RHODE ISLAND LOTTERY

(AN ENTERPRISE FUND OF THE
STATE OF RHODE ISLAND)

FISCAL YEAR ENDED JUNE 30, 2010

Dennis E. Hoyle, CPA
Acting Auditor General

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

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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

♦ *INTEGRITY*
♦ *RELIABILITY*
♦ *INDEPENDENCE*
♦ *ACCOUNTABILITY*

September 30, 2010

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER Gordon D. Fox, Chairman

Senator M. Teresa Paiva-Weed
Senator Dennis L. Algiere
Representative Nicholas A. Mattiello
Representative Robert A. Watson

We have completed our audit of the financial statements of the Rhode Island Lottery for the year ended June 30, 2010. Our report is contained herein as outlined in the Table of Contents and includes our *Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards.*

Sincerely,

Dennis E. Hoyle, CPA
Acting Auditor General

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FISCAL YEAR ENDED JUNE 30, 2010

TABLE OF CONTENTS

PAGE

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2010, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As discussed in Note 2(b), the financial statements present only the Lottery and do not purport to, and do not, present fairly the financial position of the State of Rhode Island and Providence Plantations, as of June 30, 2010, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of the Lottery as of June 30, 2010, and the changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Note 13(b) to the financial statements discloses certain operational contingencies relating to the bankruptcy proceeding by one of the Lottery's video lottery retailers that we deemed a matter worthy of emphasis to the readers of the Lottery's financial statements.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated September 21, 2010 on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The Management's Discussion and Analysis on pages 3 through 10 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

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

Dennis E. Hoyle, CPA
Acting Auditor General

September 21, 2010

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, 2010. 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 sales, commissions, and prize awards expense for each lottery game. The financial statements immediately follow this *Management's Discussion and Analysis* and are designed to highlight the Lottery's net assets and changes to those assets resulting from Lottery operations.

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

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

The deficiency in net assets of $8.1 million reported at June 30, 2010 relates entirely to the Lottery's sale of its exclusive rights to operate its gaming systems. The Lottery sold this exclusive right to its current gaming systems provider for a 20-year period at a cost of $12.5 million and immediately paid the proceeds to the State's General Fund. According to the terms of the agreement, if for any reason, this contract is voided prior to its completed term; the Lottery will be required to refund a pro-rata share of the sales price to the gaming system provider. In accordance with generally accepted accounting principles, the Lottery will recognize the revenue related to this transaction over the 20-year life of the contract.

Financial Highlights

- The Lottery transferred $344.7 million to the State's General Fund for the fiscal year ended June 30, 2010, a slight increase in net income transfers over the prior fiscal year. The increase is notable considering the recessionary economy and high levels of unemployment that existed in the State during fiscal 2010.

- Video Lottery gross profit increased by $4.0 million or 1.42% in fiscal 2010.

- Keno sales increased by $1.7 million, a 2.20% increase over fiscal year 2009.

- In January 2010, the Rhode Island Lottery became one of 42 localities offering the multi-state Mega Millions® game. This resulted in sales of \$4.1 million and a gross profit of \$1.5 million.

Assets and Liabilities

	June 30, 2010	June 30, 2009 *
Assets:		
Current assets		
Cash and cash equivalents	\$ 14,442,588	\$ 11,613,490
Accounts receivable, net	2,773,555	4,692,368
Other	1,342,403	1,151,644
Total current assets	\$ 18,558,546	\$ 17,457,502
Long-term assets		
Capital assets, net	\$ 690,870	\$ 808,117
Total assets	\$ 19,249,416	\$ 18,265,619
Liabilities:		
Current liabilities		
Due to State's General Fund	\$ 1,646,003	\$ 1,561,685
Due to State's General Fund - Operating Expenses	125,232	138,399
Accounts payable	10,462,936	8,767,673
Prize obligations	5,194,301	6,036,852
Compensated absences	140,745	127,159
Other liabilities	1,944,667	2,026,072
Total current liabilities	\$ 19,513,884	\$ 18,657,840
Long-term liabilities		
Compensated absences	\$ 221,081	\$ 157,679
Net OPEB obligation	139,451	75,100
Unearned contract revenue	7,500,000	8,125,000
Total long-term liabilities	7,860,532	8,357,779
Total liabilities	\$ 27,374,416	\$ 27,015,619
Net Assets:		
Invested in capital assets	\$ 690,870	\$ 808,117
Unrestricted	(8,815,870)	(9,558,117)
Total net assets (deficiency)	\$ (8,125,000)	\$ (8,750,000)

* Certain 2009 amounts have been reclassified to conform to the current year presentation.

The majority of the Lottery's assets consist of cash (including amounts invested in cash equivalent type instruments) and accounts receivable derived from sales of the Lottery's games. At June 30, 2010, the Lottery's assets included $14.4 million in cash and cash equivalents as compared with $11.6 million at June 30, 2009. The Lottery's accounts receivable approximated $2.8 and $4.7 million, respectively, at June 30, 2010 and 2009.

The Lottery's liabilities included at the balance sheet date are amounts owed for vendor payables, prize obligations and a residual amount owed to the State's General Fund for June's net operations and operating expenses. The amount owed to the General Fund for June's net operations approximated $1.6 million at both June 30, 2010 and June 30, 2009. At June 30, 2010, vendor payables, made up largely of commissions due to video lottery participants, and prize obligations, attributable mostly to instant ticket games and PowerBall®, were $10.5 million and $5.2 million, respectively. In comparison, vendor payables and prize obligations at June 30, 2009 were $8.8 million and $6.0 million, respectively.

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

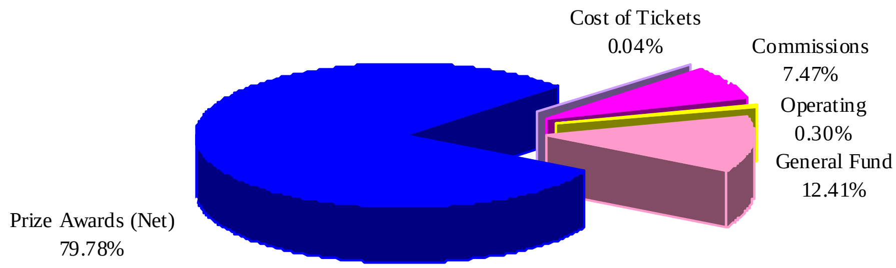
The deficiency in net assets reported at June 30, 2010, as previously explained, relates to the Lottery's immediate transfer, in a prior fiscal year, to the State's General Fund of all proceeds received from the sale of its exclusive rights over the operation of its gaming systems.

