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## RHODE ISLAND LOTTERY

Independent Auditor's Report on Internal Control Over  
Financial Reporting and on Compliance and Other Matters  
Based on an Audit of Financial Statements Performed in  
Accordance with *Government Auditing Standards*

and

MANAGEMENT COMMENTS

JUNE 30, 2007 AUDIT

Ernest A. Almonte, CPA, CFE  
Auditor General

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

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STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

ERNEST A. ALMONTE, CPA, CFE  
AUDITOR GENERAL

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

November 9, 2007

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

We have audited the financial statements of the Rhode Island Lottery (the "Lottery") for the year ended June 30, 2007 and have issued our report thereon dated September 28, 2007. The Lottery's financial statements and our independent auditor's report are included in the Lottery's *Comprehensive Annual Financial Report* for the Fiscal Year Ended June 30, 2007.

In accordance with *Government Auditing Standards*, we have also prepared a report, dated September 28, 2007 and included herein, on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations and contracts. Our report on the Lottery's internal control over financial reporting and on compliance and other matters indicated certain issues that we considered to be significant deficiencies in internal control over financial reporting. These control deficiencies are described in the accompanying Schedule of Findings and Responses.

We also noted certain matters involving compliance, internal controls, and other operational matters that are presented for your consideration. These comments and recommendations are intended to enhance compliance with laws, regulations and contracts, improve internal control, or result in other operational efficiencies.

Sincerely,

Ernest A. Almonte, CPA, CFE  
Auditor General

**RHODE ISLAND LOTTERY  
MANAGEMENT LETTER  
JUNE 30, 2007 AUDIT**

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

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

We have audited the financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2007 and have issued our report thereon dated September 28, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

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

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

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

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be

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

prevented or detected by the entity's internal control. We consider the deficiencies described in the accompanying schedule of findings and responses as Findings 2007-1 and 2007-2 to be significant deficiencies in internal control over financial reporting.

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

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

### **Compliance and Other Matters**

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

We noted certain matters that we reported to management of the Lottery (included herein as Other Findings and Recommendations).

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



Ernest A. Almonte, CPA, CFE  
Auditor General

September 28, 2007

## SCHEDULE OF FINDINGS AND RESPONSES

### Finding 2007-1

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

The Rhode Island Lottery introduced video lottery games to the public at two licensed video lottery facilities in 1992. Since its introduction, video lottery revenues have grown from \$32.7 million in fiscal 1993 to nearly \$1.6 billion in fiscal 2007. In that same period, the number of video lottery terminals in operation has increased from 1,292 to 5,671. Much of this increase occurred in the last fiscal year as a result of new agreements with each of the licensed video lottery facilities. Video gaming now comprises more than 86% of total Lottery gaming revenue and prize awards expense.

Although the Lottery has made appropriate changes in the monitoring of video lottery operations as revenues increased, most of the enhancements have involved additional security personnel to monitor physical security at the facilities and internal audit personnel to evaluate and review video lottery procedures and controls. These additional personnel have improved the Lottery's overall monitoring of video operations; however, additional enhancements are necessary to improve the efficiency and effectiveness of the daily monitoring of cash activity for each terminal and also to ensure the accuracy and reliability of the information reported from the video lottery gaming system.

#### **Daily Video Lottery Terminal Activity**

The current volume of activity for nearly 6,000 video lottery terminals (VLT) seven days a week requires a more sophisticated and automated process to assist in monitoring the daily terminal activity and cash reconciliation information.

The Lottery's current process of reviewing daily terminal activity has a significant manual component and is similar to the process followed when there were far fewer terminals. With the current number of terminals, the number of daily reporting variances that require resolution is large. Certain of these variances warrant further investigation, whereas others are routine or expected and could be resolved through more "intelligent" reporting capabilities. We observed instances during fiscal 2007 where the Lottery's procedures did not highlight variances that should have been investigated and resolved on a timely basis.

