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**RHODE ISLAND LOTTERY**

(AN ENTERPRISE FUND OF THE  
STATE OF RHODE ISLAND)

**FISCAL YEAR ENDED JUNE 30, 2014**

Dennis E. Hoyle, CPA  
Auditor General

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

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## Office of the Auditor General

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

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

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

October 8, 2014

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

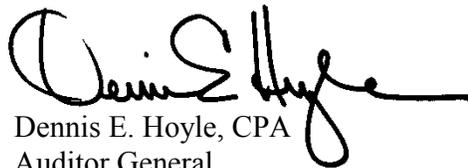
SPEAKER Nicholas A. Mattiello, Chairman

Senator M. Teresa Paiva Weed  
Senator Dennis L. Algieri  
Representative John J. DeSimone  
Representative Brian C. Newberry

We have completed our audit of the financial statements of the Rhode Island Lottery for the year ended June 30, 2014 and have issued our *Independent Auditor's Report* thereon.

Section III of this report includes our *Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards* and three management comments which are intended to enhance the Lottery's operations or its compliance with applicable laws and regulations.

Sincerely,



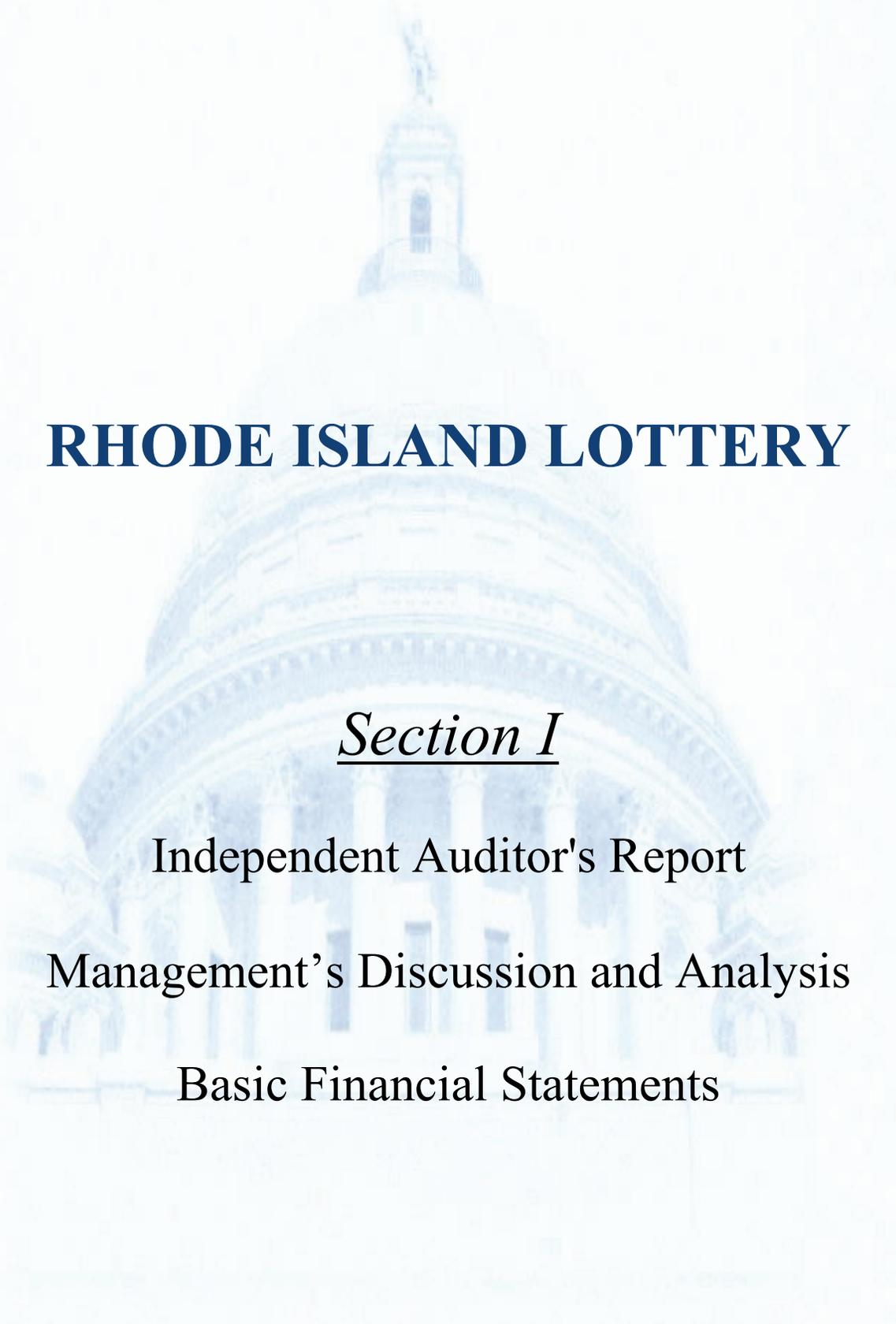
Dennis E. Hoyle, CPA  
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**RHODE ISLAND LOTTERY**  
(AN ENTERPRISE FUND OF THE STATE OF RHODE ISLAND)

*FISCAL YEAR ENDED JUNE 30, 2014*

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# **RHODE ISLAND LOTTERY**

## **Section I**

Independent Auditor's Report

Management's Discussion and Analysis

Basic Financial Statements



# Office of the Auditor General

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

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## **INDEPENDENT AUDITOR'S REPORT**

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

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

We have audited the accompanying financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements as listed in the table of contents.

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

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

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

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

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

***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Lottery as of June 30, 2014, and the changes in financial position and cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

***Emphasis of Matters***

As more fully described in Note 13(c), the Lottery's gaming operations could be adversely impacted by enacted legislation in the Commonwealth of Massachusetts allowing three casinos and one slot parlor in that State.

As discussed in Note 9, GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, is effective for fiscal 2015 and will require the Lottery to restate beginning net position at July 1, 2014 to recognize its proportionate share of the net pension liability determined for the State Employee's Retirement Plan.

As discussed in Note 2(b), the financial statements present only the Lottery enterprise fund and do not purport to, and do not, present fairly the financial position of the State of Rhode Island and Providence Plantations, as of June 30, 2014, the changes in financial position, or, where applicable, cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our opinion is not modified with respect to these matters.

***Other Matters***

***Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on pages 4 through 14 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

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

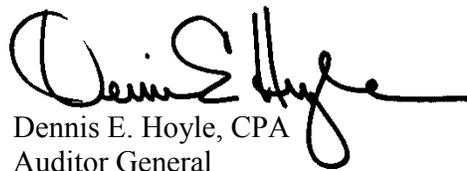
*Other Information*

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

Schedule 1 is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the basic financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, Schedule 1 is fairly stated, in all material respects, in relation to the basic financial statements as a whole.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated October 6, 2014 on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Lottery's internal control over financial reporting and compliance.

  
Dennis E. Hoyle, CPA  
Auditor General

October 6, 2014

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

Management of the Lottery provides this Management's Discussion and Analysis of their financial performance for the readers of the Lottery's financial statements. This narrative provides an overview of the Lottery's financial activity for the fiscal year ended June 30, 2014. This analysis is to be considered in conjunction with the financial statements to provide an objective analysis of the Lottery's financial activities based on facts, decisions, and conditions currently facing management.

### Understanding the Lottery's Financial Statements

The Lottery, a division of the Department of Revenue of the State of Rhode Island and Providence Plantations (State), is accounted for as an enterprise fund that reports all assets and liabilities using the accrual basis of accounting, much like a private business entity. In accordance with accounting principles generally accepted in the United States of America, this report consists of a series of financial statements, along with notes to the financial statements and a supplementary schedule detailing operating revenue and the cost of gaming operations for each lottery game. The financial statements immediately follow this *Management's Discussion and Analysis* and are designed to highlight the Lottery's net position and changes in net position resulting from Lottery operations.

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

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

The deficit in net position of \$5.6 million reported at June 30, 2014 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

- Due largely to two higher jackpots of \$636.0 million in December 2013 and \$400.0 million in March 2014, Mega Millions<sup>®</sup> sales increased by \$4.7 million or 59.16% in fiscal 2014.
- Due largely to two higher jackpots of \$378,129 in August 2013 and \$270,794 in November 2013, Wild Money sales increased \$942,024 or 26.29% in fiscal year 2014.

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

- In fiscal year 2014, the first full year of table games operations at Twin River, net table games revenue was \$88.1 million and resulted in net income of \$11.7 million from operations after the payment of related commissions and operating expenses.

	<u>June 30, 2014</u>	<u>June 30, 2013</u>
<b>Assets:</b>		
Current assets		
Cash and cash equivalents	\$ 18,563,846	\$ 18,914,619
Accounts receivable, net	6,543,195	7,325,858
Other	<u>741,075</u>	<u>740,426</u>
Total current assets	25,848,116	26,980,903
Long-term assets		
Capital assets, net	<u>460,135</u>	<u>402,288</u>
Total assets	<u>26,308,251</u>	<u>27,383,191</u>
<b>Liabilities:</b>		
Current liabilities		
Due to State's General Fund - net income from operations	\$ 270,580	\$ 847,359
Due to State's General Fund - operating expenses	270,308	353,432
Accounts payable	12,520,990	13,941,559
Prize obligations	7,907,347	7,178,210
Compensated absences	208,938	166,774
Other liabilities	<u>5,467,729</u>	<u>5,297,629</u>
Total current liabilities	26,645,892	27,784,963
Long-term liabilities		
Compensated absences	287,359	223,228
Unearned contract revenue	<u>5,000,000</u>	<u>5,625,000</u>
Total long-term liabilities	5,287,359	5,848,228
<b>Total liabilities</b>	<u>31,933,251</u>	<u>33,633,191</u>
<b>Net Position:</b>		
Net investment in capital assets	460,135	402,288
Unrestricted	<u>(6,085,135)</u>	<u>(6,652,288)</u>
<b>Total net position (deficit)</b>	<u>\$ (5,625,000)</u>	<u>\$ (6,250,000)</u>

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, 2014, the Lottery's assets included \$18.6 million in cash and cash equivalents as compared with \$18.9 million at June 30, 2013. The Lottery's accounts receivable approximated \$6.5 and \$7.3 million, respectively, at June 30, 2014 and 2013.

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

The Lottery's liabilities included at the balance sheet date are amounts owed for vendor payables, prize obligations and a residual amount owed to the State's General Fund for June net operations and operating expenses. The amount owed to the General Fund for June net operations approximated \$0.3 million at June 30, 2014 and \$0.8 million at June 30, 2013. At June 30, 2014, vendor payables, made up largely of commissions due to video lottery participants, and prize obligations, attributable mostly to instant ticket games were \$12.5 million and \$7.9 million, respectively. In comparison, vendor payables and prize obligations at June 30, 2013 were \$13.9 million and \$7.2 million, respectively.

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

The deficit in net position reported at June 30, 2014, as previously explained, relates to the Lottery's immediate transfer, in a prior fiscal year, to the State's General Fund, of all proceeds received from the sale of its exclusive rights over the operation of its gaming systems.