Lottery Operations

	Year Ended June 30, 2010	Year Ended June 30, 2009
Revenue:		
On-line games	$ 156,646,848	$ 156,130,190
Instant games	77,978,026	82,348,042
Video lottery	2,541,207,012	2,320,451,966
Other income	1,028,496	1,588,749
Total revenue	$ 2,776,860,382	$ 2,560,518,947
Expenses:		
Cost of sales	$ (2,423,163,679)	$ (2,207,437,158)
Operating expenses	(8,398,960)	(8,163,984)
Transfers to State's General Fund	(344,672,743)	(337,515,478)
Transfers to Permanent School Fund	-	(6,777,327)
Total expenses	$ (2,776,235,382)	$ (2,559,893,947)
Change in net assets	$ 625,000	$ 625,000
Total net assets (deficiency), beginning of year	(8,750,000)	(9,375,000)
Total net assets (deficiency), end of year	$ (8,125,000)	$ (8,750,000)

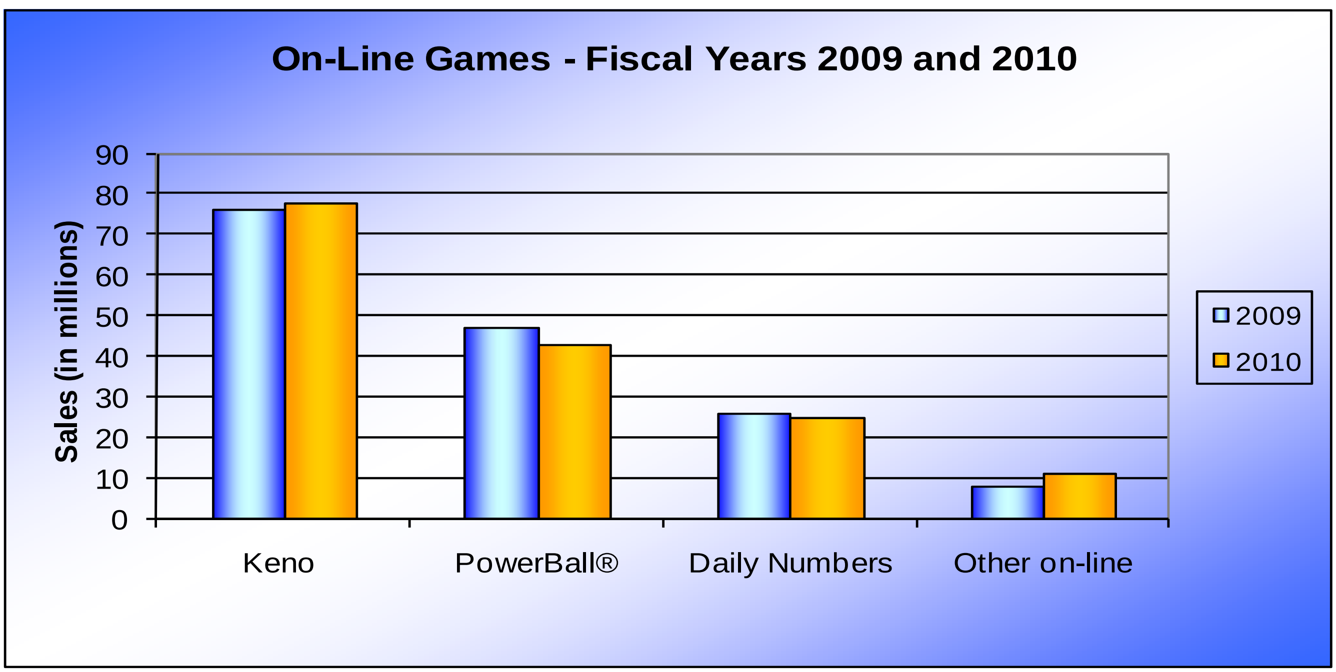
Sales

Distribution of the year's revenue was as follows:



Lottery sales are categorized as on-line, instant and video lottery games. The first category, on-line games, consisted of PowerBall®, Mega Millions®, Keno, Daily Numbers, Raffle and Wild Money at June 30, 2010. In total, on-line sales increased by $0.5 million, which is mostly attributable to increased Keno sales. Keno sales for the fiscal year ended June 30, 2010 increased $1.7 million or 2.20% over the prior fiscal year. The addition of Mega Millions® in January 2010 resulted in additional sales of $4.1 million; however, with decreased PowerBall® sales of $3.9 million, partially attributable to competition from Mega Millions® and no significant run of high Mega Millions® jackpots, the net increase of these two games combined was minimal.

The following graph depicts the Lottery's on-line sales for the fiscal years ended June 30, 2009 and 2010.



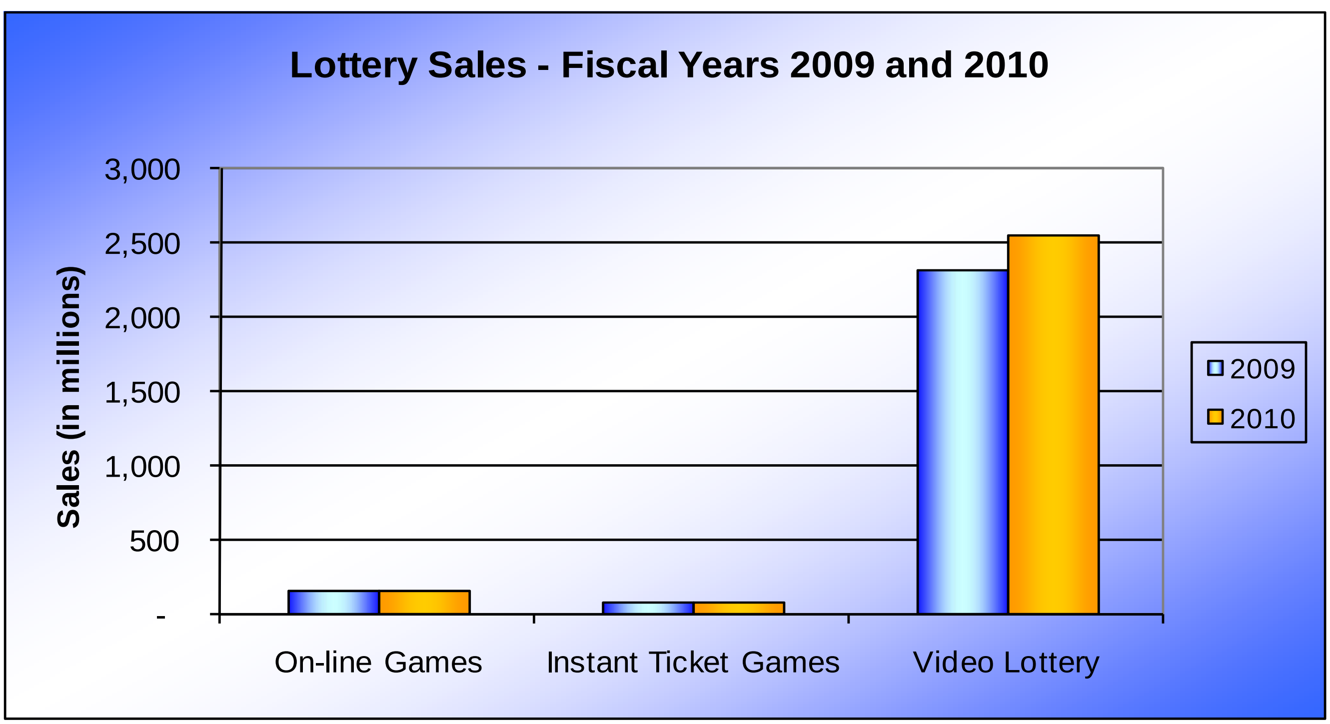
Instant tickets or "scratch" tickets are the second type of Lottery game offered to the public. Instant ticket sales for the fiscal year ended June 30, 2010 decreased $4.4 million or 5.31% over the preceding fiscal year.

The third type of game offered is video lottery. Video lottery sales increased $220.8 million with a corresponding increase of $213.9 million in prize awards. The continued increase in reported video lottery sales is mostly attributable to expanded operating hours for the entire fiscal year at the Lottery's largest video lottery facility, and the popularity of virtual multi-player video table games such as blackjack and roulette that simulates the excitement of table games.