In the interest of both efficiency and effectiveness, the Lottery should develop an automated system that could be programmed to highlight exceptions (e.g., inconsistencies in cash receipts vs. gaming activity, unusual player activity, higher than expected payouts, etc.). This exception-based reporting would enhance the Lottery's ability to identify abnormalities in VLT and gaming operations that require investigation and resolution. Ultimately, improved monitoring would enhance controls and further protect the integrity of video lottery operations.

## RECOMMENDATION

- 2007-1a      Develop video lottery exception-based reporting to enhance controls and further protect the integrity of video lottery operations. Document the resolution of variances requiring investigation.

### Auditee Views:

*The number of video lottery terminals (VLTs) at both facilities totaled 5,671 at 6/30/2007 versus 4,672 at 6/30/2006. In addition to the increase in VLTs, there were significant changes in 2007 at the facilities for retrieving and processing the daily cash wagered and for payouts at the terminal level. As a result of the expansion, there were significant changes in central system generated reports. This resulted in changes to the Lottery's procedures for monitoring daily cash wagered and the payouts. The central system and facility changes included new money room processing procedures, implementation of ticket in/ticket out technology, and change for partial sweeps. Procedures and controls over central system generated reports and facility operations were assessed by Rhode Island Lottery regulators to ensure the Lottery's objectives for both the central system and the facilities over the video operation were met.*

*Having addressed the business objectives over the revised cash management process, the Rhode Island Lottery will look to the central computer gaming system operator to provide better exception reporting capabilities to identify anomalies that may occur in gaming activities as well as improve on analytical analysis to identify abnormalities that may occur at the terminal level and enable resolution in an efficient manner.*

*Additionally, the Rhode Island Lottery will implement formal procedures to appropriately document the resolution of significant variances that may occur at the VLT level or at the central system level of operation.*

### Enhancement of Video Lottery Monitoring Capabilities

The Lottery is dependent on the video lottery gaming system maintained by its gaming system contractor to meet both its financial reporting and operational monitoring responsibilities. One of the key financial controls is the reconciliation of cash activity to information reported by the video lottery gaming system, a process which requires significant manual analysis and follow-up. While this process provides some validation of reported cash-in amounts, no such independent validation process exists for reported video lottery cash-out amounts, the other component of net terminal income. Additionally, recent enhancements to video gaming operations (e.g., ticket in-ticket out, MWAP, etc.) impact the determination of net terminal income for which the Lottery relies on amounts reported by the gaming system. As the volume of video lottery activity increases along with enhancements to actual gaming functionality, the Lottery needs to develop more efficient and effective means of monitoring video lottery operations to ensure the accuracy and reliability of the information reported from the video lottery gaming system.

Monitoring enhancements designed to validate amounts reported by the video lottery gaming system could be achieved through a variety of means. The Lottery may consider implementing a separate Internal Control System (ICS) for its video gaming system similar to the ICS for on-line games which records key revenue and prize award activity for the Lottery's drawing games (Numbers, Powerball, KENO, etc.), as well as activity for the Lottery's instant games. The ICS for the on-line gaming system operates by receiving lottery terminal gaming activity prior to its reporting to the on-line gaming central system for purposes of generating independent totals for critical on-line gaming activity. The system then compares these independent totals to those reported by the contractor's gaming system and produces a report for the Lottery which highlights any differences in reported amounts.

Additionally, the Lottery could consider periodically obtaining an independent assessment of the internal control policies and procedures used in video lottery. A "SAS 70" examination of the controls over video lottery, including tests of the operating effectiveness of the applicable controls, would provide the Lottery with additional assurance regarding the accuracy and reliability of reported video lottery activity.

Other monitoring enhancements could involve increased use of existing internal audit capabilities as a supplement to external contracted resources such as information technology risk assessments.

### RECOMMENDATION

- 2007-1b      Enhance video lottery monitoring capabilities to ensure the accuracy and reliability of information reported from the video lottery gaming system.

