While the Lottery works closely with its contractor to ensure the continuity of gaming operations, a formalized understanding of the contractor's control structure has not been documented. This more in-depth consideration of the contractor's control structure would allow for the identification of the specific controls most critical to gaming operations and the accuracy and completeness of reported gaming data that ultimately gets recorded in the Lottery's accounting system. Once identified, the effectiveness of the contractor's internal controls for critical lottery operations should be periodically evaluated.

The Lottery should obtain a periodic, independent assessment of the internal control policies and procedures used by the gaming system contractor. A "SAS 70" examination of the gaming system contractor's controls over critical lottery operations, including tests of the operating effectiveness of the applicable controls, would provide the Lottery with additional assurance regarding the integrity of its gaming operations and the accuracy and reliability of critical lottery financial data utilized in the preparation of the Lottery's financial statements.

The information obtained through periodic "SAS 70" reviews, in addition to the results of periodic information technology audits already performed in conjunction with the Lottery's oversight of its information systems security policies and procedures, would provide the Lottery with additional assurance regarding controls employed by its gaming systems contractor to ensure the integrity of the Lottery's gaming operations.

#### RECOMMENDATION

2008-1      Obtain a "SAS 70" examination periodically of the gaming system contractor's controls that are deemed most critical to the integrity of the Lottery's games and its financial reporting processes.

Auditee Views:

*The Rhode Island Lottery has contracted with its gaming systems provider to engage for an independent SAS 70 Type II level audit of its on-line and video gaming systems. The audit will assess controls over both systems and cover the period January thru June 2009, and a report will be issued subsequent to the Lottery's fiscal year-ending June 30, 2009.*

*The Lottery will include a request in its annual operating budgets subsequent to fiscal year 2010 for bi-annual SAS 70 Type II level audits of the on-line and video systems to assess procedures and controls over the integrity of the Lottery's games and its financial reporting processes.*

**Finding 2008-2**

**RECONCILIATION TO THE STATE'S ACCOUNTING SYSTEM**

The Lottery's internal general ledger accounting system is used for financial reporting; however, the Lottery utilizes the State's accounting system known as the Rhode Island Financial and Accounting Network System (RIFANS) for all disbursements relating to Lottery operations, except for prize disbursements. The Lottery records all payment transactions in both their internal accounting system and RIFANS for payments to vendors. Revenue and cash receipt transactions are also recorded in both systems although more detail is recorded in the Lottery's accounting system. The activity recorded in RIFANS is basically cash receipts and disbursements whereas the Lottery's accounting system records all activity on an accrual basis to prepare financial statements in accordance with generally accepted accounting principles.

For certain centralized billing processes used by the State (e.g., payroll, purchase cards, office supplies, etc.), payments are initiated through the State's Office of Accounts and Control and individual agencies are charged for their pro-rata share of monthly activity. In these instances, the Lottery does not initiate payment and must review reports from RIFANS to identify and record this activity in their internal accounting system.

Controls over financial reporting are weakened because a complete reconciliation is not performed between the two systems to ensure that all activity has been appropriately recorded in both accounting systems. The partial reconciliations which are performed focus primarily on cash balances reported between the two systems.

Until recently the State's accounting system was incapable of meeting the financial reporting needs of the Lottery, however RIFANS can likely accommodate the Lottery's financial reporting objectives with minimal modification (e.g., creating additional accounts). The Lottery should work with the Office of Accounts and Control within the Department of Administration to explore utilizing the State's accounting system exclusively for all accounting and financial reporting thereby eliminating the redundancy of recording activity in two systems and the effort required to perform periodic reconciliations.

Utilizing RIFANS for financial reporting would also simplify cash reconciliation procedures by eliminating the need for the three-way reconciliation between bank balances, RIFANS cash balances, and the Lottery's cash balance. Further, controls over financial reporting would be enhanced by eliminating the risk of omitting transactions recorded only in one system.

### RECOMMENDATIONS

- 2008-2a      Perform full periodic reconciliations of activity recorded in the Lottery's accounting system utilized for financial reporting and the State's accounting system.
- 2008-2b      Explore using RIFANS for Lottery financial reporting thereby eliminating the redundancy of recording Lottery activity in two accounting systems.

### Auditee Views:

*The Lottery is required by statute to submit monthly financial reports to executive and legislative officials by the twentieth business day following the close of the month. Additionally, the Lottery is required to estimate and transfer net revenues by the tenth business day. This makes it imperative to record and summarize financial information to meet the statutory timelines.*

*Currently, the Lottery records all cash receipts, video commissions, and all other invoices payable through the State of Rhode Island's RIFANS system. All credit card charges are imported by the Office of Accounts and Control into RIFANS. All other accounting activity for financial reporting is recorded only in the Lottery's general ledger system and is not recorded by the State in its accounting system. The current procedures enable the Lottery to submit timely financial statements and transfer estimated revenues. During 2008, Lottery finance personnel met with the State Controller, who recommended we not change our current procedure, because the timeliness of financial reporting and revenue transfers could be affected by utilizing the State's accounting system.*

*However, the Lottery finance department's personnel is continuing to work with the Office of Accounts and Control to determine whether establishing expense accounts for all Lottery expenditures in the State's system and reconciling monthly to the Lottery's general ledger accounts will further improve internal controls over financial reporting. Additionally, Lottery finance personnel will work with the Office of Accounts and Control to determine whether using only RIFANS for financial reporting will enable timely financial statements and transfers of estimated revenues.*

## Finding 2008-3

### INFORMATION SYSTEMS SECURITY POLICIES AND PROCEDURES

The Lottery has a comprehensive information system security plan designed to safeguard the information systems utilized within its operations. Due to the highly computerized nature of the Lottery's operations, these policies and procedures are vital to ensuring the integrity of these computerized systems. The Lottery ensures compliance with these procedures through monitoring procedures performed by internal information technology (IT) security staff as well as contracted professionals who assist with evaluating the compliance of the Lottery's gaming systems contractor.