The ability and preference of video lottery patrons to easily transfer credits between video lottery terminals (VLTs) using Ticket In/Ticket Out (TITO) technology, that is offered on all video terminals, also continues to impact reported sales and prize awards. This technology allows patrons to conveniently move their credits from VLT to VLT without having to redeem cash-out tickets for cash. This can result in reported terminal activity that flows through a number of VLTs without being exposed to the designed payout percentages applicable to video lottery games – causing an equivalent increase in sales and prize awards resulting from this type of patron play. While the video patron has always had the freedom to repeatedly redeem and reinvest their "unplayed" credits in other VLTs, the ease of such a transfer through the utilization of TITO has made this process much more common within video operations.

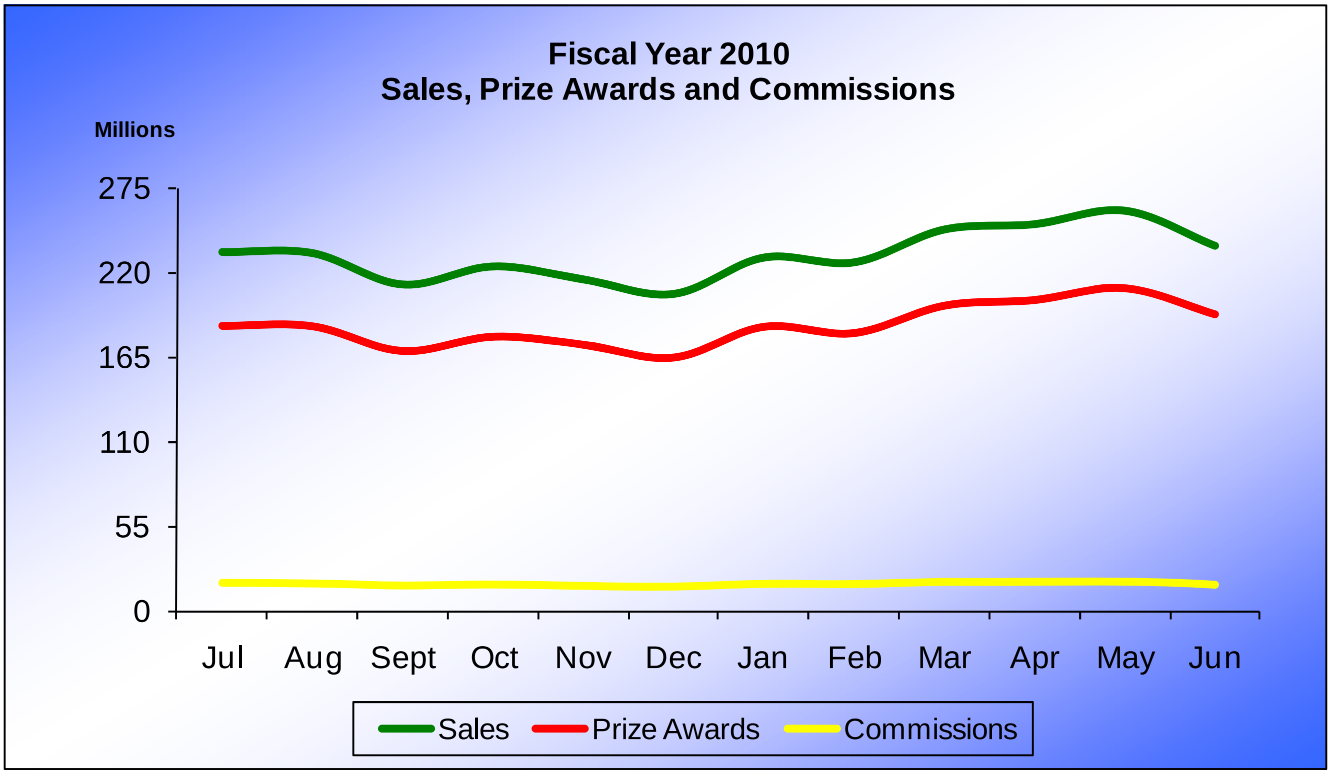
The Lottery continued to allot credits to each video lottery facility for patrons enrolled in their player rewards program. The credits, which approximated $10.2 million in redeemed free play for fiscal 2010, are part of increased marketing efforts to increase gross and net video lottery revenues. The promotional credits redeemed by patrons are not included in reported revenues, however any winnings (cash-outs) relating to the free play are recorded as prize awards by the Lottery.

The following graph depicts the Lottery's on-line, instant, and video lottery sales for the fiscal year ended June 30, 2009 in comparison to fiscal year ended June 30, 2010.



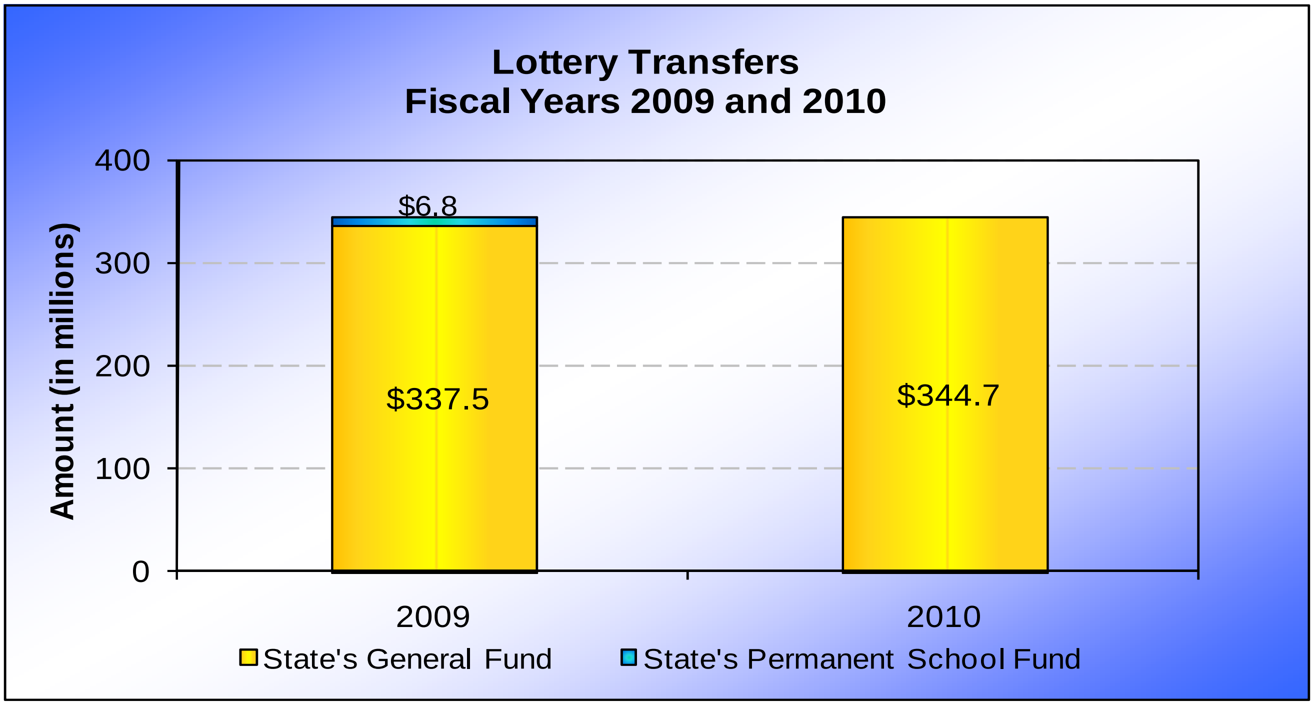
Commissions and Prize Awards Expense

As the following graph depicts, the Lottery's most significant expenses (commissions and prize awards) are predictable because they have a direct correlation to sales. As lottery sales 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.