### Lottery Operations

	<u>June 30, 2014</u>	<u>June 30, 2013</u>
Revenue:		
On-line games	\$ 158,810,169	\$ 168,360,807
Instant games	83,975,581	85,003,754
Video lottery, Net	507,056,712	520,747,106
Table games	88,108,367	1,881,238
Other income	<u>1,131,429</u>	<u>1,209,985</u>
Total revenue	<u>839,082,258</u>	<u>777,202,890</u>
Expenses:		
Cost of gaming operations	(451,679,526)	(390,103,599)
Operating expenses	<u>(10,473,985)</u>	<u>(7,521,824)</u>
Total expenses	<u>(462,153,511)</u>	<u>(397,625,423)</u>
Income before transfers	376,928,747	379,577,467
Transfers to State's General Fund	(376,327,120)	(379,224,717)
Transfers from RI Capital Plan Fund	<u>23,373</u>	<u>272,250</u>
Increase in net position	625,000	625,000
Total net position (deficit), beginning of year	(6,250,000)	(6,875,000)
Total net position (deficit), end of year	<u>\$ (5,625,000)</u>	<u>\$ (6,250,000)</u>

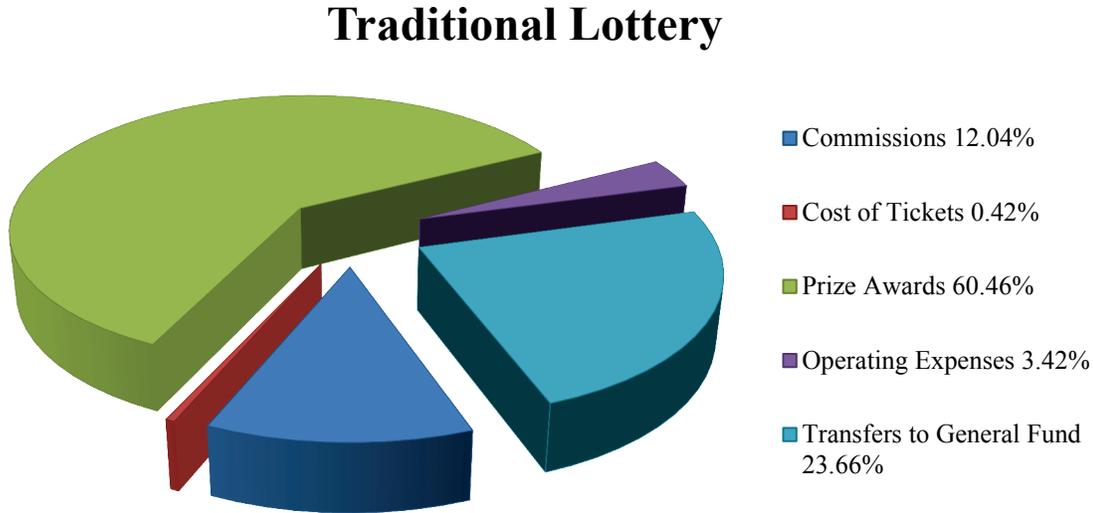
# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

### Revenue

#### Traditional Lottery

- Traditional Lottery games consist of on-line and instant ticket games. Distribution of the year's traditional lottery revenue was as follows:

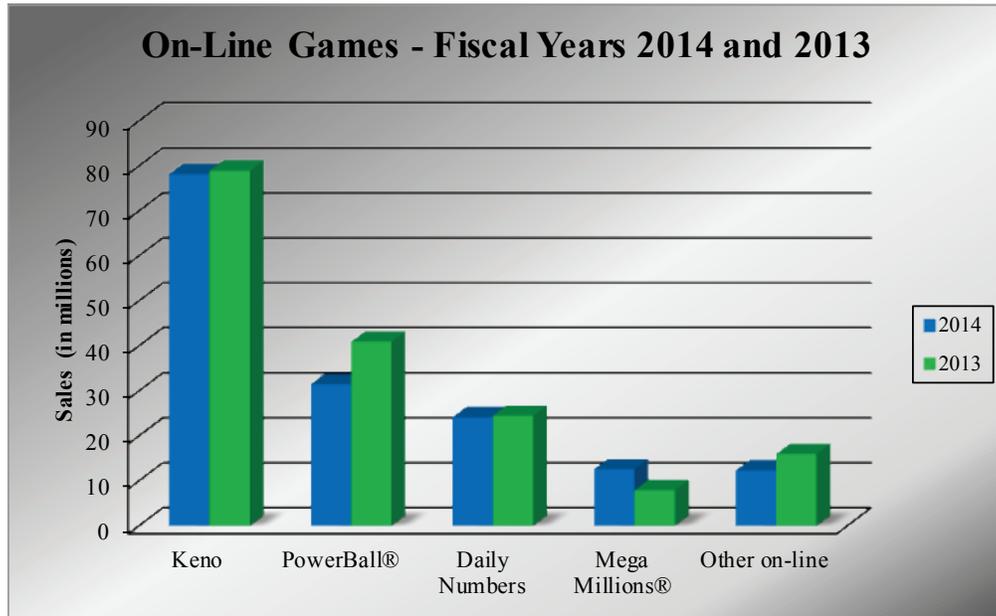


- On-line games offered were PowerBall<sup>®</sup>, Mega Millions<sup>®</sup>, Keno, Bingo, Daily Numbers, Wild Money and Lucky for Life<sup>®</sup> at June 30, 2014. In total, on-line revenue decreased by \$9.6 million. Significant changes in on-line game revenue from the prior year included:
  - The Raffle game which generated \$2.3 million in revenue for fiscal year 2013 was not offered in fiscal year 2014.
  - Revenue from Powerball<sup>®</sup> decreased \$9.5 million for fiscal 2014 over the prior year in large part from higher rolling jackpots in the prior year.
  - Revenue from Mega Millions<sup>®</sup> increased \$4.7 million for fiscal 2014 over the prior year mostly due to two large jackpots including a record \$636 million previously discussed.
  - Revenue from Lucky for Life<sup>®</sup> sales decreased \$2.0 million from the prior year.
- Instant ticket revenue for the fiscal year ended June 30, 2014 decreased slightly from the preceding fiscal year.

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

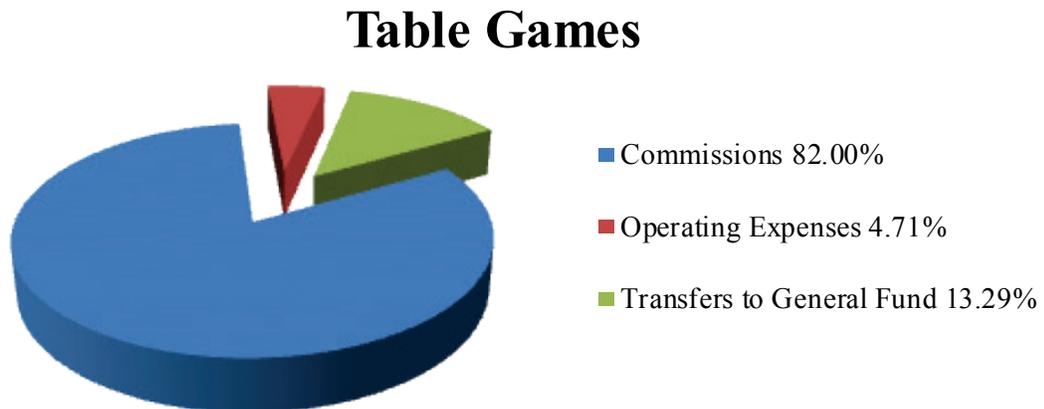
The following graph depicts the Lottery's on-line sales for the fiscal years ended June 30, 2014 and 2013.



### Table Games

- Table games were introduced at Twin River in Lincoln, Rhode Island in mid-June 2013. For the fiscal year ending June 30, 2014, net table game revenue was \$88.1 million. During the fiscal year ending June 30, 2014, the number of available gaming tables went from 66 to 80.

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



# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

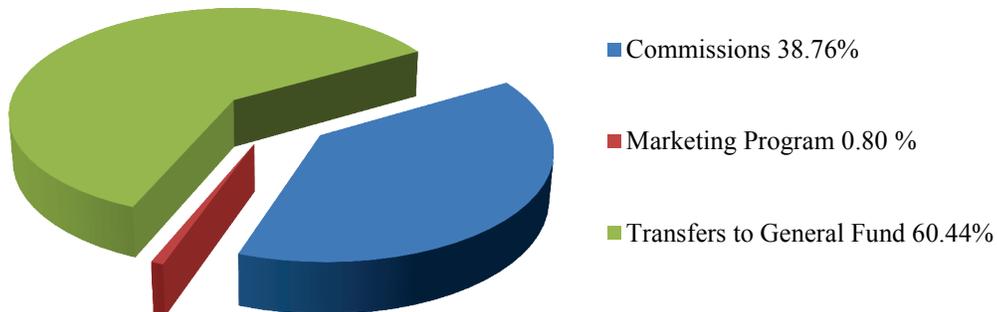
### Video Lottery

- Video lottery net revenue decreased \$13.7 million or 2.6% over the prior fiscal year. During fiscal year 2014, video terminal inputs (cash and credits transferred) decreased by \$164 million; and, patrons cashed out (terminal outputs) \$150 million less as compared to the prior year.

Video lottery net terminal income at both Twin River and Newport Grand trended down for fiscal 2014. Net terminal income at Twin River totaled \$462.4 million, a 2.2% decrease compared to fiscal 2013. Net terminal income at Newport Grand totaled \$44.7 million, a 7.2% decrease compared to fiscal 2013. Total terminal inputs (cash and credits played) decreased by \$164.1 million in fiscal 2014 as compared to fiscal 2013 while a related reduction in terminal outputs of \$150.3 million was noted between the fiscal years. The payout percentage (terminal outputs / terminal inputs) was comparable between the years and did not significantly impact net terminal income derived from operations between the years. While it is difficult to attribute the decrease in video lottery net terminal income to one specific reason, the decreases experienced at both facilities is consistent with those experienced in the regional market as a whole.

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

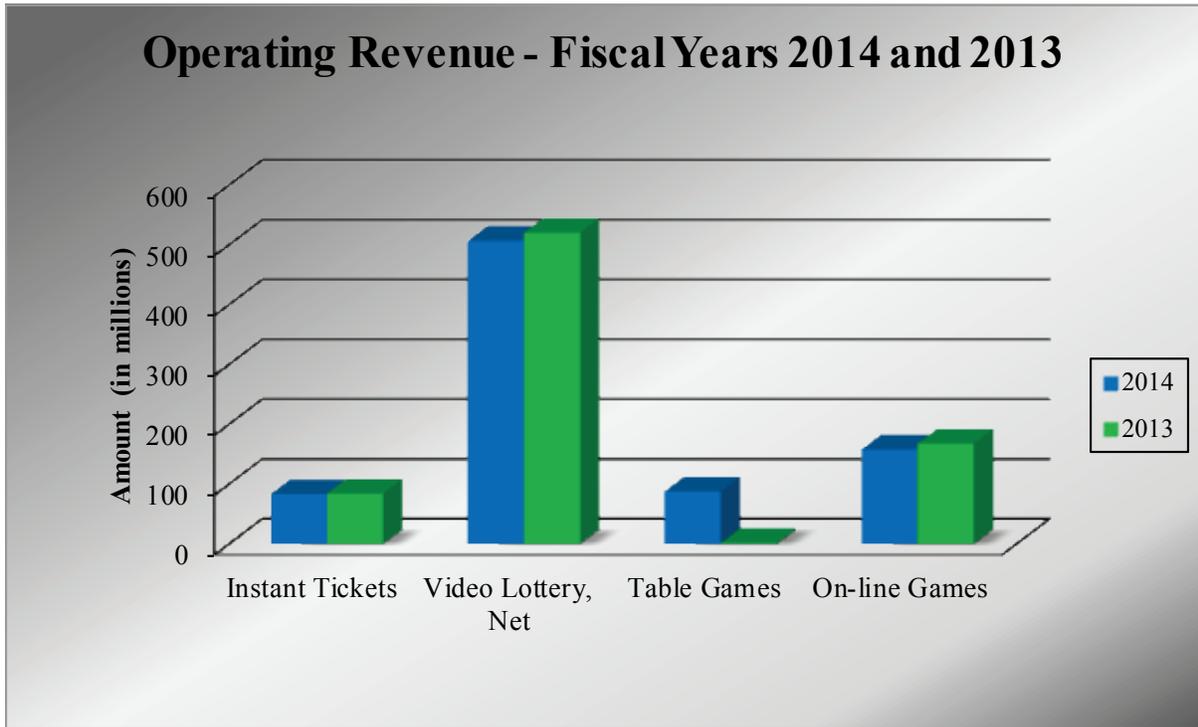
### **Video Lottery**



# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

The following graph depicts the Lottery's on-line, instant, table games, and video lottery operating revenue for the fiscal year ended June 30, 2014 in comparison to fiscal year ended June 30, 2013.

