
RHODE ISLAND LOTTERY

(AN ENTERPRISE FUND OF THE
STATE OF RHODE ISLAND)

FISCAL YEAR ENDED JUNE 30, 2009

Ernest A. Almonte, CPA, CFF
Auditor General

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



STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS
GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

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

ERNEST A. ALMONTE, CPA, CFF
AUDITOR GENERAL
ernest.almonte@oag.ri.gov

September 30, 2009

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER William J. Murphy, Chairman

Senator M. Teresa Paiva-Weed
Senator Dennis L. Algiere
Representative Gordon D. Fox
Representative Robert A. Watson

We have completed our audit of the financial statements of the Rhode Island Lottery for the year ended June 30, 2009. Our report is contained herein as outlined in the Table of Contents.

Sincerely,

Ernest A. Almonte, CPA, CFF
Auditor General

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

FISCAL YEAR ENDED JUNE 30, 2009

TABLE OF CONTENTS

| | PAGE |
|--|-------------|
| I. <u>INDEPENDENT AUDITOR'S REPORT</u> | 1 |
| II. <u>MANAGEMENT'S DISCUSSION AND ANALYSIS</u> | 3 |
| III. <u>BASIC FINANCIAL STATEMENTS</u> | |
| Statement of Net Assets | 11 |
| Statement of Revenue, Expenses and Changes in Net Assets | 12 |
| Statement of Cash Flows | 13 |
| Notes to Financial Statements..... | 15 |
| V. <u>SUPPLEMENTARY INFORMATION</u> | |
| Schedule 1 - Sales, Commissions and Prize Awards Expense | 31 |



STATE of RHODE ISLAND and PROVIDENCE PLANTATIONS
GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

ERNEST A. ALMONTE, CPA, CFF
AUDITOR GENERAL
ernest.almonte@oag.ri.gov

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

INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of the Rhode Island Lottery (Lottery), an enterprise fund of the State of Rhode Island and Providence Plantations, as of and for the year ended June 30, 2009, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As discussed in Note 2(b), the financial statements present only the Lottery and do not purport to, and do not, present fairly the financial position of the State of Rhode Island and Providence Plantations, as of June 30, 2009, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to previously present fairly, in all material respects, the financial position of the Lottery as of June 30, 2009, and the changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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

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

In accordance with *Government Auditing Standards*, we have also issued our report dated September 23, 2009 on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

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



Ernest A. Almonte, CPA, CFF
Auditor General

September 23, 2009

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, 2009. This analysis is to be considered in conjunction with the financial statements to provide an objective analysis of the Lottery's financial activities based on facts, decisions, and conditions currently facing management.

Understanding the Lottery's Financial Statements

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

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

Most assets included on the Statement of Net Assets represent current amounts such as cash and accounts receivable from Lottery retailers. Most liabilities represent current prize awards owed, vendor commission payments, and amounts due to the State's General Fund. Current assets approximate the amounts required to satisfy current liabilities at June 30.

The deficiency in net assets of \$8.8 million reported at June 30, 2009 relates entirely to the Lottery's sale of its exclusive rights to operate its gaming systems. The Lottery sold this exclusive right to its current gaming systems provider for a 20-year period at a cost of \$12.5 million and immediately paid the proceeds to the State's General Fund. According to the terms of the agreement, if for any reason, this contract is voided prior to its completed term; the Lottery will be required to refund a pro-rata share of the sales price to the gaming system provider. In accordance with generally accepted accounting principles, the Lottery will recognize the revenue related to this transaction over the 20-year life of the contract.

Financial Highlights

- The Rhode Island Lottery's sales for fiscal year 2009 totaled \$2.6 billion as compared to fiscal year 2008 sales of \$2.4 billion, an increase of 6.79%.
- The Lottery successfully introduced a new on-line game called Raffle during fiscal 2009. Raffle involves the sale of lottery tickets, each representing an entry in a future drawing. The game ran for several months with all 120,000 tickets being sold for the Raffle drawing which took place on New

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

Year's Eve. The Lottery sold \$2.4 million in lottery tickets and awarded prizes of \$1.2 million including the \$1 million grand prize.