Lottery Transfers

Net income transferred by the Lottery for the fiscal years ended June 30, 2010 and June 30, 2009 were \$344.7 million and \$344.3 million, respectively. In fiscal year 2009, the total transfer of \$344.3 million included \$6.8 million transferred to the State's Permanent School Fund. This was in accordance with RI General Law ("General Laws") section 42-61.2-7, effective until June 30, 2009, which allocated the State's share of net terminal income from the video lottery facilities' additional hours of operation. All fiscal 2010 transfers were made by the Lottery directly to the State's General Fund, as required by the General Laws.



Debt Administration

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

Capital Assets

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

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

Potential Factors Impacting Future Operations

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

- In June 2009, the President and Chief Operating Officer of UTGR, Inc., the owner and operator of the Twin River video lottery facility, filed for Chapter 11 relief with the United States Bankruptcy Court for the District of Rhode Island. A preliminary agreement had been reached with the first and second lienholders shortly before the bankruptcy filing. In January 2010, the debtors filed their Second Amended Disclosure Statement and Second Amended Plan with respect to the reorganization. This was approved by the United States Bankruptcy Court with minor changes in June 2010. Legislation to eliminate dog racing and to achieve certain requirements of the restructuring became law in May 2010. Although the plan requires the State to make additional investments in marketing for the facility, it is not anticipated that the bankruptcy will have a significant impact on the lottery revenues the State expects to receive.

- Recently enacted legislation requires the Lottery to make additional investments in marketing the video lottery facilities. The law authorizes each facility to operate a promotional points program of up to 4% of the facilities' net terminal income of the prior marketing year. Additionally, the law requires, beginning in fiscal 2011, reimbursement of allowable marketing expenses by the Lottery upon the facilities meeting mandated increases in net terminal income. The maximum amounts payable by the Lottery for marketing expense reimbursements are $3.7 million and $0.5 million for the Twin River and Newport Grand facilities, respectively.

- The Lottery's video lottery operations currently compete with Indian gaming casinos in nearby Connecticut. Proposals are sometimes made in Rhode Island, as well as neighboring Massachusetts, to seek approval from the voters to allow other casinos in Rhode Island and Massachusetts. The Lottery's operations may be impacted by competition from future gaming interests that may be developed within Rhode Island or neighboring states.

- Revenues overall are down at many gaming venues throughout New England due to current economic conditions. Competition among gaming venues has increased, resulting in more promotional allowances and player reward incentives being offered.

Contacting the Lottery's Financial Management

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

RHODE ISLAND LOTTERY

Statement of Net Assets

June 30, 2010

Current assets:		
Cash and cash equivalents (note 3)	$	14,442,588
Accounts receivable-less allowance for doubtful accounts of $129,057		2,773,555
Deposits with Multi-State Lottery Association (MUSL) (note 1)		151,806
Ticket inventory		1,190,597
Total current assets	$	18,558,546
Capital assets, net (note 4)		690,870
Total assets	$	19,249,416

Liabilities

Current liabilities:		
Due to State's General Fund (note 5)	$	1,646,003
Due to State's General Fund - Operating expenses		125,232
Obligation for unpaid prize awards		5,194,301
Accounts payable		10,462,936
Accrued expenses		1,158,529
Compensated absences (note 7)		140,745
Deferred revenue		161,138
Unearned contract revenue (note 8)		625,000
Total current liabilities	$	19,513,884
Long-term liabilities:		
Compensated absences (note 7)	$	221,081
Net OPEB obligation (note 10)		139,451
Unearned contract revenue (note 8)		7,500,000
Total long-term liabilities		7,860,532
Total liabilities	$	27,374,416

Net Assets

Invested in capital assets (note 8)		690,870
Unrestricted (note 8)		(8,815,870)
Total net assets (deficiency)	$	(8,125,000)

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Revenue, Expenses and Changes in Net Assets

Year Ended June 30, 2010

Sales (schedule 1):		
On-line games	$	156,646,848
Instant games		77,978,026
Video lottery		2,541,207,012
Total sales	$	2,775,831,886
Cost of sales:		
Commissions (note 6)	$	207,499,193
Prize awards		2,217,708,746
Unclaimed prize recovery		(3,270,897)
Cost of tickets		1,226,637
Total cost of sales		2,423,163,679
Gross profit	$	352,668,207
Operating expenses:		
Personal services	$	4,727,577
Advertising		2,441,014
Contract services		57,509
Depreciation		246,683
Other		926,177
Total operating expenses		8,398,960
Operating income	$	344,269,247
Non-operating income (expenses):		
Investment income		98,194
Other income		930,302
Income before Transfers		345,297,743
Transfers to State's General Fund (note 5)		(344,672,743)
Change in net assets	$	625,000
Total net assets (deficiency), beginning of year		(8,750,000)
Total net assets (deficiency), end of year (note 8)	$	(8,125,000)

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Cash Flows

Year Ended June 30, 2010

Cash flows from operating activities:	
Cash received from lottery sales	$ 2,777,607,264
Cash received from MUSL for grand prize winners	3,549,000
Cash received from sale of other tickets	143,942
Cash received from rental income and other receipts	452,624
Cash paid for prizes other than MUSL grand prize winners	(2,215,280,398)
Cash paid to MUSL grand prize winners	(3,549,000)
Cash paid for commissions - retailers	(8,334,037)
Cash paid for commissions - video lottery	(177,252,004)
Cash paid for commissions - on-line games contractor	(20,363,068)
Cash paid to suppliers for goods and services	(4,965,158)
Cash paid to employees for services	(4,567,917)
Net cash provided by operating activities	347,441,248
Cash flows from noncapital financing activities:	
Transfers to State's General Fund	(344,588,425)
Transfers from State's Permanent School Fund	9,659
Net cash used for noncapital financing activities	(344,578,766)
Cash flows from capital and related financing activities:	
Purchase of capital assets	(131,578)
Net cash used for capital and related financing activities	(131,578)
Cash flows from investing activities:	
Interest income	98,194
Net cash provided by investing activities	98,194
Net increase in cash and cash equivalents	2,829,098
Cash and cash equivalents at July 1, 2009	11,613,490
Cash and cash equivalents at June 30, 2010	$ 14,442,588

See accompanying notes to financial statements.

Continued.

RHODE ISLAND LOTTERY

Statement of Cash Flows (continued)

Year Ended June 30, 2010

Reconciliation of operating income to net cash provided by operating activities:	
Operating income	$ 344,269,247
Adjustments to reconcile operating income to net cash provided by (used for) operating activities:	
Depreciation	246,683
Miscellaneous receipts classified as operating activities	107,393
Rental income and other receipts	200,049
(Increase) decrease in assets:	
Accounts receivable	1,918,813
Inventory	(452,993)
Deposits with MUSL	252,575
Increase (decrease) in liabilities:	
Obligation for unpaid prize awards	(842,551)
Accounts payable	1,695,263
Due to State's General Fund - Operating expenses	(13,167)
Accrued expenses and Other	212,172
Deferred revenue	(152,236)
Total adjustments	3,172,001
Net cash provided by operating activities	$ 347,441,248

See accompanying notes to financial statements.