#### Auditee Views:

*The Lottery is in agreement that internal controls over the central computer gaming system need to be continuously assessed and monitored, since the Lottery is dependent on the reliability of the transaction reporting of all VLT activity from its central system provider. The Lottery has been and will continue to consider independent, external and internal audits to provide reasonable assurance of complete, accurate, and timely reporting by the central system. The Lottery believes this is best accomplished by the performance of a SAS 70 audit of the VLT central system operations to ensure all transactions are properly accounted for and provided to the Lottery in systems generated reports. The SAS 70 audit objectives include audits of the central system software application development and roll-out procedures and controls over all applications that result in systems generated reports used by the Lottery for financial reporting. Additionally, the on-going annual audits by an independent Information Technology audit consultant will assess the completeness of financial transactions processed by the central system.*

*The Lottery believes that an independent Internal Control System (ICS) will not provide sufficient evidence on the completeness, accuracy and timeliness of reported financial transactions from the central system, since this independent system would most likely*

*receive and store the same erroneous information, if any, which might be initially generated by the central system. Also at this time, the Lottery does not want to risk the stability of the system by interfacing it to an ICS system. However, the Lottery will investigate all available options in the requirements of the new video system.*

## Finding 2007-2

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

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

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

Controls over financial reporting are weakened because a complete reconciliation is not performed between the two systems to ensure that all activity has been appropriately recorded in both accounting systems. Partial reconciliations are now performed mostly focusing on cash balances reported between the two systems.

The Lottery should explore the option of utilizing the State's accounting system exclusively for all accounting and financial reporting thereby eliminating the redundancy of recording activity in two systems and the effort required to perform periodic reconciliations. Further, controls over financial reporting would be enhanced by eliminating the risk of omitting transactions recorded only in one system.

Until recently the State's accounting system was incapable of meeting the financial reporting needs of the Lottery, however RIFANS can likely accommodate the Lottery's financial reporting objectives with minimal modification (e.g., creating additional accounts).

Utilizing RIFANS for financial reporting would also simplify cash reconciliation procedures by eliminating the need for the three-way reconciliation between bank balances, RIFANS cash balances, and the Lottery's cash balance.

## RECOMMENDATIONS

- 2007-2a      Perform full periodic reconciliations of activity recorded in the Lottery's accounting system utilized for financial reporting and the State's accounting system.
- 2007-2b      Explore using RIFANS for Lottery financial reporting thereby eliminating the redundancy of recording Lottery activity in two accounting systems.

### Auditee Views:

*The Rhode Island Lottery, an enterprise fund of the State, has maintained its own general ledger for financial reporting purposes and utilized the RIFANS system for its accounts payable and the State's volume purchasing for office supplies. Previously, the RIFANS could not accommodate the Rhode Island Lottery's general ledger accounts. The Lottery will research to determine if RIFANS can now accommodate the Lottery's general ledger accounts, and whether using the State's system for financial reporting will be a more efficient process.*

*According to §42-61-4(7) of RIGL, the Lottery must provide a monthly financial report to the State Budget Office, Auditor General, Permanent Joint Committee on State Lottery, the Legislative Fiscal Advisors, and the Governor no later than the 20<sup>th</sup> business day following the close of the month. Requests have been made to when at all possible, provide this monthly financial report sooner than is required by law. Because of this statutory requirement, the Lottery reconciles its accounts monthly to its own general ledger currently used for financial reporting. The Lottery also reconciles its payables to the payments designated in the RIFANS system and utilizes the State's volume purchasing. Reconciling other accounts currently maintained in the State's accounting system would result in significant time and is a duplication effort since the financial information reported by the Lottery must be supplied to the State in a timely fashion.*

*The Lottery will explore the efficiency and effectiveness of using the State's accounting system for its financial reporting and implement financial recording through the RIFANS system if advantageous.*

## **OTHER FINDINGS AND RECOMMENDATIONS**

### **Finding 2007-3**

#### **CONSIDER THE IMPACT OF CHANGES IN OPERATING PRACTICES ON FINANCIAL REPORTING**

The Lottery's accounting procedures are designed to accurately record the results of gaming activity consistent with the design and operation of the Lottery's games. We noted that the Lottery did not appropriately consider how a change in operating practice would impact its financial reporting process.