- Instant sales increased by \$0.8 million, a 0.97% increase over fiscal year 2008.
- For fiscal year 2009, expanded video lottery operations resulted in transfers totaling \$6,777,327 to the Permanent School Fund which was then to be allocated as aid to local education authorities.

Assets and Liabilities

| | June 30, 2009 | June 30, 2008 |
|--|----------------|----------------|
| Assets: | | |
| Current assets | | |
| Cash and cash equivalents | \$ 11,613,490 | \$ 12,744,369 |
| Accounts receivable, net | 4,692,368 | 4,505,749 |
| Other | 1,151,644 | 1,078,862 |
| Total current assets | \$ 17,457,502 | \$ 18,328,980 |
| Long-term assets | | |
| Capital assets, net | \$ 808,117 | \$ 908,218 |
| Total assets | \$ 18,265,619 | \$ 19,237,198 |
| Liabilities: | | |
| Current liabilities | | |
| Due to State's General Fund | \$ 1,561,685 | \$ 521,090 |
| Due to Permanent School Fund | - | 1,152,762 |
| Due to State's General Fund - Operating Expenses | 138,399 | - |
| Accounts payable | 8,767,673 | 10,090,670 |
| Prize obligations | 6,036,852 | 5,631,954 |
| Other liabilities | 2,310,910 | 2,403,746 |
| Total current liabilities | \$ 18,815,519 | \$ 19,800,222 |
| Long-term liabilities | | |
| Net OPEB obligation | \$ 75,100 | \$ 61,976 |
| Unearned contract revenue | 8,125,000 | 8,750,000 |
| Total long-term liabilities | 8,200,100 | 8,811,976 |
| Total liabilities | \$ 27,015,619 | \$ 28,612,198 |
| Net Assets: | | |
| Invested in capital assets | \$ 808,117 | \$ 908,218 |
| Unrestricted | (9,558,117) | (10,283,218) |
| Total net assets (deficiency) | \$ (8,750,000) | \$ (9,375,000) |

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, 2009, the Lottery's assets included \$11.6 million in cash and cash equivalents as compared with \$12.7 million at June

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

30, 2008. The Lottery's accounts receivable approximated \$4.7 and \$4.5 million, respectively, at June 30, 2009 and 2008.

The Lottery's liabilities included at the balance sheet date are amounts owed for vendor payables, prize obligations and a residual amount owed to the State's General Fund for June's net operations and operating expenses. The amount owed to the General Fund for June's net operations approximated \$1.6 million at June 30, 2009 as compared with \$0.5 million due at June 30, 2008. At June 30, 2009, vendor payables, made up largely of commissions due to video lottery participants, and prize obligations, attributable mostly to instant ticket games and PowerBall®, were \$8.8 million and \$6.0 million, respectively. In comparison, vendor payables and prize obligations at June 30, 2008 were \$10.1 and \$5.6 million, respectively.

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

The deficiency in net assets reported at June 30, 2009, as previously explained, relates to the Lottery's immediate transfer, in a prior fiscal year, to the State's General Fund of all proceeds received from the sale of its exclusive rights over the operation of its gaming systems.