(1) *Organization*

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

The Lottery offers:

- On-line games that include: Daily Numbers, Keno, Wild Money, PowerBall®, Mega Millions®, and Raffle. Powerball® and Mega Millions® are multi-state games operated in accordance with rules and agreements established by the Multi-State Lottery Association (MUSL).

- Instant tickets sold through licensed lottery retailers.

- Video lottery games which are located at two licensed facilities.

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

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

(1) *Organization* – (Continued)

(a) *PowerBall®*

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

The prize pool for PowerBall® is 50% of each drawing period's ticket sales. MUSL has placed 2% of each drawing period's ticket sales for PowerBall®, included as part of each member's prize liability, in prize reserve funds. The maximum balance on the prize reserve funds for PowerBall® is $100.0 million. Once the prize reserve funds exceed this designated cap, the excess becomes part of the prize pool. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities, and these reserve funds are to be used at the discretion of the MUSL Board of Directors. The prize reserve funds are refundable to MUSL members if the MUSL disbands or if a member leaves MUSL. Members leaving MUSL must wait one year before receiving their remaining share, if any, of prize reserve funds. At June 30, 2010, the prize reserve funds for the PowerBall® game reported a balance of $84.3 million of which the Lottery's share was $1.5 million. The Lottery has charged amounts placed into the prize reserve funds to prize awards expense as the related sales have occurred.

All investment earnings relating to the prize reserve funds are credited to an unreserved account for each member state. This account can be utilized to offset operating costs or for the promotion of any MUSL game as approved by the MUSL Board of Directors. During fiscal year 2010, MUSL reduced the Lottery's unreserved account by $74,752 for a pro rata share of annual operating expenses. The Lottery has recorded all income and operating expenses related to its unreserved account and has reported the balance of $151,806 at June 30, 2010 on the Statement of Net Assets in "Deposits with MUSL".

(b) *Mega Millions®*

MUSL also 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

(1) *Organization* – (Continued)

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® is up to 51% of each drawing period's sales after prize reserve accounts are funded, but may be higher or lower based on the number of winners at each prize level, as well as funding required to meet a guaranteed annuity grand prize. An amount of up to 1% of a participating lottery's sales and 4.93% of Megaplier® (game option where patrons can wager an additional sum for the chance at multiplying any low-tier prize amounts by a randomly drawn factor of 2, 3, or 4) sales is included in trust in one or more prize reserve accounts held by MUSL for its participating members. Contributions to prize reserve accounts are made only when the reserve balances are below the maximum balances designated by MUSL. The maximum deduction to be taken from the grand prize pool to fund the prize reserve account is 1%. The MUSL Board of Directors, with the approval of the Finance and Audit Committee, is responsible for establishing the maximum prize reserve amount. No maximum prize reserve balance was established during fiscal 2010. The Mega Millions® reserve accounts and Mega Millions® rollover monies (excess contributions), if any, may be used to fund a deficiency in Megaplier® prizes. At June 30, 2010, the prize reserve fund for the Mega Millions® game reported a deficit of $629,706 of which the Lottery's share was $12,493 of the deficit balance. The prize reserve deficit will be offset by future contributions. Effective December 1, 2010, funding of the prize pool for Mega Millions® will increase to 52.5% of each drawing period's sales.

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

(c) *Video Lottery*

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

(2) *Summary of Significant Accounting Policies*

(a) *Basis of Accounting*

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

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

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

(b) *Reporting Entity*

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

(c) *Revenues and Expenses*

The Lottery defines all revenues and expenses deriving from on-line, instant ticket and video lottery sales as operating. All other revenues and expenses are defined as non-operating.

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

1. On-line lottery games with specific drawing dates - when the related drawings are held.
2. Instant ticket lottery games - when ticket packets are charged to retailers. Prize expense is recognized in proportion to the number of tickets sold based on the stated prize structure for a specific instant ticket game.
3. Video lottery games - when game credits are purchased and when game credits are redeemable. Video lottery revenue and prize expenses are recorded at the amount of credits purchased and the amount of credits redeemable or allocated to progressive jackpots. These amounts are net of credits won and played.

(2) <u>*Summary of Significant Accounting Policies*</u> – (Continued)

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 the cost of sales.

(d) *Capital Assets*

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

(e) *Cash Equivalents*

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

(f) *Ticket Inventory*

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

(g) *Deferred Revenue*

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

(h) *Unearned Contract Revenue*

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

(i) *Use of Estimates*

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

(3) *<u>Deposits and Investment Risk</u>*

(a) *Deposits*

The Lottery's cash deposit balances at June 30, 2010 totaled $1,409,991, with corresponding bank balances totaling $1,469,687. The bank balances consisted of $246,355 in demand deposit accounts and $1,223,332 in collateralized deposit investment accounts. 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.

All deposits were in the custody of the State General Treasurer. All General Treasurer accounts at a single institution are aggregated for purposes of determining federal depository insurance coverage. Balances are insured up to $250,000 for each official custodian by institution.

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, 2010 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 at June 30, $1,469,687 was collateralized by securities held by an independent third party custodian.

(b) *Investments*

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

At June 30, 2010, the Lottery's investment balance consisted of money market mutual funds as follows:

Investment Description	Fair Value at June 30, 2010	Credit Rating	Average Maturity
BlackRock Liquidity Funds – FedFund Institutional Shares	$ 13,032,597	AAAm (S&P) Aaa (Moody's)	42 days

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

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.

(c) *Cash and Cash Equivalents*

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

Cash deposit balance per books	$ 1,409,991
Investments classified as cash equivalents	13,032,597
Cash and cash equivalents	$ 14,442,588

(4) *Capital Assets*

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

A summary of capital assets follows:

(4) *Capital Assets* – (Continued)

	Estimated Useful Life	Balance at July 1, 2009	2010 Additions	2010 Disposals	Balance at June 30, 2010
Cost					
Building	20	$ 1,468,983	$ -	$ -	$ 1,468,983
Building improvements	10	1,875,846	126,230	(54,850)	1,947,226
Ticket production equipment	10	14,938	-	-	14,938
Office equipment	10	123,197	164	(19,159)	104,202
Furniture and fixtures	10	92,332	-	-	92,332
Lottery drawing equipment	3	87,023	-	(621)	86,402
Automobiles	3	271,044	-	-	271,044
Computer equipment	3	245,271	5,184	(13,508)	236,947
Trucks	3	22,445	-	-	22,445
Total		$ 4,201,079	$ 131,578	$ (88,138)	$ 4,244,519
Less: Accumulated Depreciation					
Building		$ 1,449,901	$ 1,552	$ -	$ 1,451,453
Building improvements		1,277,437	183,971	(54,850)	1,406,558
Ticket production equipment		14,939	-	-	14,939
Office equipment		37,021	9,550	(17,017)	29,554
Furniture and fixtures		65,301	7,363	-	72,664
Lottery drawing equipment		87,023	-	(621)	86,402
Automobiles		194,353	43,069	-	237,422
Computer equipment		244,542	1,178	(13,508)	232,212
Trucks		22,445	-	-	22,445
Total		$ 3,392,962	$ 246,683	$ (85,996)	$ 3,553,649
Capital assets, net		$ 808,117	$ (115,105)	$ (2,142)	$ 690,870

(5) *Transfers to the State*

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

(a) Transfers to the State's General Fund for fiscal 2010 are reported as follows in the Lottery's financial statements:

Due to State's General Fund, beginning of year	$ 1,561,685
Transfers to State's General Fund	344,672,743
Cash paid during fiscal year	(344,588,425)
Due to State's General Fund, end of year	$ 1,646,003

(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).