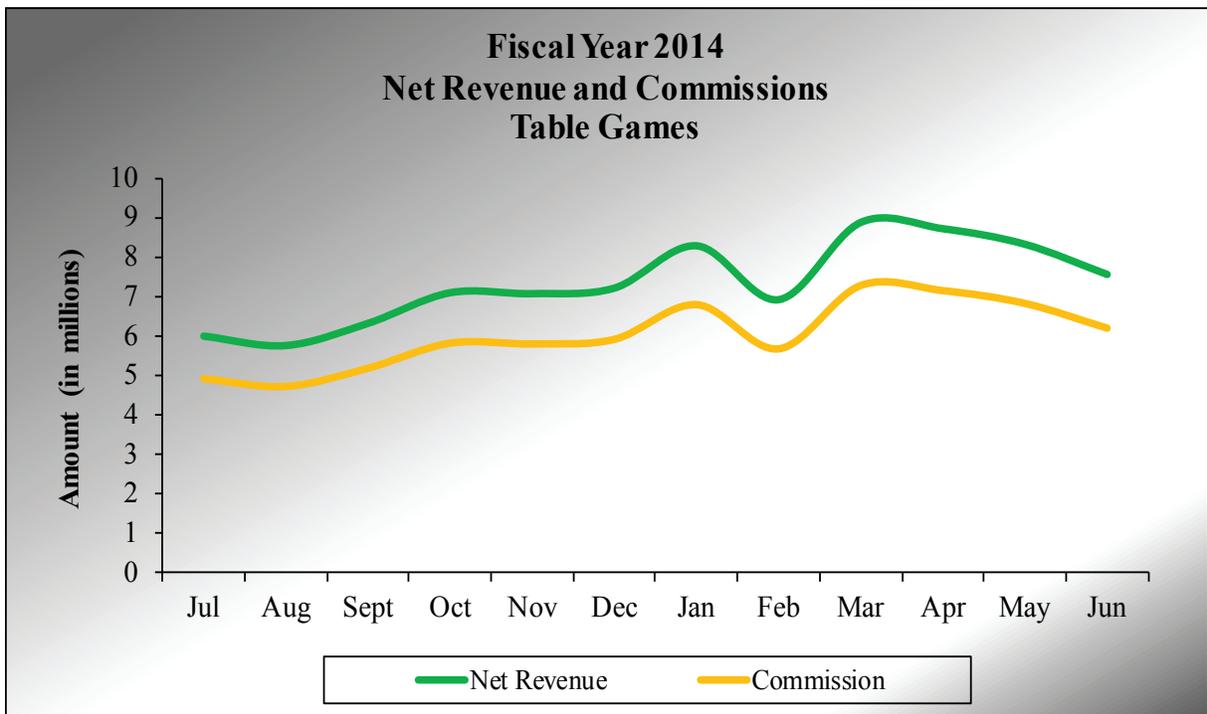
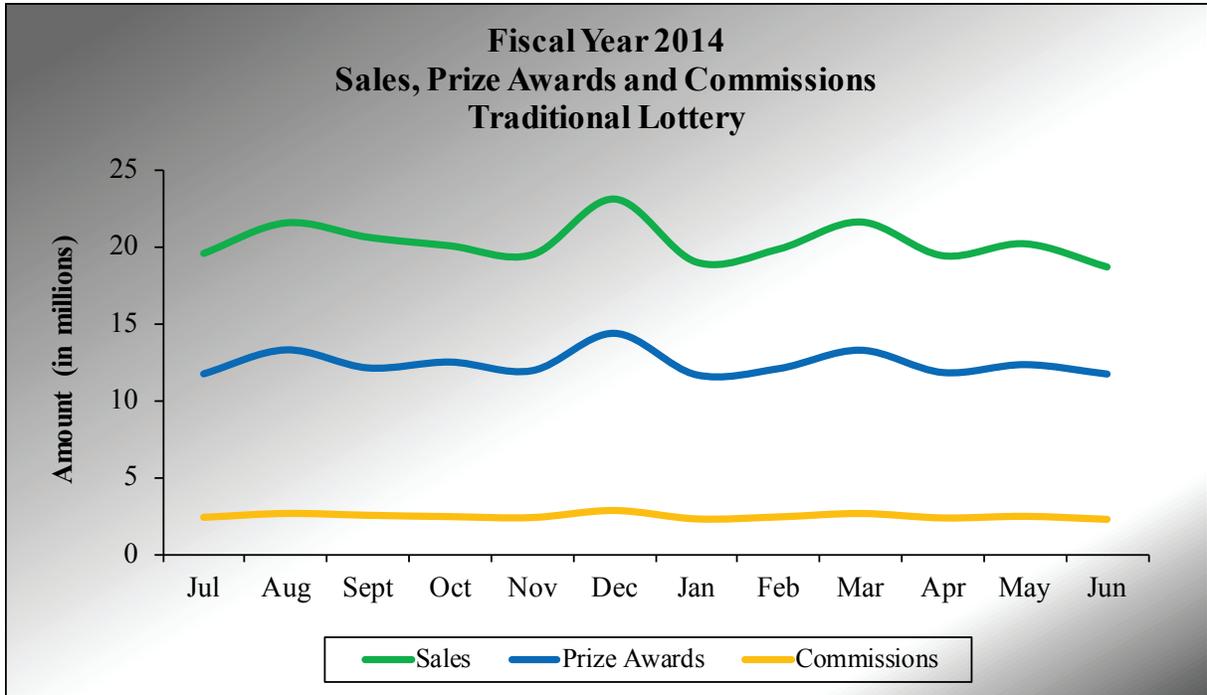


### Commissions and Prize Awards Expense

As the following graphs depict, the Lottery's most significant expenses (commissions and prize awards) are predictable because they have a direct correlation to sales. As lottery revenues increase, so do the related prizes and commissions paid by the Lottery. While each Lottery game has a designed prize payout structure, the overall amount paid as prize awards expense is consistent in relation to sales. The second and third graphs compare table games net revenue and video lottery net revenues to their related commissions.

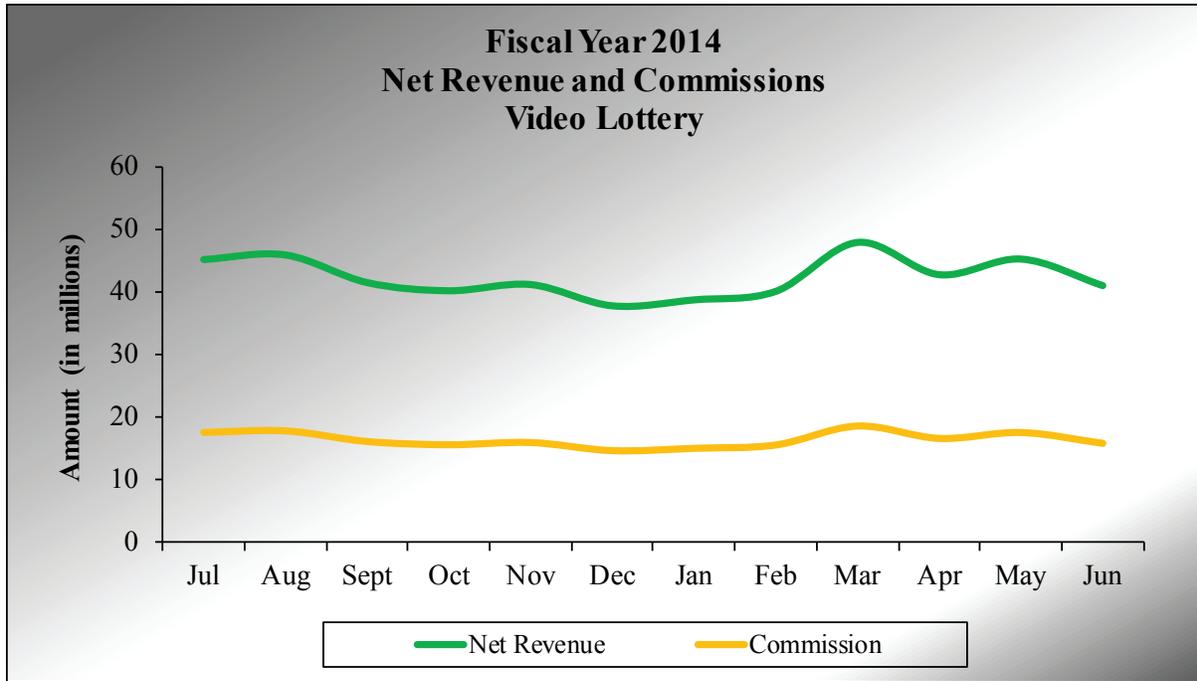
# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis



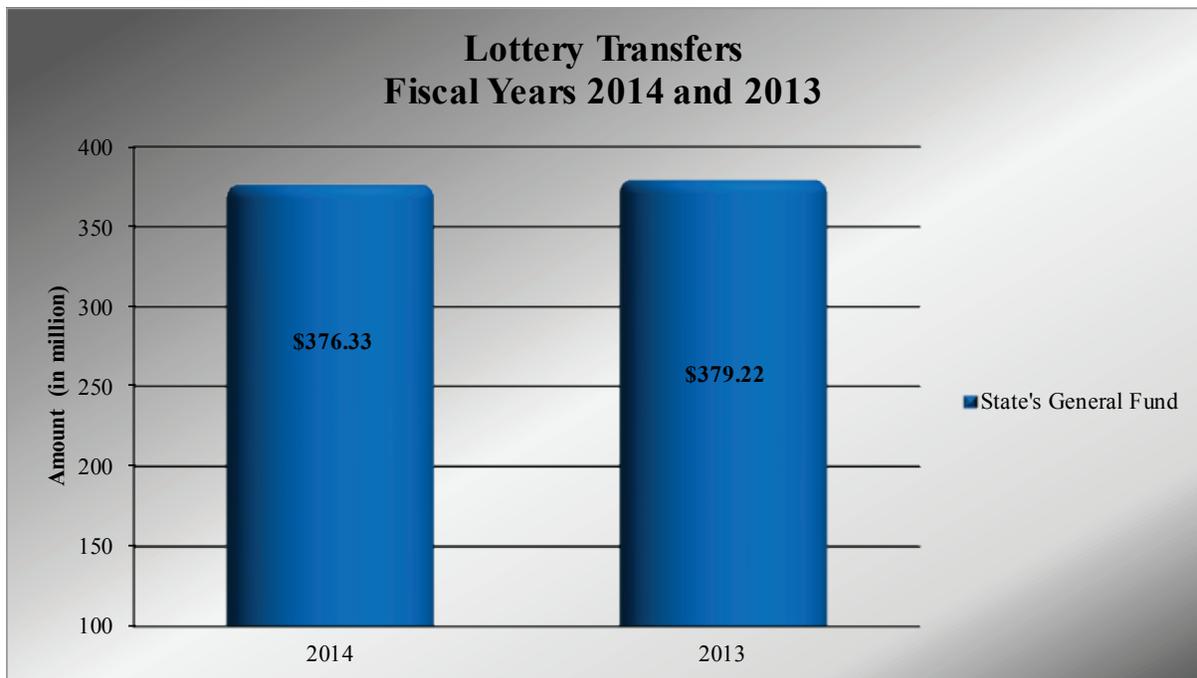
# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis



### Lottery Transfers

Net income transferred by the Lottery for the fiscal years ended June 30, 2014 and June 30, 2013 was \$376.3 million and \$379.2 million, respectively. All fiscal 2014 transfers were made by the Lottery directly to the State's General Fund, as required by the General Laws.



# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

### Debt Administration

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

As of September 2013, the Lucky for Life<sup>®</sup> regional game offers top and second prize winners an annuity or cash option payment. If selected by the winner, the Lucky for Life<sup>®</sup> regional game requires each selling lottery to purchase an insurance annuity to fully fund the top and second prizes won in that state. All participating lotteries share in the cost of the insurance annuity or cash option, however, the selling lottery is responsible for settling the top and second prize liabilities. Annuities shall be purchased in accordance with the applicable laws of the state purchasing the annuity. Qualified insurance companies must meet the minimum rating requirements established by each participating state. Rhode Island has not had a top prize winner to date but plans to purchase its annuities for any future top prize winners through MUSL with an insurance company with an AM Best rating of A or better. Rhode Island has purchased its second prize winners' annuities through MUSL in accordance with insurance company rating requirements.

### Capital Assets

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

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

### Potential Factors Impacting Future Operations

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

- Master video lottery contracts and amendments thereto with its video lottery facilities, Twin River and Newport Grand include provisions for the continued operation of promotional play programs where the facilities reward patrons with free video terminal play up to an amount authorized by the Lottery. These agreements also require the Lottery to reimburse the facilities for its net terminal income share of certain qualified marketing and promotional expenses. These agreements provide significant incentives for the facilities to continue to invest appropriately in the promotion of their facilities and the Lottery's video and table games activities. See Note 12 to the financial statements for details regarding these agreements.

# RHODE ISLAND LOTTERY

## Management's Discussion and Analysis

- The Lottery's gaming operations currently compete with casinos in nearby Connecticut. In addition, Massachusetts's law makers passed legislation allowing three resort-style casinos and one slot parlor in the State. Massachusetts has divided the State into three regions and accepted license applications for each. The regions include Eastern Massachusetts (region A), Western Massachusetts (region B), and Southeastern Massachusetts (region C) as category 1 resort-style casino licenses. The Western Massachusetts (region B) category 1 license was awarded in June 2014 and the Eastern Massachusetts (region A- Greater Boston) category 1 license was awarded in September 2014. The category 1 license award in the Southeastern Massachusetts (region C) is anticipated to be awarded in August 2015. Additionally, a category 2 slots only license was awarded in February 2014. In November 2014, Massachusetts voters will consider a statewide ballot referendum to reverse the prior approval of casino gaming. The Lottery and the State continually monitor the risk to gaming operations resulting from competition in nearby states.
- The General Laws delineating the allocation of net table game revenue between Twin River Casino and the State included modification of the commission percentage for Twin River Casino and the Town of Lincoln subsequent to the first full year video lottery net terminal income decreases after the implementation of table games. For the fiscal year ending June 30, 2014, net terminal income at Twin River decreased from the prior year. This results in the State's share of fiscal year 2015 net table game revenue decreasing by 2% to 16%, and an additional 1% going to Twin River and an additional 1% going to the Town of Lincoln. The additional 1% to the Town of Lincoln is payable through June 30, 2018 when this 1% will be paid to Twin River.
- In fiscal year 2014, Newport Grand entered into a purchase and sale agreement of its state-licensed video lottery facility. Recent legislation authorizes a statewide and local majority on the November 2014 ballot to authorize casino gaming including table games upon passage. The sale is contingent on the passage of casino gaming in Newport Rhode Island and subject to regulatory approval.

### Contacting the Lottery's Financial Management

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

# RHODE ISLAND LOTTERY

## Statement of Net Position

June 30, 2014

### Assets

#### Current assets:

Cash and cash equivalents (note 3)	\$	18,563,846
Accounts receivable-less allowance for doubtful accounts of \$100,363		6,543,195
Deposits with Multi-State Lottery Association (MUSL) (note 1)		42,042
Prepaid Expense		3,375
Ticket inventory		695,658
Total current assets		25,848,116
Capital assets, net (note 4)		460,135
Total assets		26,308,251

### Liabilities

#### Current liabilities:

Due to State's General Fund - net income from operations (note 5)	\$	270,580
Due to State's General Fund - operating expenses (note 5)		270,308
Accounts payable		12,520,990
Obligation for unpaid prize awards		7,907,347
Accrued expenses		4,484,411
Compensated absences (note 7)		208,938
Advances for future drawings		221,162
Unearned contract revenue (note 8)		625,000
Other current liabilities		137,156
Total current liabilities		26,645,892

#### Long-term liabilities:

Compensated absences (note 7)		287,359
Unearned contract revenue (note 8)		5,000,000
Total long-term liabilities		5,287,359
Total liabilities		31,933,251

### Net Position

Net position, net investment in capital assets (note 8)		460,135
Unrestricted (deficit) (note 8)		(6,085,135)
Total net position (deficit)	\$	(5,625,000)

See accompanying notes to financial statements.

## RHODE ISLAND LOTTERY

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

Year Ended June 30, 2014

Operating Revenue (schedule 1):	
On-line games	\$ 158,810,169
Instant games	83,975,581
Video lottery (note 2)	507,056,712
Table games (note 2)	88,108,367
	<hr/>
Total revenue	837,950,829
	<hr/>
Cost of gaming operations (schedule 1):	
Commissions (note 6)	298,517,746
Prize awards, online and instant games	148,570,701
Incentive programs, video lottery	4,070,183
Advertising	2,089,016
Unclaimed prize recovery	(2,611,675)
Cost of tickets	1,043,555
	<hr/>
Total cost of gaming operations	451,679,526
	<hr/>
Gross profit	386,271,303
	<hr/>
Operating expenses:	
Personal services	9,438,106
Contract services	56,822
Depreciation and amortization	114,087
Other	864,970
	<hr/>
Total operating expenses	10,473,985
	<hr/>
Operating income	375,797,318
	<hr/>
Non-operating income (expenses):	
Investment income	108,350
Other income (expenses)	1,023,079
	<hr/>
Income before transfers	376,928,747
	<hr/>
Transfers to State's General Fund (note 5)	(376,327,120)
Transfers from RI Capital Plan Fund	23,373
	<hr/>
Increase in net position	625,000
	<hr/>
Total net position (deficit), beginning of year	(6,250,000)
	<hr/>
Total net position (deficit), end of year (note 8)	\$ (5,625,000)
	<hr/>

See accompanying notes to financial statements.

## RHODE ISLAND LOTTERY

### Statement of Cash Flows

Year Ended June 30, 2014

Cash flows from operating activities:	
Receipts from lottery sales, online and instant games	\$ 243,577,754
Receipts from video lottery operations	507,056,712
Receipts from table games	88,108,367
Receipts from MUSL for grand prize winners	2,333,000
Receipts from MUSL for Lucky for Life <sup>®</sup> top prize winners	711,604
Receipts for problem gambling program	100,000
Receipts from sale of other tickets	67,069
Other receipts	347,042
Payments for on-line and instant ticket prizes	(145,938,994)
Payments to MUSL grand prize winners	(2,333,000)
Payments for commissions - retailers	(8,932,729)
Payments for commissions - video lottery	(196,559,997)
Payments for commissions - table games	(73,602,436)
Payments to facilities - video lottery incentive program	(4,079,733)
Payments for commissions - on-line games contractor	(20,642,722)
Payments to suppliers for goods and services	(4,286,788)
Payments to employees for services	(9,331,812)
Net cash provided by operating activities	<u>376,593,337</u>
Cash flows from noncapital financing activities:	
Transfers to State's General Fund	(376,903,899)
Transfers from RI Capital Plan Fund	23,373
Net cash used for noncapital financing activities	<u>(376,880,526)</u>
Cash flows from capital and related financing activities:	
Purchase of capital assets	<u>(171,934)</u>
Net cash used for capital and related financing activities	<u>(171,934)</u>
Cash flows from investing activities:	
Interest income	<u>108,350</u>
Net cash provided by investing activities	<u>108,350</u>
Net decrease in cash and cash equivalents	(350,773)
Cash and cash equivalents at July 1, 2013	<u>18,914,619</u>
Cash and cash equivalents at June 30, 2014	<u>\$ 18,563,846</u>

See accompanying notes to financial statements.

Continued.

## RHODE ISLAND LOTTERY

### Statements of Cash Flows (Continued)

Year Ended June 30, 2014

Reconciliation of operating income to net cash provided by operating activities:	
Operating income	<u>\$ 375,797,318</u>
Adjustments to reconcile operating income to net cash provided by (used for) operating activities:	
Depreciation and amortization	114,087
Miscellaneous receipts classified as operating activities	50,822
Rental income and other receipts	347,256
(Increase) decrease in assets:	
Accounts receivable	782,663
Deposits with MUSL	(214)
Prepaid expense	(3,375)
Inventory	2,939
Increase (decrease) in liabilities:	
Due to State's General Fund - operating expenses	(83,124)
Accounts payable	(1,420,567)
Obligation for unpaid prize awards	729,137
Accrued expenses and other	273,172
Advances for future drawings	<u>3,223</u>
Total adjustments	<u>796,019</u>
Net cash provided by operating activities	<u><u>\$ 376,593,337</u></u>

See accompanying notes to financial statements.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (1) Organization

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

The Lottery offers the following games to the public:

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

- i) Traditional in-state drawing games including Daily Numbers – Midday and Evening, Keno, Bingo, and Wild Money. The drawings for these games are administered by the Rhode Island Lottery and offer patrons set prize amounts or smaller progressive jackpots. Keno and Bingo are considered monitor games where drawings are held every 4 or 8 minutes, respectively, on “monitors” in sales locations across the State.
- ii) Multi-state games, which include PowerBall<sup>®</sup> and Mega Millions<sup>®</sup>, which are operated in accordance with rules and agreements established by the Multi-State Lottery Association (MUSL). These games offer jackpot prize awards to patrons in participating states. Specific details regarding the operations of these games are as follows:

##### (a) *PowerBall*<sup>®</sup>

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

The prize pool for PowerBall<sup>®</sup> is 50% of each drawing period's ticket sales. MUSL may place up to 5% of each drawing period's ticket sales for PowerBall<sup>®</sup>, included as part of each member's prize liability, in prize reserve funds. The prize reserve deduction begins at 2% when an annuity jackpot exceeds \$120 million and 4% when an annuity jackpot exceeds \$250 million. The maximum balance on the prize reserve funds for PowerBall<sup>®</sup> is \$80 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.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(1) Organization - (Continued)

At June 30, 2014, the prize reserve funds for the PowerBall<sup>®</sup> game reported a balance of \$76.3 million of which the Lottery's share was \$1.0 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. The Lottery has recorded all income and operating expenses related to its unreserved account and has reported the balance of \$42,042 at June 30, 2014 on the Statement of Net Position in "Deposits with MUSL".