Lottery Operations

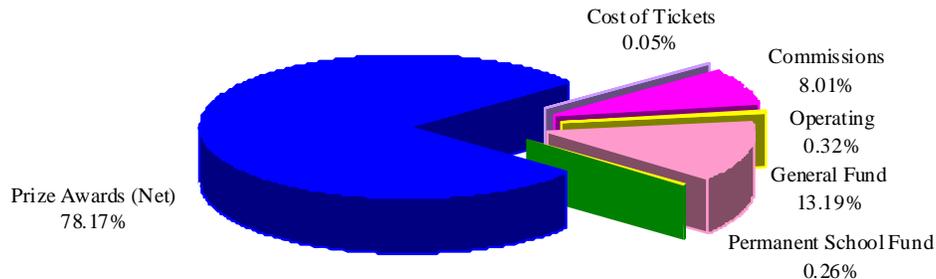
| | Year Ended June 30, 2009 | Year Ended June 30, 2008 |
|---|-----------------------------|-----------------------------|
| Revenue: | | |
| On-line games | \$ 156,130,190 | \$ 159,680,172 |
| Instant games | 82,348,042 | 81,557,881 |
| Video lottery | 2,320,451,966 | 2,155,163,234 |
| Other income | 1,588,749 | 2,514,101 |
| Total revenue | \$ 2,560,518,947 | \$ 2,398,915,388 |
| Expenses: | | |
| Cost of sales | \$ (2,207,437,158) | \$ (2,034,448,975) |
| Operating expenses | (8,163,984) | (8,273,339) |
| Transfers to State's General Fund | (337,515,478) | (354,321,087) |
| Transfers to Permanent School Fund | (6,777,327) | (1,152,762) |
| Transfers to RI Council on the Arts | - | (94,225) |
| Total expenses | \$ (2,559,893,947) | \$ (2,398,290,388) |
| Change in net assets | \$ 625,000 | \$ 625,000 |
| Total net assets (deficiency), beginning of year | (9,375,000) | (10,000,000) |
| Total net assets (deficiency), end of year | \$ (8,750,000) | \$ (9,375,000) |

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

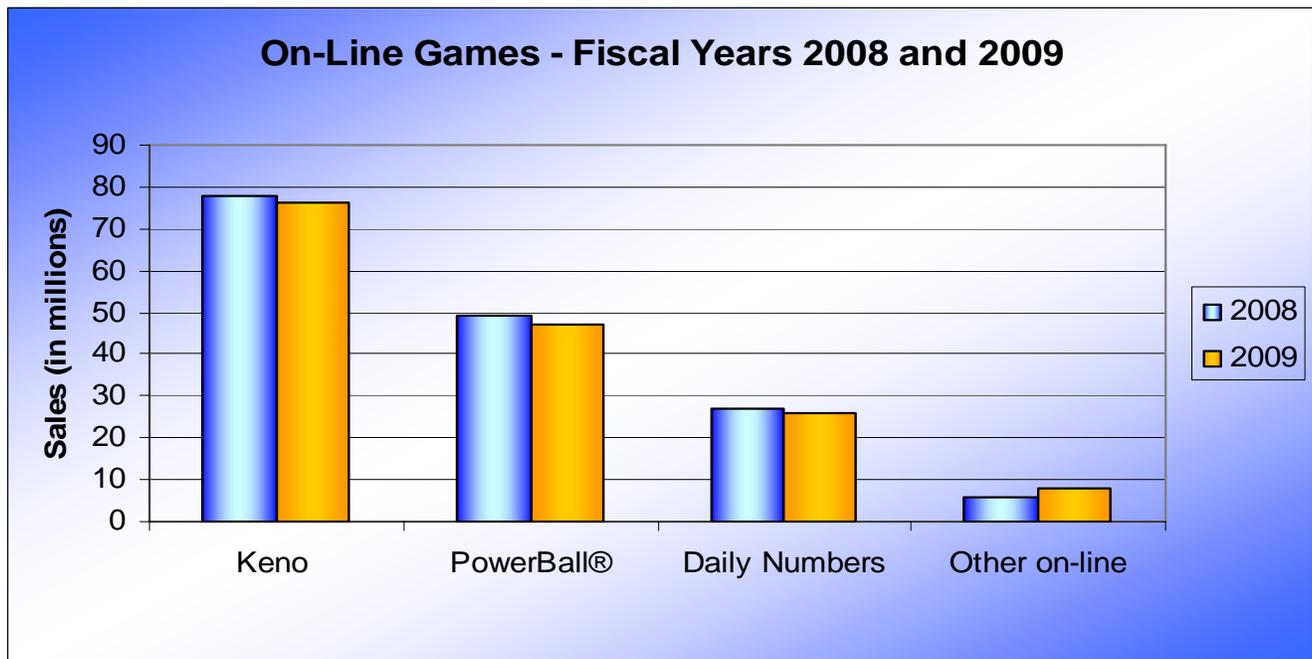
Sales

Distribution of the year's revenue was as follows:



Lottery sales are categorized as on-line, instant and video lottery games. The first category, on-line games, consisted of PowerBall®, Keno, Daily Numbers, Rhody Poker™, Raffle and Wild Money at June 30, 2009. In total, on-line sales decreased by \$3.5 million, which is mostly attributable to decreased PowerBall® sales. PowerBall® sales for the fiscal year ended June 30, 2009 decreased \$2.3 million or 4.65% over the prior fiscal year. In January 2009, the PowerBall® structure was modified to increase the starting jackpot from \$15 million to \$20 million and to increase the number of million dollar winners in the subsidiary prize category.