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 $361,826 and $284,838 as of June 30, 2010 and 2009, respectively, and is recorded as a liability in the Statement of Net Assets. The current portion as reported was estimated based on a two year average of employee utilization experience.

Changes in the reported liability for compensated absences for fiscal 2010 are as follows:

	Balance at July 1, 2009	Increase	Decrease	Balance at June 30, 2010
Liability for Compensated Absences	$284,838	$306,308	$229,320	$361,826

(8) *Net Assets - (Deficiency)*

On May 12, 2003, the Lottery entered into a 20-year contract, effective July 1, 2003, with its current gaming system provider. The contract granted the provider the right to be the Lottery's exclusive vendor of hardware and software, together with the related services necessary for the operation of the Lottery's computerized games, through June 30, 2023. In return, the provider made a one-time payment of $12.5 million to the Lottery as consideration for this exclusive contract right. The Lottery recorded unearned contract revenue in the amount of $12.5 million and transferred the cash to the State's General Fund on June 30, 2003. This prior year transfer of unearned contract revenue resulted in a deficiency in net assets at June 30, 2010 of $8.1 million. As the contract revenue is recognized over the twenty-year life of the contract, the deficiency in net assets will be reduced by $625,000 per year.

Net assets reported by the Lottery also include its investment in capital assets, net of accumulated depreciation. The Lottery had no debt related to capital assets at June 30, 2010.

(9) <u>*Retirement Plan*</u>

Plan Description:

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

Funding Policy:

The funding policy, as set forth in the General Laws, Section 36-10-2, provides for actuarially determined periodic contributions to the plan. Lottery employees are required to contribute 8.75% of their annual covered salary. The Lottery is required to contribute at an actuarially determined rate; the rate was 20.78% of annual covered payroll for the fiscal year ended June 30, 2010. The Lottery contributed $582,513, $586,324 and $605,223 for the fiscal years ended June 30, 2010, 2009 and 2008, respectively, equal to 100% of the required contributions for each year.

(10) <u>*Postemployment Healthcare Plan*</u>

Plan Description:

As a division of the State of Rhode Island, the Lottery participates in a State administered defined benefit post-employment health care plan known as the Rhode Island Retiree Health Care Benefit Plan (RIRHCBP). The RIRHCBP is an agent multiple employer plan.

The RIRHCBP is reported in an internal service fund of the State using the accrual basis of accounting. The fund reports all employer and retiree (plan member) contributions to the plan. Contributions are recognized when made. Benefits (health care claims) and refunds are recognized when due and payable in accordance with the terms of the plan. A liability for incurred but not reported claims is determined based on past claims payment trends and is included in the State's financial statements. Working premium rates are determined by the State each fiscal year after consultation with an employee benefits consultant and are designed to fund current claims incurred during the fiscal year as well as the costs of administering the plan. For the year ended June 30, 2010, the plan operated on a pay as you go basis and no provision has been made to fund future benefits to be provided to RIRHCBP members. The RIRHCBP does not issue a stand-alone financial report.

(10) *Postemployment Healthcare Plan* – (Continued)

Funding Policy:

RIGL Sections 36-10-2, 36-12.1, 36-12-2.2 and 36-12-4 govern the provisions of the RIRHCBP. The contribution requirements of plan members, the State and other participating employers are established and may be amended by the General Assembly.

For those who retired on or before September 30, 2008, the State provides two types of subsidies for health care benefits. The Tier I subsidy applies to non-Medicare eligible retirees and provides that the State will pay the portion of the cost of post-retirement health care for the retiree and any dependents above the active group rate. The retiree pays the active monthly rate and the State pays the difference between the active group rate and the early retiree rate. This subsidy is not based on years of service and ends at age 65. In addition to the Tier I benefits, the State pays a portion of the cost of post-retirement health care above the Tier I costs for certain retirees meeting eligibility requirements based upon the age and service of the retiree, which is referred to as the Tier II benefit.

For those who retired on or before September 30, 2008, the fiscal 2010 contributions are as follows:

Retiree Age	Years of Service	Amount of Cost Paid by Retiree
Below 60: (1)	28-34	10%
	35+	0%
Retiree Age from 60 to 65: (2)	10 – 15	50%
	16 – 22	30%
	23 – 27	20%
	28+	0%
Retiree Age Greater than 65: (3)	10 – 15	50%
	16 – 19	30%
	20 – 27	10%
	28+	0%

(1) The monthly premium rate was $789.76 for fiscal year 2010 for the individual plan. The retiree's cost is then calculated based on a maximum of $501.68 (the active plan rate).
(2) The monthly premium rates are the same as indicated above for the Retiree Age Below 60 category.
(3) The monthly premium rate for the Medicare Supplemental plan is $218.54 for the individual plan, and the monthly premium for the Medicare HMO plan was $115 for the first six months of fiscal year 2010 and $142 thereafter. Retirees can choose between the two plans. The retiree's cost is then calculated based on their years-of-service subsidy above.

For anyone who retired on or after October 1, 2008, age 59 through 64, with a minimum of 20 years of service, the State will pay 80% of the actual cost of health care coverage. The State contributed $631.81 per month for these retirees during fiscal 2010. For eligible retirees ages 65 or older, the State pays 80% of the cost of the Medicare supplement products as described in note (3) above.

(10) Postemployment Healthcare Plan – (Continued)

Annual Other Postemployment Benefit (OPEB) Cost and Net OPEB Obligation:

As required by GASB Statement 45, the Lottery recognized an expense equal to; a.) the annual required contribution of the employer (ARC), which was actuarially determined to be 7.91% of covered payroll for all State employees for fiscal year 2010, plus b.) interest on the net OPEB obligation at the beginning of the fiscal year, and less c.) the ARC adjustment (discounted present value of the OPEB liability at the beginning of the fiscal year). The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal costs each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years. The ARC for fiscal 2010 was determined based on an actuarial valuation performed as of June 30, 2007. For fiscal year 2010, the ARC, based on the Lottery's covered payroll of $2,803,656 totaled $221,769. The Lottery actually contributed $157,565, which was 5.62% of annual covered payroll for fiscal 2010. The Lottery's annual OPEB cost and the net OPEB obligation for fiscal 2010, were as follows:

Annual required contribution (ARC)	$ 221,769
Plus: Interest on net OPEB obligation at beginning of year	2,678
Less: Adjustment to ARC	(2,531)
Annual OPEB cost	$ 221,916
Contributions made	(157,565)
Increase in OPEB obligation	64,351
Net OPEB obligation at beginning of year	75,100
Net OPEB obligation at end of year	$ 139,451

The Lottery's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for 2010, 2009 and 2008 (first year of GASB 45 implementation) was as follows:

Fiscal Year Ended	Annual OPEB Cost	Percentage of Annual OPEB Cost Contributed	Net OPEB Obligation
June 30, 2008	$176,982	65.0%	$ 61,976
June 30, 2009	$168,980	92.2%	$ 75,100
June 30, 2010	$221,916	71.0%	$139,451

Funded Status and Funding Progress:

The State has obtained an actuarial valuation for the RIRHCBP, which determined the collective Actuarial Accrued Liabilities (AAL) and Unfunded Actuarial Accrued Liabilities for all State employees participating in the plan and separate liability amounts for each discretely presented component unit with employees participating in the plan. The liabilities relating to the Lottery's employees, as part of the primary government, are included in the collective amounts reported for all State employees. The AAL and UAAL for the RIRHCBP at June 30,

(10) *Postemployment Healthcare Plan* – (Continued)

2010 will be reported in the State's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2010.