(b) *Mega Millions*<sup>®</sup>

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

- iii) Lucky for Life<sup>®</sup>, a regional game operates under an agreement between the six New England states ("Party Lotteries") to offer a game with a top prize of \$1,000 per day for life. A new second tier prize offer of \$25,000 a year for life was introduced in 2014. The Lottery sells Lucky for Life<sup>®</sup> tickets, collects all revenues, and pays prizes based on its share of total sales, as a party lottery operating the regional game. The party lotteries have entered into an agreement with MUSL to administer certain aspects of the game. MUSL communicates and collects the share of prize amounts owed by each party lottery. The top prize and second prize is paid in accordance with official game rules and is shared based on each state's percentage of sales in proportion to the total top prize liability. Total low-tier prizes are shared based on a percentage of sales in proportion to the total low-tier prize liability.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (1) Organization - (Continued)

#### Top Prize Settlement

All top prizes are funded through the purchase of insurance annuities with an alternative cash option which was added in September 2013. For the annuity option top prizes are based on a \$365,000 deferred annuity paid annually based on the winner's natural life with a minimum payment period of 20 years. If there is more than one top prize winner, up to 14 winners, the annuitized prize will be split equally, including the number of top prize winners exercising the cash option, with a minimum value of \$500 per week to each winner exercising the annuity option.

For top prizes claimed in Rhode Island, the Lottery will utilize MUSL to purchase insurance annuities to satisfy the prize liability. The Lottery has adopted the following minimum qualification requirements for insurance companies providing insurance annuities for top prize winners:

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

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

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

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

#### Second Tier Prize Settlement

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

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(1) Organization - (Continued)

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

All low-tier prizes (all levels except the top prize and second prizes) are paid in one lump sum cash payment through the Selling Lottery. There is a reconciliation by the Game Administrator for both low-tier and unclaimed expired prizes (prize levels 2-10) when a party lottery varies from its projected prize liabilities and its unclaimed expired prizes.

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

(C) Video lottery games are operated through 5,637 video lottery terminals (VLTs) at two licensed facilities, Twin River and Newport Grand. Video lottery offers various virtual and multi-layer display games, hosting a wide array of card and theme games to the public.

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

(D) Table games are operated at the Twin River Casino in Lincoln, Rhode Island. Chapter 42-61.2 of the General Laws authorizes the State to operate casino gaming, and the Lottery Division to promulgate rules and regulations and set policy for table gaming. This chapter stipulates the allocation of net table game revenue. Consistent with the General Laws, net table game revenue derived from Twin River is deposited in the State Lottery Fund for administrative purposes with commissions distributed to Twin River (82% of net table game revenue for fiscal year 2014), and the balance being remitted to the General Fund. Consistent with the general laws, subsequent to the first full State fiscal year that video net terminal income is less than the prior year, the commissions distributed to Twin River Casino are 83% and to the Town of Lincoln, RI are 1% through June 30, 2018, at which point the commission to Twin River Casino is 84%.

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.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(1) Organization - (Continued)

<u>Game</u>	<u>Prize Payout</u>	<u>Mandated Payments to the State</u>
Daily Numbers Instant Ticket Games PowerBall® Mega Millions® Wild Money Lucky for Life® Bingo	Not less than 45% or more than 65% of sales	Payments to the General Fund – net of prizes, commissions, administrative and operating expenses.
Keno	Not less than 45% or more than 72% of sales	Payments to the General Fund – net of prizes, commissions, administrative and operating expenses.
Video Lottery	Prize payout not established by law	Payments to the General Fund - net terminal income (video lottery credits purchased less credits redeemed or redeemable, including prize contributions to multi-state video lottery progressive jackpots) minus commission payments and incentive program reimbursements.
Table Games	Prize payout not established by law	Payments to the General Fund - net table game revenue minus commission payments and table game administrative and operating expenses.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (2) Summary of Significant Accounting Policies

#### (a) *Basis of Accounting*

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

The Lottery has considered the impact and requirements of newly effective GASB Statements in the preparation of these financial statements. Specifically, the application of GASB Statement No. 65 – *Items Previously Reported as Assets and Liabilities* resulted in no amounts that were required to be reported as deferred inflows or outflows of resources for fiscal 2014.

#### (b) *Reporting Entity*

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

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

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

The Lottery defines all revenues and expenses deriving from on-line, instant ticket, video lottery, and table games as operating. The Lottery accrues for the maximum prizes payable. Prize obligations, other than those relating to prizes payable in installments, that remain unclaimed one year after the drawing date are reported as a reduction to cost of sales.

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

1. On-line lottery games with specific drawing dates - when the related drawings are held. For the Mega Millions<sup>®</sup> and Powerball<sup>®</sup> games, prize awards expense is recorded equal to the required contributions to the jackpot pool and low-tier prizes won. For the Lucky for Life<sup>®</sup> game, prize awards expense is recorded equal to the estimated cost of actual prizes won. Prize awards expense is subsequently adjusted based on the Lottery's share of purchased annuities for the top prize and a settlement for actual low tier prizes won in all participating states.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

2. Instant ticket lottery games - when ticket packets are charged to retailers. Prize expense is recognized in proportion to the number of tickets sold based on the stated prize structure for a specific instant ticket game.
3. Video lottery games - are reported on a net basis. Gross revenue is recognized when game credits are purchased via cash or credit redemption at the terminal (gross terminal inputs). Related prizes are recognized when game credits are issued by a video lottery terminal making them redeemable as credits in another video terminal or for cash by a patron (gross terminal outputs).

The gross video lottery terminal inputs and outputs for fiscal 2014 and reported video lottery net revenue are detailed in the following schedule:

<b>Schedule of Video Lottery Net Revenue For the Fiscal Year Ended June 30, 2014</b>	
<b>Video Terminal Cash-In (Gross Terminal Inputs):</b>	
Cash collected from video lottery terminals	\$ 1,470,158,673
Plus: Credit vouchers redeemed for play in video lottery terminals	<u>1,811,079,883</u>
Total cash in reported by video lottery terminals	3,281,238,556
<b>Less:</b>	
<b>Video Terminal Cash-out (Gross Terminal Outputs):</b>	
Video lottery credit vouchers issued by video lottery terminals	2,773,955,394
Plus: Contributions to progressive video jackpots from patron play	<u>226,450</u>
Total cash-out amounts reported by video lottery terminals	<u>2,774,181,844</u>
Video lottery revenue, net	<u><u>\$ 507,056,712</u></u>

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

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

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

All other revenues and expenses are defined as non-operating. Non-operating revenues include income from pull tab tickets (the Lottery is not responsible for prizes won), rental income, and refunds from the Multi-state Lottery Association.

(d) *Capital Assets*

Capital assets are stated at historical cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets. Asset and useful lives are as follows:

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

In addition, the Lottery capitalizes certain intangible assets and amortizes those assets over their expected benefit period. Beginning in fiscal year 2013, the Lottery adopted the State's capitalization threshold and useful lives for capital asset categories.

(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.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

(g) *Advances for Future Drawings*

Tickets can be purchased in advance of scheduled drawing dates. Revenue from advance ticket sales is recognized during the period in which the related drawing is held.

(h) *Unearned Contract Revenue*

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

(i) *Incentive Programs – Video Lottery*

The Lottery reimburses its contracted video lottery facilities for the State's share (net terminal income percentage) of certain marketing and promotional expenses incurred by the facilities. Complete details of the Lottery's reimbursement are disclosed in Note 12, Commitments.

(j) *Compulsive and Problem Gambling Program*

Pursuant to section 42-61.2-14 of the Rhode Island General Laws, the Lottery is required to establish a program for compulsive and problem gamblers in conjunction with Twin River and Newport Grand to include awareness, player self-exclusion, and promotion of a problem gambling hotline. The program is funded through aggregate reimbursements made by Twin River and Newport Grand totaling not less than \$100,000 annually. At June 30, 2014, the Lottery, included \$50,064 in accrued expenses representing the unexpended portion of the annual reimbursements from the facilities for the compulsive and problem gambling program.

(k) *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.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (3) Deposits and Investment Risk

#### (a) *Deposits*

The Lottery's cash deposit balances at June 30, 2014 totaled \$10,781,427, with corresponding bank balances totaling \$10,755,401. The bank balances consisted of \$941,819 in demand deposit accounts and \$9,813,582 in collateralized deposit investment accounts.

All deposits were in the custody of the State General Treasurer. Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are (a) uncollateralized, (b) collateralized with securities held by the pledging financial institution, or (c) collateralized with securities held by the pledging financial institution's trust department or agent but not in the Lottery's (or State's) name.

In accordance with Chapter 35-10.1 of the General Laws, depository institutions holding deposits of the State, its agencies or governmental subdivisions of the State, shall at a minimum, insure or pledge eligible collateral equal to one hundred percent of time deposits with maturities greater than 60 days. Any of these institutions which do not meet capital standards prescribed by federal regulators shall insure or pledge eligible collateral equal to 100% of deposits, regardless of maturity. None of the cash deposits of the Lottery were required to be collateralized at June 30, 2014 pursuant to Chapter 35-10.1 of the General Laws. However, the State Investment Commission has adopted a collateralization requirement for institutions holding the State's deposits. Financial institutions are required to pledge collateral equal to 102% of the uninsured deposit amounts. Of the total bank deposit balance totaling \$10,755,401 at year-end, the entire amount was either covered by federal depository insurance or collateralized by securities held by an independent third party custodian.

#### (b) *Investments*

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."

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

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

At June 30, 2014, the Lottery had investments consisting of \$7,782,419 in the Ocean State Investment Pool Trust (OSIP), an investment pool established by the State General Treasurer. The Lottery's investment accounted for less than 2% of the total investment in OSIP at June 30, 2014. Agencies, authorities, commissions, boards, municipalities, political subdivisions, and other public units of the State may invest in OSIP. OSIP operates in a manner consistent with SEC Rule 2a-7 like pools and thus, reports all investments at amortized cost rather than fair value. The OSIP is not rated and the weighted average maturity of investments held in the pool, by policy, is not to exceed 60 days. OSIP issues a publicly available financial report that can be obtained by writing to the Office of the General Treasurer, Finance Department, 50 Service Avenue - 2<sup>nd</sup> Floor, Warwick, RI 02886.

Custodial Credit Risk: Investment securities are exposed to custodial risk if the securities are uninsured, are not registered in the name of the government and are held by either: a) the counterparty or b) the counterparty's trust department or agent but not in the government's name.

Pursuant to guidelines established by the SIC, securities purchased, or underlying collateral, are required to be delivered to an independent third party custodian.

Interest Rate Risk: Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Based on SIC policy, the State's short-term investment portfolio, whenever possible, will be structured to minimize interest rate risk, by matching the maturities of investments with the requirements for funds disbursement. The Lottery's investments are typically money market mutual funds or investments with maturities less than 30 days thereby minimizing the Lottery's exposure to interest rate risk.

Credit Risk: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The SIC has adopted policies regarding acceptable short-term investment types. Credit risk is mitigated by the SIC's minimum rating criteria policy, collateralization requirements, and limiting the maximum participation by any one issuer to 35% of the State's total short-term investment portfolio. Credit risk policies have been developed for investments in commercial paper.