The following graph depicts the Lottery's on-line sales for the fiscal years ended June 30, 2008 and 2009.



Instant tickets or “scratch” tickets are the second type of Lottery game offered to the public. Instant ticket sales for the fiscal year ended June 30, 2009 increased \$0.8 million or 0.97% over the preceding fiscal year.

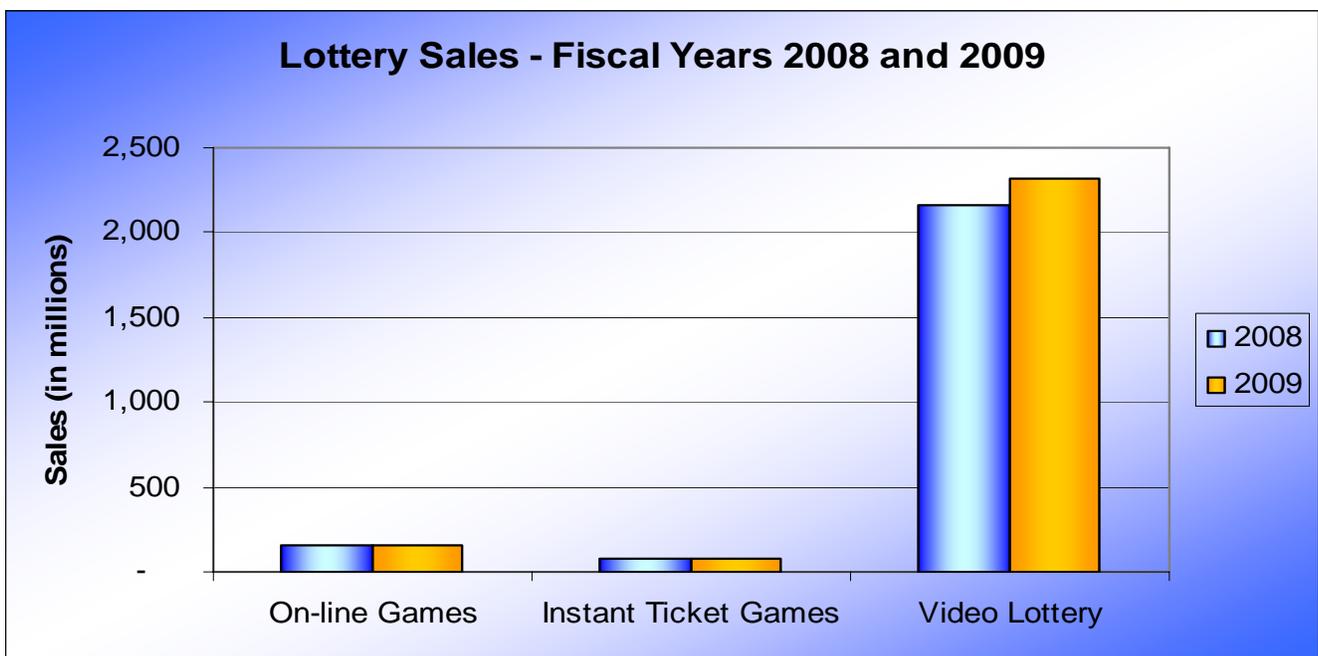
RHODE ISLAND LOTTERY

Management's Discussion and Analysis

The third type of game offered is video lottery. Video lottery sales increased \$165.3 million with a corresponding increase of \$182.2 million in prize awards. The continued increase in reported video lottery sales is mostly attributable to expanded operating hours for the majority of the fiscal year at the Lottery's largest video lottery facility, and the popularity of virtual multi-player video table games such as blackjack and roulette that simulates the excitement of table games. The increase of prize awards in excess of the video lottery revenue increase for fiscal 2009 was mostly attributable to the Lottery's authorization of bonus play as a marketing tool for the State's video lottery facilities. Bonus play, which was first introduced in June 2008, is free promotional play (credits) awarded to rated patrons (those