The Lottery records an estimate for accrued instant ticket revenue and related prize awards at year-end. The Lottery's on-line gaming system presently records instant ticket sales, per packet of instant tickets, when a) a retailer manually settles a packet of instant tickets, b) 70% of the number of low-tier prize awards relating to a particular packet of tickets has been validated, or c) a packet of tickets has remained active but unsettled for 90 days (180 days previous to fiscal 2007). Due to the manner in which the gaming system recognizes instant ticket revenue, the Lottery utilizes an estimation process to ensure that all gaming activity is reported on an accrual basis in the Lottery's financial statements at fiscal year end.

During fiscal 2007, the Lottery reduced the maximum number of active days that a ticket packet could remain active without being considered sold from 180 to 90 days. The Lottery did not modify its accounting procedures to reflect this change until noted during our audit. While the Lottery's financial statements were ultimately corrected, we found no process to ensure that changes in operating procedure are formally communicated to and considered by the finance department.

The Lottery should formalize a process to ensure that changes in operating procedures are communicated to and considered by the finance department. The process should ensure that the Lottery's accounting procedures accurately reflect the results of lottery operations in the financial statements.

#### **RECOMMENDATION**

- 2007-3      Formalize a process to ensure that changes in operating procedures are communicated to and considered by the finance department.

#### **Auditee Views:**

*The Lottery Finance Division will document the procedure to require adequate communication and monitoring of changes affecting accounting information for financial reporting.*

## Finding 2007-4

### **ENHANCE THE LOTTERY'S REPORTING CAPABILITIES TO SUPPORT MONITORING AND FINANCIAL REPORTING**

The Lottery relies heavily on a variety of gaming activity data to administer its financial reporting and monitoring responsibilities. This data almost exclusively originates from the Lottery's gaming systems which are operated by a contracted system provider. We noted the following concerns relating to the Lottery's report generating capabilities:

- The Lottery utilizes software to query databases and produce reports needed for financial reporting and monitoring. Accuracy and quality control issues exist when data is routinely generated by queries which are not subject to the same quality control procedures as standardized gaming system reports.
- Obtaining required reports from the gaming systems is often unsuccessful or time consuming. Report requests are run against the live production segment of these systems which are simultaneously performing all system operations. Consequently, operations, rather than report requests receive system priority. Although the current gaming systems were designed to utilize data warehouse capabilities to better accommodate report queries; such capabilities have not been fully achieved.
- One of the video lottery facilities changed the frequency of video terminal cash sweeps to alternating days; however, a standard report utilized by the Lottery to monitor and adjust terminal activity was not updated to accommodate this procedural change.
- Inconsistencies existed between different system generated reports for video lottery that included the same data elements (e.g., cash-in). Follow-up on these inconsistencies determined that one of the reports was incorrectly omitting certain video terminal adjustments. While this issue did not specifically impact the Lottery's financial reporting, it raised concerns regarding the quality control procedures performed by the Lottery and its gaming system contractor on new or edited system reports.

The Lottery's ability to obtain reliable data regarding gaming operations is critical to ensure proper financial reporting and monitoring of lottery operations. The Lottery needs to work with its gaming system contractor to address the above noted weaknesses in report accuracy and reporting capability to ensure that it can meet its monitoring and financial reporting responsibilities.

### **RECOMMENDATION**

2007-4      Enhance the Lottery's reporting capability to better support all monitoring and financial reporting responsibilities.