Concentration of Credit Risk: The SIC has adopted limitations as to the maximum percentages of the State's total short-term investment portfolio that may be invested in a specific investment type or with any one issuer of securities.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(3) Deposits and Investment Risk – (Continued)

(c) Cash and Cash Equivalents

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

Cash deposit balance per books	\$ 10,781,427
Investments classified as cash equivalents	<u>7,782,419</u>
 Cash and cash equivalents	 <u>\$ 18,563,846</u>

(4) Capital Assets

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

A summary of capital assets follows:

	Estimated Useful Life	Balance at June 30, 2013	2014 Additions	2014 Disposals	Balance at June 30, 2014
<u>Cost</u>					
Building	50	\$ 1,437,912			\$ 1,437,912
Building improvements	20	1,944,601			1,944,601
Ticket production equipment	5	11,486			11,486
Office equipment	5	101,237			101,237
Furniture and fixtures	5	90,856			90,856
Lottery drawing equipment	5	99,402			99,402
Automobiles	5	315,673	171,934	(60,863)	426,744
Computer equipment	5	179,692		(9,997)	169,695
Trucks	5	22,445			22,445
Intangible Assets	7	175,424			175,424
Total		<u>\$ 4,378,728</u>	<u>\$ 171,934</u>	<u>\$ (70,860)</u>	<u>\$ 4,479,802</u>
 <u>Less: Accumulated Depreciation and Amortization</u>					
Building		\$ 1,437,912			\$ 1,437,912
Building improvements		1,838,795	4,273		1,843,068
Ticket production equipment		11,486			11,486
Office equipment		56,387	44,848		101,235
Furniture and fixtures		90,856			90,856
Lottery drawing equipment		97,644	752		98,396
Automobiles		234,403	37,246	(60,863)	210,786
Computer equipment		171,893	1,908	(9,997)	163,804
Trucks		22,445			22,445
Intangible Assets		14,619	25,060		39,679
Total		<u>\$ 3,976,440</u>	<u>\$ 114,087</u>	<u>\$ (70,860)</u>	<u>\$ 4,019,667</u>
Capital assets, net		<u>\$ 402,288</u>	<u>\$ 57,847</u>	<u>\$ -</u>	<u>\$ 460,135</u>

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(5) Transfers to the State

- (a) The Lottery is required to transfer net proceeds from the Lottery's games in accordance with RI General Laws sections 42-61-15 and 42-61.2-7. Transfers to the State's General Fund for fiscal 2014 are reported as follows in the Lottery's financial statements:

Due to State's General Fund, beginning of year	\$ 847,359
Transfers to State's General Fund	376,327,120
Cash paid during fiscal year	<u>(376,903,899)</u>
Due to State's General Fund, end of year	<u>\$ 270,580</u>

The General Assembly recently modified the requirements for transfers to the State general fund in anticipation of GASB Statement No. 68, *Accounting and Financial Reporting for Pensions- an amendment of GASB Statement No. 27*, becoming effective in fiscal 2015. Beginning in fiscal 2015, the Lottery will still be mandated to transfer net income to the State's general fund based on pension expense reflecting the Lottery's actual contributions (which is the actuarially determined contribution required to be made by law) to the State Employees' pension plan. Pension expense reported in the Lottery's financial statements in accordance with GASB 68 will be a different amount reflecting the change in the net pension liability during the fiscal year.

- (b) The Lottery also reimburses the State's General Fund for a variety of operating expenses associated with personnel costs, information technology resources, utilities, etc. Amounts owed to the General Fund at year-end for operating expenses totaled \$270,308. This amount is reported on the Statement of Net Position separate of amounts due to the State's General Fund-net income from operations.

(6) Commissions

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

The General Laws provide for reductions of certain video lottery commissions. The amount reduced is to be credited to the State's Distressed Communities Relief Fund, which is part of the State's General Fund. The Lottery has reflected the actual video commissions paid as an expense. The amount to be credited to the Distressed Communities Relief Fund is included in the payments to the State's General Fund.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(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 \$496,297 as of June 30, 2014 and is recorded as a liability in the Statement of Net Position. The current portion of \$208,938 as reported was estimated based on a three year average of employee utilization experience.

Changes in the reported liability for compensated absences for fiscal 2014 are as follows:

	Balance at July 1, 2013	Increase	Decrease	Balance at June 30, 2014
Liability for Compensated Absences	\$390,002	\$325,190	\$218,895	\$ 496,297

(8) Net Position - (Deficit)

On May 12, 2003, the Lottery entered into a 20-year contract, effective July 1, 2003, with its gaming system provider. The contract granted the provider the right to be the Lottery's exclusive vendor of hardware and software, together with the related services necessary for the operation of the Lottery's computerized games, through June 30, 2023. In return, the provider made a one-time payment of \$12.5 million to the Lottery as consideration for this exclusive contract right. The Lottery recorded unearned contract revenue in the amount of \$12.5 million and transferred the cash to the State's General Fund on June 30, 2003. This prior year transfer of unearned contract revenue resulted in a deficit in net position at June 30, 2014 of \$5.63 million. As the contract revenue is recognized over the twenty-year life of the contract, the deficit in net position will be reduced by \$625,000 per year. Accordingly, the Lottery has recognized \$625,000 as the current portion of unearned revenue as of June 30, 2014.

Net position reported by the Lottery also includes its net investment in capital assets. The Lottery had no debt related to capital assets at June 30, 2014.

(9) Retirement Plan

The State administered retirement system includes both defined benefit and defined contribution plan components.

*Defined Benefit Plan Description:*

All Lottery employees participate in a cost-sharing multiple-employer defined benefit pension plan administered by the State of Rhode Island Employees' Retirement System (ERS). The plan provides retirement and disability benefits and death benefits to plan members and beneficiaries. The level of benefits provided to state employees is established by Chapter 36-10 of the General Laws, which is subject to amendment by the General Assembly.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (9) Retirement Plan - (Continued)

#### *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. The Lottery employees are required to contribute 3.75% of their annual covered salary. The Lottery is required to contribute at an actuarially determined rate; the rate 23.05% of annual covered payroll for the fiscal year ended June 30, 2014. The Lottery contributed \$1,127,463, \$730,252, and \$728,878 for the fiscal years ended June 30, 2014, 2013 and 2012, respectively, equal to 100% of the required contributions for each year.

#### *New Accounting Guidance Effective For Fiscal 2015:*

GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, is effective for fiscal 2015 and is applicable for employees participating in a cost-sharing multiple employer plan such as ERS. The Lottery will be required to restate beginning net position as of July 1, 2014 to recognize the employer's proportionate share of the plan's net pension liability. Pension expense reported in the Lottery's financial statements will reflect the change in the net pension liability for the fiscal year.

#### *Defined Contribution Plan Description:*

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

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

The Lottery contributed \$48,914 and \$34,479 for the fiscal years ended June 30, 2014 and 2013 (which was the first year of the defined contribution plan), respectively, equal to 100% of the required contributions for these years.

The ERS issues a publicly available financial report that includes financial statements and required supplementary information for plans administered by the system. The report may be obtained by writing to the Employees' Retirement System of Rhode Island, 50 Service Avenue, Warwick, RI 02886.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (10) Postemployment Healthcare Plan

#### *Plan Description:*

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

Pursuant to legislation enacted by the General Assembly, a trust has been established to accumulate assets and pay benefits and other costs associated with the system.

The OPEB system issues a stand-alone financial report. A copy can be obtained from the State Controller's Office, 1 Capitol Hill, Providence, RI 02908.

#### *Funding Policy*

RIGL Sections 36-12.1, 36-12-2.2, and 36-12-4 govern the provisions of the OPEB System. The contribution requirements of plan members, the State, and other participating employers are established and may be amended by the General Assembly. Active employees make no contribution to the OPEB plan. Employees who retired after October 1, 2008 must contribute 20% of the annual estimated benefit cost (working rate) or annual premium for Medicare supplemental coverage. Employees retiring before October 1, 2008 have varying co-pay percentages ranging from 0% to 50% based on age and years of service at retirement. Further information about the contributions of plan members can be found in the financial report of the OPEB System.

For fiscal 2014, employers were required to contribute 7.07% of covered payroll. The employer required contribution rate is determined on an actuarially determined basis consistent with a funding approach outlined in the General Laws and as adopted by the OPEB System Board. The Lottery fully funded its required contribution to the plan for the years ended June 30, 2014, 2013 and 2012 which were \$345,821, \$236,522 and \$218,485 respectively.

### (11) Deferred Compensation

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

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (12) Commitments

- (a) Gaming Systems Provider – 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%

The Lottery also leases to the vendor a portion of its headquarters to house the computer hardware and office space necessary for the operation of the Lottery's games. The term of the lease is five (5) years, commencing October 19, 2012 and the square footage leased is 5,101 square feet. The annual lease amount for the first year approximated \$117,000 and the four (4) remaining years will increase by four percent (4%) per annum, effective October 19. The tenant has one (1) four (4) year term renewal option. The base rate for the renewal options will be an increase of four percent (4%) per annum unless a mutually acceptable rate is negotiated.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (12) Commitments – (Continued)

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

On July 18, 2005, the Lottery entered into a five (5) year Master Video Lottery Terminal Contract with UTGR, Inc. (UTGR), the owners of Twin River, to manage one of the State's licensed video lottery facilities. The contract entitles UTGR to compensation ranging from 26% to 28.85% of video lottery net terminal income at the facility. UTGR and the lottery extended the contract and signed the first five-year extension term commencing on July 18, 2010. The second term would commence on July 18, 2015. Certain extensions are contingent on UTGR's compliance with full-time employment mandates.

The Master Contract has been amended in recent years to reflect the statutory authorization of a promotional points program at Twin River. In fiscal 2014, Twin River was authorized and issued approximately \$33.4 million in promotional points to facility patrons.

The Master Contract has also been amended to reflect the statutory requirement that the Lottery reimburse UTGR for allowable marketing expenses at an amount not to exceed \$6 million multiplied by the Lottery's percentage of net terminal income (61.02% and 61.12% for fiscal years 2014 and 2013, respectively). The reimbursement of marketing expenses by the Lottery occurs only after UTGR has incurred \$4 million in qualified marketing expenses (with marketing expenses defined by the Lottery). The Master Contract is being amended to reflect recently enacted legislation regarding the Lottery's reimbursement to UTGR for allowable marketing expenses not to exceed an additional \$3 million multiplied by the Lottery's percentage of net terminal income. The reimbursement of marketing expenses by the Lottery occurs after UTGR has incurred an additional \$4 million in qualified marketing expenses defined by the Lottery.

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

On November 23, 2005, the Lottery entered into a five (5) year Master Video Lottery Terminal Contract with Newport Grand to continue to manage one of the State's licensed video lottery facilities. Newport Grand and the Lottery extended the contract and signed the first five-year extension term of the contract commencing on November 23, 2010. The second term, which would commence on November 23, 2015, is contingent on Newport Grand's compliance with full-time employment mandates specified in the 2010 law. The contract, as amended, entitles Newport Grand to compensation equal in percentage of net terminal income to that of Twin River. Recent legislation increased the percentage of net terminal income by 2.25% effective July 1, 2013, and expiring June 30, 2015.