Comprehensive assessments of the Lottery's gaming systems have been performed routinely over the past few years by an independent contractor. These assessments included an extensive evaluation of various general and application control elements. These assessments were performed based on IT security best practices and RILOT Security Policies and Procedures.

Although the majority of the Lottery's information systems policies and procedures were found to be in place and operating effectively within the gaming systems operated by the contractor, certain control weaknesses were identified and communicated to the Lottery in relation to both the On-line and Video Lottery gaming systems. Although a number of technical, operational, and administrative controls are in place consistent with industry standards and best practices, the effectiveness of these controls are undermined by the presence of these identified deficiencies. The Lottery should ensure that these deficiencies are corrected to enhance controls over the gaming system environment.

In addition to the resolution of currently known control deficiencies, the Lottery must consider additional monitoring procedures to ensure the continued compliance of the Lottery's IT policies and procedures. These procedures need to prevent the types of IT security weaknesses that have been periodically identified by the Lottery's IT security contractor.

#### RECOMMENDATIONS

- 2008-3a      Address all significant IT security deficiencies reported by the Lottery's information systems security contractor.
- 2008-3b      Consider additional monitoring procedures to ensure the continued compliance with IT security policies and procedures.

#### Auditee Views:

*The Lottery has been working with its on-line and video gaming systems provider to correct the identified issues noted in the various audit assessment reports provided to the Lottery by the Office of Auditor General and by the Lottery's information security contractor.*

*Most of the on-line system issues noted within the audit assessments have been addressed.*

*Most of the video system issues noted within the audit assessments have been addressed, but there are a few issues that the Lottery is working on with its gaming systems provider to resolve.*

*The Lottery's gaming system provider needs to improve its oversight responsibility in the area of information security. Once the system provider improves this oversight responsibility, additional monitoring procedures can be implemented. The Lottery is working with the system provider to see that this issue is resolved in a manner that is acceptable to both the Lottery and the system provider.*

## **OTHER FINDING AND RECOMMENDATION**

### **Finding 2008-4**

#### **MONITORING OF VIDEO LOTTERY OPERATIONS**

The Rhode Island Lottery introduced video lottery games at two licensed facilities in 1992. Since its introduction, video lottery revenues have grown from \$32.7 million in fiscal 1993 to nearly \$2.2 billion in fiscal 2008. In that same period, the number of video lottery terminals in operation has increased from 1,292 to 5,827. Much of this increase occurred in recent fiscal years as a result of new agreements with each of the licensed video lottery facilities. Video gaming now comprises approximately 90% of the Lottery's total revenue and prize awards expense.

Video lottery gaming operations are operated in large part by contractors that operate the video gaming system and provide the video terminals played by gaming patrons. The monitoring of video lottery operations and its participating contractors has evolved as revenues have increased. Over time, control enhancements have included additional security personnel to monitor physical security at the facilities and accounting personnel to evaluate and review video lottery procedures and controls. Further enhancements were implemented during fiscal 2008 in the form of newly designed video reports that were designed to more effectively identify differences between cash count amounts and system reported cash-in amounts. These reporting enhancements allowed for more effective monitoring of video lottery terminal variances.

Although the monitoring of reported terminal variances has improved, the current volume of activity for nearly 6,000 video lottery terminals (VLT) seven days a week requires a sophisticated and automated process to conduct the types of comprehensive monitoring of video operations needed to safeguard the integrity of the Lottery's gaming activities. The Lottery can best accomplish this objective by developing an ad-hoc reporting capability that will allow the Lottery to identify abnormalities in video lottery operations. Examples of irregularities in video lottery operations that may represent a breach in gaming integrity include identifying terminals or games that are reporting game play and/or terminal cash-out activity in excess of normal operating trends.

Once developed, the Lottery should consider customizing daily reports to identify abnormal gaming activities for all critical components of video lottery operations (i.e., cash-in, cash-out, ticket-in, validations, credits played, credits won, etc.). Such reports will allow the Lottery to investigate and resolve areas of concern highlighted by the continual analysis of video data and provide a high level of assurance over the continued safeguarding of the Lottery's video operations.

## RECOMMENDATION

2008-4        Enhance the Lottery's reporting capability by developing ad-hoc programming and reporting capabilities that can produce daily reports that highlight irregular video lottery activity within the Lottery's approximately 6,000 operating terminals.

### Auditee Views:

*The requirements being written for the new video system planned for 2012 include requirements for additional exception reporting and alerting capabilities to identify anomalies for cash in, cash out, cash won, cash played, automatic adjustments, manual adjustments, TITO adjustments, and game payout percentages above normal thresholds. The request for the additional reporting capabilities has been indicated, although more specific detailed requirements must be identified. In the interim, the Lottery utilizes enhanced reports to identify cash in and cash out variances as well as game preference reports identifying abnormalities in designed payouts.*