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The Schedule of Funding Progress for RIRHCBP shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits. This schedule will be included in the State's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2010.

Actuarial Methods and Assumptions:

Projections of benefits for financial reporting purposes are based on the plan and include the types of benefits provided at the time of each valuation. The actuarial assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

The annual required contribution for fiscal year 2010 was determined based on the June 30, 2007 valuation. The Unfunded Actuarial Accrued Liability (UAAL) was amortized by a level (principal and interest combined) percent of payroll contribution for each component unit employer. The UAAL was determined using the actuarial value of assets and actuarial accrued liability calculated as of the valuation date. The UAAL is being amortized over the remainder of a closed 30-year (or shorter) period from June 30, 2006.

Plan changes effective for employees retiring after October 1, 2008 have been reflected in the actuarial valuations performed as of June 30, 2007.

The individual entry-age actuarial cost method is used to determine the annual required contribution amounts and the annual net OPEB obligation. The actuarial assumptions include a 3.566% discount rate based upon the average rate of return during the 10 years ended June 30, 2008 for short term investments of the State's General Fund; a healthcare cost trend assumption of 10% progressively declining to 4.50% after 8 years; and a salary growth rate assumption ranging from 9% in the first year of service to 4.50% in year 15 and beyond for the 2007 valuation. Other assumptions including those relating to rates of termination, rates of retirement, percent married, and retiree health care election rates were based on the experience study for the Employees' Retirement System of Rhode Island as well as anticipated experience changes in conjunction with the newly adopted plan changes that were recently enacted through legislation.

(10) *Postemployment Healthcare Plan* – (Continued)

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events in the future. Examples include assumptions about employment, mortality and healthcare cost trends. Actuarial valuations are subject to continual revision as actual results are compared to past expectations and new estimates are formulated about the future.

(11) *Deferred Compensation*

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

(12) *Commitments*

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

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

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

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

Commission Percentages	
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%

(12) *Commitments* – (Continued)

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

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

On July 18, 2005, the Lottery entered into a five (5) year Master Video Lottery Terminal Contract with UTGR, Inc. (UTGR), the owners of Twin River, to manage one of the State's licensed video lottery facilities. The contract entitles UTGR to compensation ranging from 26% to 28.85% of video lottery net terminal income at the facility. Under the contract, UTGR has the right and option to extend the term of the agreement for two (2) successive five (5) year periods by giving notice to the Lottery at least ninety (90) days prior to the expiration of the agreement. Certain extensions are contingent on UTGR's compliance with full-time employment mandates.

In May 2010, legislation was enacted which authorized the Lottery to amend its Master Contract with UTGR and which satisfied certain requirements of UTGR's corporate reorganization (as defined in Note 13). The legislation provides for a promotional points program up to 4% of the facility's prior year net terminal income. The legislation also requires the Lottery, beginning in fiscal 2011, to reimburse UTGR for allowable marketing expenses at an amount not to exceed $6 million multiplied by the Lottery's percentage of net terminal income (approximately 61% for fiscal 2010). The reimbursement of marketing expenses by the Lottery occurs only after UTGR has incurred $4 million in qualified marketing expenses (as defined by the Lottery) and is contingent on the State receiving net terminal income from UTGR at least equal to fiscal year 2009 amounts.

UTGR gave notice of its intent to extend the contract and the first five-year extension term of the Lottery's contract with UTGR commenced on July 18, 2010.

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

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

(12) *Commitments* – (Continued)

In May 2010, legislation was enacted that authorized the Lottery to amend its Master Contract with Newport Grand to include two (2) successive five (5) year extension terms with the first term commencing on November 23, 2010. On September 21, 2010, Newport Grand gave notice of its intent to extend the contract and the first five-year extension term of the contract will commence on November 23, 2010. The second term, which would commence on November 23, 2015, is contingent on Newport Grand's compliance with full-time employment mandates.

The legislation also provides for a promotional points program up to 4% of the facility's prior year net terminal income and requires the Lottery, beginning in fiscal 2011, to reimburse Newport Grand for allowable marketing expenses at an amount not to exceed $840,000 multiplied by the Lottery's percentage of net terminal income (approximately 63% for fiscal 2010). The reimbursement of marketing expenses by the State occurs only after Newport Grand has incurred $560,000 in qualified marketing expenses (as defined by the Lottery) and is contingent on the State receiving net terminal income from Newport Grand at least equal to fiscal year 2010 amounts.

(13) *Contingencies*

(a) The Lottery's master contracts with its video lottery facility managers contain revenue protection provisions in the event that existing video lottery facilities incur revenue losses caused by new gaming ventures within the State.

(b) In March 2008, UTGR, Inc., the owner and manager of Twin River, one of two licensed video lottery facilities of the State, defaulted on loan payments to its lenders who provided a $565.0 million loan package to UTGR, Inc. and its parent companies to buy and expand the Twin River facility. As a result of defaulting on loan payments, UTGR entered into a forbearance agreement with its lenders. The forbearance agreement expired January 31, 2009 and was not extended.

On or about June 23, 2009, UTGR, Inc., d/b/a Twin River, BLB Management Services, Inc., and BLB Worldwide Holdings, Inc. (collectively, the "Debtors") commenced a Chapter 11 bankruptcy proceeding by filing voluntary petitions for relief in the United States Bankruptcy Court for the District of Rhode Island. The filing was made when – after months of discussions and negotiations – the Debtors, their lenders and the State reached an agreement in principle with respect to a consensual reorganization plan, which is subject to approval of the Bankruptcy Court. The consensual plan contemplates, among other things, that the lenders will remove approximately $290.0 million of the approximately $590.0 million of debt on the balance sheet of the facility and, subject to the State's regulatory approval process, the lenders would become the new owners of the facility and search for a new operator for the facility to replace the Debtors. Progress has been made toward a successful restructuring of the companies. Since the filing, the Debtors have continued in the management and operation of the business as debtors in possession and Twin River has continued to remain open as usual.

(13) *Contingencies* – (Continued)

On or about January 2, 2010, the Debtors filed their Second Amended Disclosure Statement and Second Amended Plan with respect to the reorganization. On June 23, 2010, the United States Bankruptcy Court approved the Debtors' Second Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code with a few minor changes. Although the plan provides for the State to make additional investments in the marketing and management for the facility, it is not anticipated that the bankruptcy will have a significant impact on the lottery revenues the State expects to receive from the facility. The legislation authorizing the changes necessary to achieve certain requirements of the restructuring became law with the governor's signature on May 26, 2010. The Rhode Island Lottery continues to control and regulate the video lottery operations at the facility, including cash receipts, cash transfers and cash deposits. The cash management process continues to be carried out with a high degree of physical security and financial integrity.