The Master Contract has been amended in recent years to reflect the statutory authorization of a promotional points program at Newport Grand. In fiscal 2014, Newport Grand was authorized and issued approximately \$5.4 million in promotional points to facility patrons.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

(12) Commitments - (Continued)

The Master Contract has also been amended to reflect the statutory requirement that the Lottery reimburse Newport Grand for allowable marketing expenses at an amount not to exceed \$840,000 multiplied by the Lottery's percentage of net terminal income (59.23% and 61.67% for fiscal years 2014 and 2013, respectively). The reimbursement of marketing expenses by the State occurs only after Newport Grand has incurred \$560,000 in qualified marketing expenses (with marketing expenses to be defined by the Lottery).

(13) Contingencies

- (a) The Lottery's master contracts with its video lottery facilities contain revenue protection provisions in the event that existing video lottery facilities incur revenue losses caused by new gaming ventures within the State.
- (b) A significant portion of the Lottery's revenues are derived from video lottery gaming at two licensed video lottery facilities. Newport Grand, one of those video lottery facilities is subject to certain financing agreement restrictions. In 2008, Newport Grand entered into a \$25,000,000 financing agreement with two banks for expansion and renovation of its video lottery terminal facility. Prior events of default relative to failing to meet earnings levels amended the loan agreement which required additional partner contributions, quarterly deposits and restricted dividend distributions. During fiscal 2014, a subsequent loan amendment required continued deposits and a new loan covenant requirement.
- (c) The Lottery's gaming operations could be adversely impacted by enacted legislation in Massachusetts allowing three casinos and one slot parlor in that State. Massachusetts has divided the State into three regions and accepted license applications for three category 1 resort-style casinos. In addition, a category 2 slots only license was awarded in February 2014. The Western Massachusetts (region B) category 1 license was awarded in June 2014 and the region A Greater Boston category 1 license was awarded in September 2014. The region C Southeastern Massachusetts category 1 license is anticipated to be awarded in August 2015. The region C Southeastern Massachusetts category 1 licenses were recently opened to new applicants. Depending on the resulting location of the facilities within Massachusetts, lottery revenues in Rhode Island could decrease. Massachusetts voters will consider a statewide ballot question in November 2014 to reverse the prior approval of casino gambling in Massachusetts.

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

### (13) Contingencies – (Continued)

- (d) The Narragansett Indian Tribe filed a complaint against the State of Rhode Island in the Superior Court on or about September 28, 2011, inter alia, challenging the constitutionality of the casino gaming act on the grounds that it would not be "state-operated" and the act "delegates unconstitutional authority to a private corporation", on or about June 29, 2012. The Superior Court found that the Narragansett Indian Tribe had not sustained their burden of proof that the act violates the state or United States constitution. The Narragansett Indian Tribe filed a notice of appeal of that decision with the Rhode Island Supreme Court. Legal briefs are expected to be filed by the parties in the Supreme Court on the constitutional issues in October 2014. The Court will thereafter schedule the matter for hearing either later in the current term or next term. The remaining issues in the case which are still pending in the Superior Court relate to whether the state "operates" Twin River and Newport Grand. There has been no further action taken in that matter.
- (e) In the event of default on an insurance annuity contract for a Rhode Island winner of the Lucky for Life<sup>®</sup> jackpot prize award, the Lottery may be contingently liable for any remaining prize amounts due the winner.

### (14) Risk Management

The Lottery is exposed to various types of risk related to its operations. These risks can result in losses incurred from property damage or destruction, inability to operate gaming activities and worker compensation claims. The Lottery manages these risks through the purchase of commercial insurance. During fiscal 2014, the Lottery maintained its amount of purchased insurance coverage. Claims and settlements incurred for fiscal years 2014, 2013 and 2012 have not exceeded the Lottery's insurance coverage.

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

### (15) Subsequent Event

Lottery management has evaluated subsequent events through October 6, 2014, the date for which the financial statements were available for issuance.

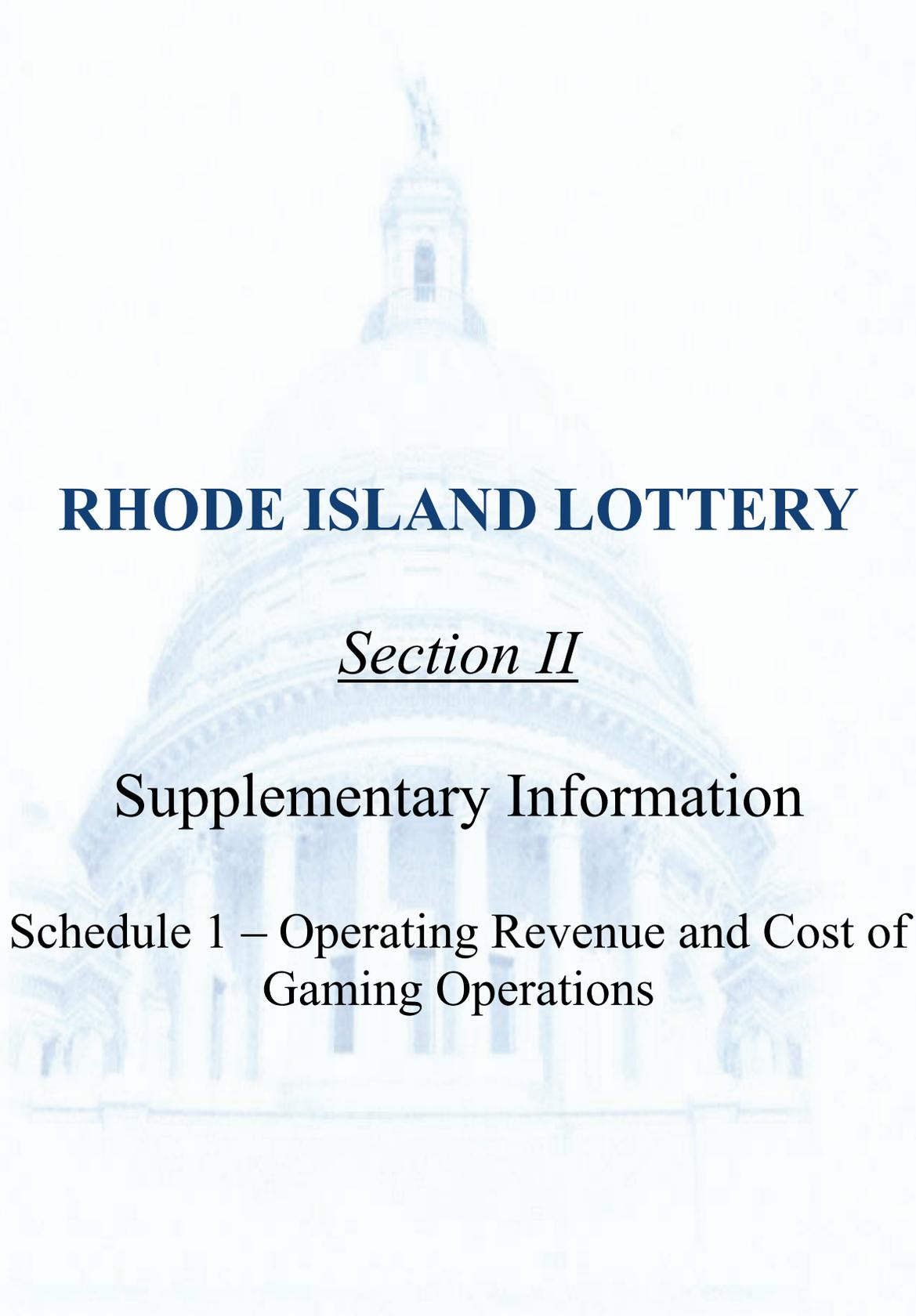
In July 2014, GTECH, S.p.A, and IGT (International Gaming Technology) entered into a definitive merger agreement for the acquisition of IGT by GTECH. Under the terms of the agreement, IGT and GTECH will combine under a newly formed holding company organized in the United Kingdom.

In July 2014, Twin River Management Group, Inc., sole owner of UTGR Inc., purchased a casino in Biloxi Mississippi. Twin River refinanced existing and added new debt as a result of the purchase. There is a new regulatory agreement by and amongst the Division of Lotteries, the Rhode Island Department of Business Regulation, Twin River Management Group, Twin River Worldwide Holdings, Inc., and UTGR. The regulatory agreement contains certain reporting obligations applicable to Twin River Worldwide Holdings, Inc., Twin River Management Group,

# RHODE ISLAND LOTTERY

## Notes to Financial Statements

and UTGR. These include new notification requirements, filing requirements, compliance reports, and minimum capital expenditures.