Auditee Views:

*The Lottery obtains various central system generated reports for specific uses. All financial related reports are generated from the live central system. Non-financial reports are generated from the data warehouse. As a result of the expansion at the facilities and resulting operational changes throughout 2007 and beyond, the Lottery developed one report to properly account for operational changes at the facilities. The Lottery's internally generated report is temporary until the central system provider produces reports to account for partial sweep activity. This is anticipated by the end of October 2007. The central system will be modified to be more efficient.*

*The Lottery will look to its central system provider to provide a data warehouse of information, separate from the live environment, to enable query requests for reports and information to be run outside the live environment and obtained in a more efficient, timely manner. Additionally, subsequent to the completion of the facilities' expansion and related operational procedures, the Lottery will work to improve the necessary reports to enable complete, timely, and accurate information. The Lottery will ensure consistencies among reports to properly account for all financial activity to be reported.*

## **Finding 2007-5**

### **SAFEGUARD PERSONAL INFORMATION**

The Lottery and its licensed video lottery facilities are responsible for reporting prize awards over a specified dollar amount to the Internal Revenue Service (IRS). To comply with these requirements, the Lottery and video lottery facilities are required to obtain certain personal information from prize claimants in order to complete required IRS filings. In addition, the Lottery also electronically receives other personal information for purposes of withholding amounts from prize claimants for amounts owed to Rhode Island Family Court for unpaid child support and the Department of Labor and Training for overpayment of unemployment benefits. Although certain procedures are utilized by the Lottery, no formal policies are in place to ensure the protection of sensitive personal data stored on information systems operated by the Lottery or its licensed video lottery facilities.

The Lottery should formalize procedures to improve controls over sensitive personal data stored on its information systems. These procedures should ensure that standardized controls are in place relating to the transmission, storage, archival, removal, and destruction of personal data. The Lottery should also develop procedures to ensure that it can monitor all access to and use of this data by both authorized and unauthorized users.

### **RECOMMENDATION**

- 2007-5      Formalize procedures to improve controls relating to the safeguarding of sensitive personal data stored on information systems of the Lottery, its gaming contractor or the licensed video lottery facilities.

Auditee Views:

*Currently, the Lottery requires the central system and facilities provide for confidentiality and security over Internal Revenue Service and other personal information. The Lottery has developed and is formalizing specific policies and procedures over the safeguarding of personal identification obtained from prize winners for the Internal Revenue Service. Relative to the safeguarding of information provided to the Lottery from the other state departments regarding delinquent child support payments and overpayment of unemployment benefits, the Lottery has requested that the information provided by these departments be sent by secure file, to be consistent with the Lottery's safeguarding policies and procedures. Additionally, the Lottery will require ongoing on-site audits of the facilities and central system provider for compliance with laws and regulations in this area.*

## **Finding 2007-6**

### **UTILIZE CENTRALIZED STATE FUNCTIONS FOR EFFICIENCY**

Beginning in fiscal 2006, the Lottery was reorganized as an executive branch agency, first as the Division of Lotteries within the Department of Administration, and more recently as part of the newly created Department of Revenue. Since the reorganization, the Lottery has had informal discussions with the Department of Administration regarding its use of certain centralized State functions; however, no formal understanding has been realized. An assessment of all centralized services (e.g., insurance, personnel, accounting systems, state fleet operations, etc.) available to the Lottery should be performed to determine if utilizing these services could be more efficient or cost effective. This assessment will ensure that services are being performed in the most effective and efficient manner and will also eliminate any differences between the Lottery's current policies and procedures and those applicable to other departments and agencies of the executive branch.

### **RECOMMENDATION**

- 2007-6      Conduct an assessment of all centralized State services available to the Lottery that could enhance efficiency and/or effectiveness. Formalize an understanding with the Department of Administration regarding the Lottery's use of specific centralized State services.

Auditee Views:

*Although the Lottery has been reorganized under the Department of Revenue (formerly the Department of Administration until July 2006), Chapters 42-61 and 61.1 of the RIGL relating to operation of the Lottery have not changed, other than to transfer the previous powers of the Commission to the Lottery Director. In addition, the Lottery remains exempt from the Administrative Procedures Act. However, the Lottery does utilize State*

*central services when advantageous to the operation of the Lottery and pricing and will continue to take advantage of State central services.*