The Department of Revenue, Division of State Lottery, and the Department of Business Regulation continue to closely monitor the situation. Any proposal to have a new owner of the facility and/or any proposal to transfer ownership of the facility would need regulatory approval. Certain applications for licensure have been submitted by the lenders to the Department of Business Regulation and these applications are currently under review.

(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 year 2010, the Lottery has maintained its amount of purchased insurance coverage. Claims and settlements incurred for fiscal years 2010, 2009 and 2008 have not exceeded the Lottery's insurance coverage.

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

RHODE ISLAND LOTTERY

Sales, Commissions and Prize Awards Expense

Year Ended June 30, 2010

Schedule 1

	Sales	Commissions	Prize Awards Expense	Unclaimed Prize Recovery	Cost of Tickets	Cost of Sales	Gross Profit
Lottery games:							
On-line games							
Keno	$ 77,708,084	$ 10,088,252	$ 51,055,640	$ (293,994)	$ -	$ 60,849,898	$ 16,858,186
PowerBall®	42,684,765	5,541,439	21,346,308	(1,283,088)	-	25,604,659	17,080,106
Daily Numbers	25,176,010	3,268,411	13,744,851	(178,971)	-	16,834,291	8,341,719
Mega Millions®	4,067,206	533,514	2,068,147	-	-	2,601,661	1,465,545
Wild Money	4,755,803	617,410	2,591,617	(72,405)	-	3,136,622	1,619,181
Raffle	2,254,980	325,255	1,200,200	(34,000)	-	1,491,455	763,525
	156,646,848	20,374,281	92,006,763	(1,862,458)	-	110,518,586	46,128,262
Instant tickets	77,978,026	8,296,029	52,267,055	(1,237,059)	1,226,637	60,552,662	17,425,364
Video Lottery	2,541,207,012	178,828,883	2,073,434,928	(171,380)	-	2,252,092,431	289,114,581
Totals	$ 2,775,831,886	$ 207,499,193	$ 2,217,708,746	$ (3,270,897)	$ 1,226,637	$ 2,423,163,679	$ 352,668,207

Video Lottery Commissions - Detail	
Facilities	127,840,660
Technology Providers	32,108,347
Central Communications Provider	11,691,815
City/Town	6,490,439
Narragansett Indian Tribe	697,622
Total	$ 178,828,883

STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

DENNIS E. HOYLE, CPA
ACTING AUDITOR GENERAL
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♦ *INTEGRITY*
♦ *RELIABILITY*
♦ *INDEPENDENCE*
♦ *ACCOUNTABILITY*

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

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

We have audited the financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2010 and have issued our report thereon dated September 21, 2010. 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.

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

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above. However, we identified a deficiency in internal control over financial reporting, described in the accompanying schedule of findings and responses as Finding 2010-1, that we consider to be a significant deficiency in internal control over financial reporting. A significant deficiency is a deficiency, or 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.

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

Compliance and Other Matters

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

The Lottery's response to the finding identified in our audit is described in the accompanying schedule of findings and responses. We did not audit the Lottery's response and, accordingly, we express no opinion on it.

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

Dennis E. Hoyle, CPA
Acting Auditor General

September 21, 2010

SCHEDULE OF FINDINGS AND RESPONSES

Finding 2010-1

INFORMATION SYSTEMS SECURITY POLICIES AND PROCEDURES – MONITORING AND ASSESSMENT

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

The Lottery contracted with an IT security consultant during fiscal 2010 to conduct a comprehensive assessment of the significant information systems utilized within the Lottery's operations. The scope of this review involved evaluating compliance of all significant information systems (whether operated by the Lottery, its contractors, or other licensees involved in the operation of Lottery games) with the Lottery's comprehensive information system security policies and industry accepted security standards.

The majority of the Lottery's information systems policies and procedures were found to be in place and operating effectively by the consultant; however, instances of noncompliance with these policies were observed and reported by the contracted IT security professionals. Due to the significance of certain instances of reported noncompliance, the Lottery must ensure that these deficiencies are corrected to enhance controls over the gaming system environment and over financial reporting. Additionally, the Lottery should assess its overall monitoring efforts to ensure comprehensive coverage of all critical IT security components. As necessary, the scope and frequency of scheduled monitoring procedures should be modified to ensure timely identification of noncompliance with mandated IT security policies.

To ensure continuous compliance with its mandated policies and procedures over all information systems utilized within Lottery operations, the Lottery should:

- Conduct a more formalized risk assessment process on an annual basis (with updates performed as prompted by significant system modifications) to better identify critical IT risk areas. A formalized risk assessment process will identify risks more timely and assist the Lottery in utilizing its internal and external monitoring resources.

- Mandate that all contractors and licensees involved in the operation of lottery games have an Information Security Administrator function with responsibility for ensuring their entity's compliance with the Lottery's information system security policies.

- Contract annually, based upon risk assessment outcomes, for a comprehensive review of all significant system components involved in the operation of the Lottery's games.

These recommendations will enhance the Lottery's existing monitoring efforts to ensure compliance with its information systems security policies.

RECOMMENDATIONS

2010-1a Address IT security deficiencies reported by the Lottery's information systems security contractor.

2010-1b Conduct more formalized risk assessment processes on an annual basis with updates as needed for significant system modifications to better identify critical IT risk areas and utilize resources (both internal and external) to mitigate these risks.

2010-1c Mandate that all contractors and licensees involved in the operation of lottery games have an Information Security Administrator function with responsibility for ensuring their entity's compliance with the Lottery's information system security policies.

2010-1d Contract on an annual basis for a comprehensive security review of all significant information systems involved in the operation of the Lottery's games.

Auditee views:

2010-1a

With the implementation of GTECH's anti-virus and patching program, as well as the newly-implemented controls and additional oversight over the Facilities' Player Tracking systems, the overall program is much stronger.

The findings within the contractor's report were easily correctable, and this review was different from any previous review, due to the scope of the audit. Previously, the Lottery had auditing firms review the Online and Video Systems separately. This review had a much broader scope that included all the Online and Video Systems and associated infrastructure. Also, the review was done by an auditing firm that provided a different perspective than reviews done in the past. The Lottery ISA and Video Systems Manager heavily monitor and regulate the security over the GTECH and VLT Facility Systems. The Lottery also relies on the annual external audits to strengthen the overall program. The Lottery has been working with all parties involved to address the deficiencies reported in the most recent audit. As stated, most of the deficiencies (80%) have been closed; and the remaining deficiencies will be completed within 60 days.

2010-1b:

The Lottery MIS Director and ISA perform internal reviews of all IT Security areas throughout the year to ensure that the current monitoring process and implemented security controls in place are effective. These reviews include:

- *Network management*
- *System management*
- *User and group policy management*
- *Intrusion detection system review*
- *Firewall review*
- *Review of all device syslogs*
- *Change management controls*
- *Software and hardware inventory review*
- *Software release management*
- *Anti-virus and security update review*

2010-1c:

The Lottery understands the value of having an Information Security Administrator function and continues in its well-established efforts to ensure that GTECH and the VLT Facilities assign designated resources to this job function to ensure compliance with the Lottery's policies.

2010-1d:

Over the past ten years, the Lottery has engaged the services of consultants to perform annual external security reviews. Each time the Lottery has had an external auditing firm perform an IT Security review, the auditing scope has been reviewed by the Auditor General's Office to ensure that they are involved with the process and that the scope is satisfactory. The Lottery will continue this important practice to ensure its Information Security Program is what it should be and to protect the revenue source the Lottery systems generate.