# **RHODE ISLAND LOTTERY**

## **Section II**

### **Supplementary Information**

#### **Schedule 1 – Operating Revenue and Cost of Gaming Operations**

# RHODE ISLAND LOTTERY

## Operating Revenue and Cost of Gaming Operations Year Ended June 30, 2014

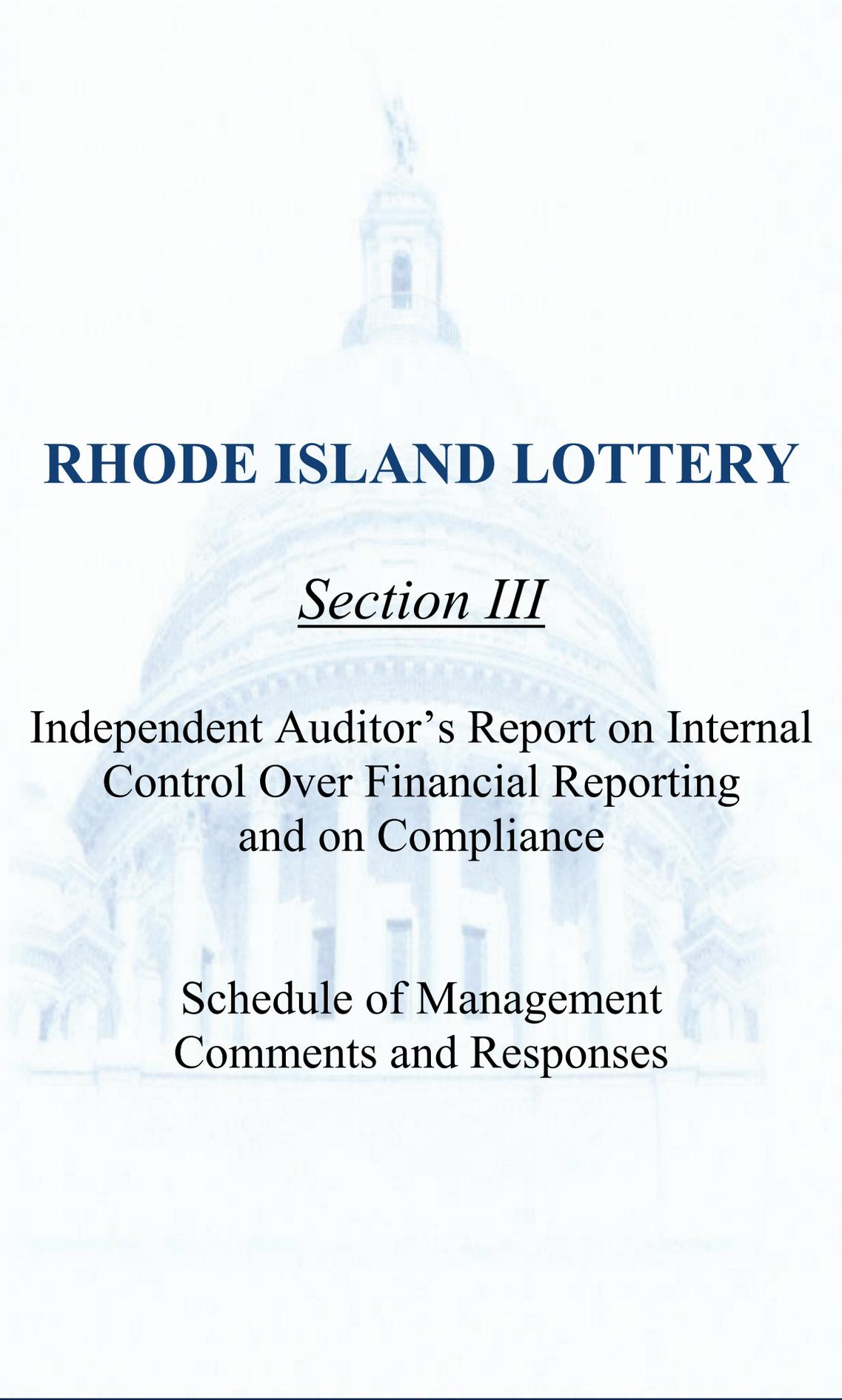
### Schedule 1

	Revenue <sup>(2)</sup>	Commissions	Prize Awards Expense	Unclaimed Prize Recovery	Cost of Tickets	Advertising	Incentive Programs	Cost of Gaming Operations	Gross Profit/(Loss)
Lottery games:									
On-line games									
Keno	\$ 78,203,765	\$ 10,164,476	\$ 51,499,700	\$ (252,337)	\$ -	\$ 196,804	\$ -	\$ 61,608,643	\$ 16,595,122
Bingo	1,094,274	142,435	761,457	(10,839)	-	2,501	-	895,554	198,720
PowerBall <sup>®</sup>	31,502,543	4,095,516	15,756,377	(518,473)	-	629,577	-	19,962,997	11,539,546
Daily Numbers	24,141,676	3,137,694	11,617,948	(240,169)	-	120,729	-	14,636,202	9,505,474
Mega Millions <sup>®</sup>	12,622,344	1,641,096	6,413,442	(75,725)	-	388,824	-	8,367,637	4,254,707
Wild Money	4,525,777	588,318	2,533,489	(42,575)	-	53,651	-	3,132,883	1,392,894
Lucky for Life <sup>®</sup>	6,719,790	873,187	3,114,053	(229,553)	-	183,525	-	3,941,212	2,778,578
Raffle	-	-	-	(29,500)	-	-	-	(29,500)	29,500
	<u>158,810,169</u>	<u>20,642,722</u>	<u>91,696,466</u>	<u>(1,399,171)</u>	<u>-</u>	<u>1,575,611</u>	<u>-</u>	<u>112,515,628</u>	<u>46,294,541</u>
Instant tickets	83,975,581	8,932,729	56,874,235	(1,034,882)	1,043,555	513,405	-	66,329,042	17,646,539
Video Lottery <sup>(1)</sup>	507,056,712	196,693,434	-	(177,622)	-	-	4,070,183	200,585,995	306,470,717
Table Games	88,108,367	72,248,861	-	-	-	-	-	72,248,861	15,859,506
Totals	<u>\$ 837,950,829</u>	<u>\$ 298,517,746</u>	<u>\$ 148,570,701</u>	<u>\$ (2,611,675)</u>	<u>\$ 1,043,555</u>	<u>\$ 2,089,016</u>	<u>\$ 4,070,183</u>	<u>\$ 451,679,526</u>	<u>\$ 386,271,303</u>
<u>Video Lottery Commissions - Detail</u>									
Facilities		\$ 141,216,322							
Technology Providers		34,964,634							
Central Communications Provider		12,570,589							
City/Town		7,155,819							
Narragansett Indian Tribe		786,070							
Total		<u>\$ 196,693,434</u>							

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

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

See accompanying notes to financial statements.



# **RHODE ISLAND LOTTERY**

## **Section III**

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

**Schedule of Management  
Comments and Responses**



# Office of the Auditor General

State of Rhode Island and Providence Plantations - General Assembly

Dennis E. Hoyle, CPA - Auditor General

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

86 Weybosset Street • Providence, RI • 02903-2800

tel: 401.222.2435 • fax: 401.222.2111

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

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

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements, and have issued our report thereon dated October 6, 2014.

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

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

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

Our consideration of internal control 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 material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

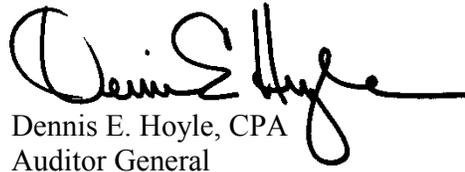
Joint Committee on Legislative Services, General Assembly  
State of Rhode Island and Providence Plantations:

### **Compliance and Other Matters**

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

### **Purpose of this Report**

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



Dennis E. Hoyle, CPA  
Auditor General

October 6, 2014

## SCHEDULE OF MANAGEMENT COMMENTS AND RESPONSES

### **Management Comment 2014-1**

#### **MAINTAINING SUFFICIENT INFORMATION TECHNOLOGY RESOURCES AT NEWPORT GRAND**

Nearly all operations at the Lottery's licensed gaming facilities are administered through the use of complex information systems. These systems operate and/or control the video lottery terminals, the player rewards promotional points programs, employee security access, as well as the overall monitoring and reporting of gaming activity. The importance and reliance on these critical information systems necessitates that each facility have sufficient IT security resources to safeguard these operations from unintended access or use.

Newport Grand has been challenged in retaining adequate IT security resources to fully meet its IT security needs. Newport Grand has hired contract IT security professionals in an attempt to mitigate its IT security risks; however, these resources have not been completely effective in ensuring the continued security of the facility's information systems.

The Lottery mandated each facility to contract for external IT security reviews of the information system security policies and procedures during fiscal 2014. In response to certain IT security deficiencies noted by external assessments performed at Newport Grand, the Lottery mandated the hiring of an IT Director by the gaming facility. Additionally, the Lottery also required Newport Grand to implement an IT security function and recommended they hire a full time Information Security Officer. In the interim, the Lottery has actively monitored information system security at Newport Grand by working with the IT security resources contracted by the facility to ensure that highlighted security risks are being addressed in a timely manner.

The Lottery must continue to monitor Newport Grand's compliance with IT security measures and require timely corrective actions when warranted. These actions are necessary to continuously safeguard the facility's information systems.

#### **RECOMMENDATION**

2014-1            Continue to monitor Newport Grand's compliance with IT security measures and require timely corrective actions to continuously safeguard the facility's information systems.

#### **Auditee Views:**

*Newport Grand has hired an IT Director to oversee its IT Department. Newport Grand has addressed some of the issues noted in the security reviews; however, some outstanding issues hinge on whether or not the referendum to allow table games at Newport Grand passes in November. The Lottery has also implemented the requirement of the current third-party security firm to expand its role to provide more IT security related oversight. Lottery IT has reviewed the expanded role requirements between the two parties, and an agreement between Newport Grand and the third-party vendor has been signed.*

*Lottery IT has met with the new IT Director to discuss his role at Newport Grand as it relates to IT security and their systems. Since starting in this position, the new IT Director has*

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

*developed IT security policies which have been presented to the Lottery. The IT Director is working on developing procedures that will be incorporated in to the new policies.*

### **Management Comment 2014-2**

#### **INFORMATION TECHNOLOGY OPERATIONAL ISSUES ASSOCIATED WITH THE PROPOSED GAMING EXPANSION AT NEWPORT GRAND**

If approved by the voters in November 2014, table games could be implemented at Newport Grand in addition to those now offered at Twin River. The Lottery should anticipate and consider various operational and IT related issues associated with the potential expansion of gaming options at Newport Grand.

As outlined in the Management Comment 2014-1, Newport Grand must enhance the overall IT resources deployed to maintaining its systems particularly those addressing IT security functions. This becomes additionally important with any expansion of gaming options and the need for different types of systems and monitoring procedures required for tables games. Secondly, the Lottery should explore whether it should require Newport Grand (should table games be approved) to adopt the same IT monitoring and control systems for table games and player promotional programs as those used by Twin River. By mirroring the functions, security, and systems of the other casino, the Lottery can leverage the knowledge and resources it already has in place to efficiently and effectively monitor and regulate all gaming activities offered by Newport Grand.

As Newport Grand contemplates the expansion of gaming options, modification and renovation of its facility, and a change in ownership, the Lottery should require implementation of a comprehensive IT plan as part of these anticipated changes. The plan should fully address both the existing IT security deficiencies, the additional IT aspects associated with the expansion of gaming options, and the Lottery's efforts to require common IT applications and platforms at its gaming locations.

#### **RECOMMENDATION**

2014-2      Require implementation of a comprehensive plan for Newport Grand to address its existing IT security risks, the additional information technology requirements of expanded gaming options, and the Lottery's efforts to require common IT applications and platforms at its gaming facilities.

#### **Auditee Views:**

*Lottery IT has met with the management of Newport Grand to discuss potential solutions to the current issues and also discussed the best direction to take with regards to the player tracking system at Newport Grand if table games are approved. The Lottery will be working closely with the new IT Director at Newport to ensure that Newport Grand's IT systems comply with all Lottery requirements. If table games are approved, the goal will be to have both Twin River and Newport Grand adhere to the same controls over their respective systems with the two facilities mirroring each other's processes as much as possible.*

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

### **Management Comment 2014-3**

#### **UTILIZATION OF THE STATE'S ACCOUNTING SYSTEM FOR FINANCIAL REPORTING**

The Lottery's internal general ledger accounting system ("Great Plains") is used for financial reporting; however, the Lottery also 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.

Recording all financial transactions in two separate accounting systems is obviously time-consuming due to the duplicate recording of each transaction and required reconciliation of the systems. A reasonable expectation is that both systems would contain exactly the same information despite different design and account structures; however, these differences exist:

- The activity recorded in RIFANS is basically cash receipts and disbursements whereas the Lottery's accounting system records all gross financial information 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.
- The Lottery performs reconciliations of cash and certain expenditure categories between their internal general ledger and RIFANS, however, differences in the fiscal closing processes for the RIFANS and Lottery accounting systems can still lead to variances between the financial activity reported by the two systems.

Recording activity in two separate accounting systems is inherently challenging. We believe the current practice should be examined and challenged from the perspective of measuring the benefit derived, if any.

We believe that accounting for Lottery operations solely through RIFANS may provide the most efficient and effective means of meeting operational, financial reporting, and internal control objectives. RIFANS would require modification (e.g., adding accounts), but could most likely fully meet the Lottery's requirements. Utilizing RIFANS in this manner is also consistent with the State's objective of having a comprehensive statewide accounting system.

The Lottery, Department of Revenue and Office of Accounts and Control should more fully explore how RIFANS could be used as the sole accounting system for the Lottery.

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

### RECOMMENDATION

2014-3            Explore using RIFANS solely to meet the Lottery's operational and financial reporting needs thereby eliminating the inefficiency of recording Lottery activity in two separate accounting systems

#### Auditee Views:

*Lottery Finance will again meet with the State Controller and other State accounting personnel to discuss the possibility of utilizing the RIFANS State accounting system for the financial reporting requirements. Previous meetings with State accounting personnel on implementing the State's general ledger system and still complying with the Lottery's statutory reporting requirements and General Fund transfers have resulted in the determination that utilizing the State's accounting system would result in the inability of the Lottery to adhere to statutory time requirements for financial recording, reporting and General Fund transfers.*