averaging a certain level of video lottery play) that frequented the State's largest video lottery facility. Promotional or Bonus Play allows patrons, once awarded, to download free credits to be played on video lottery terminals (VLTs). These bonus video lottery credits are not recorded as sales by the Lottery, however, any corresponding prize awards won from the play of bonus credits are redeemable for cash and thus are recognized as prize awards.

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

The following graph depicts the Lottery's on-line, instant, and video lottery sales for the fiscal year ended June 30, 2008 in comparison to fiscal year ended June 30, 2009.

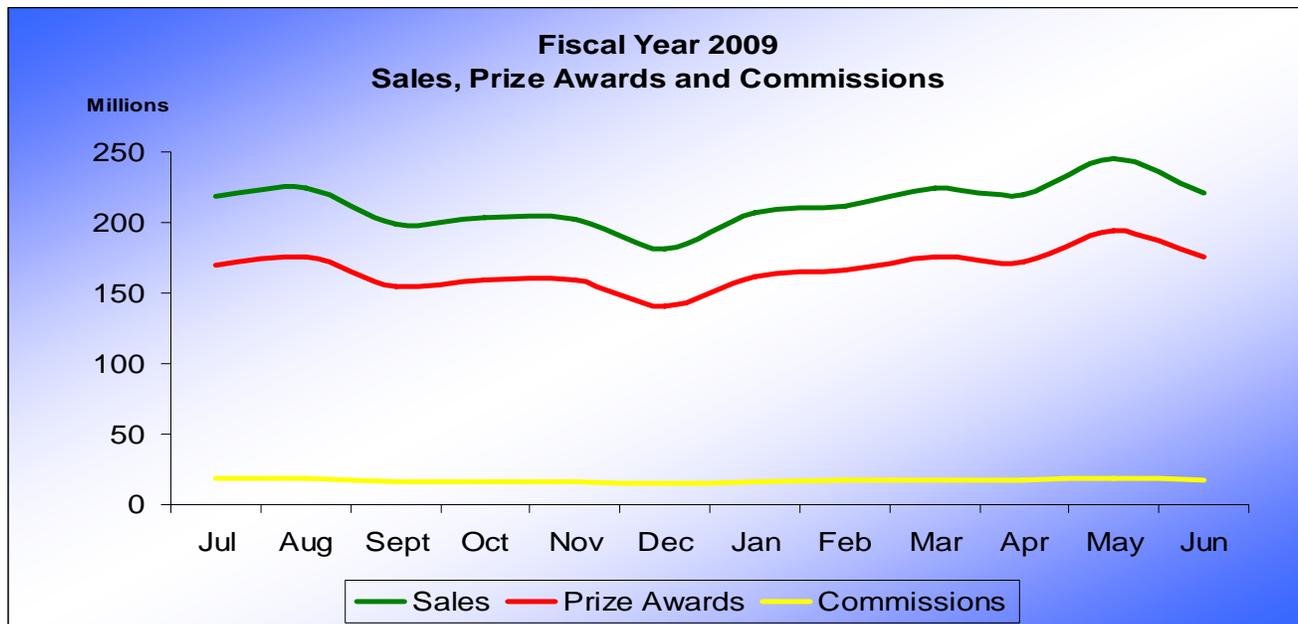


RHODE ISLAND LOTTERY

Management's Discussion and Analysis

Commissions and Prize Awards Expense

As the following graph depicts, the Lottery's most significant expenses (commissions and prize awards) are predictable because they have a direct correlation to sales. As lottery sales increase, so do the related prizes and commissions paid by the Lottery. While each Lottery game has a designed prize payout structure, the overall amount paid as prize awards expense is consistent in relation to sales.



Transfers to the State's General Fund

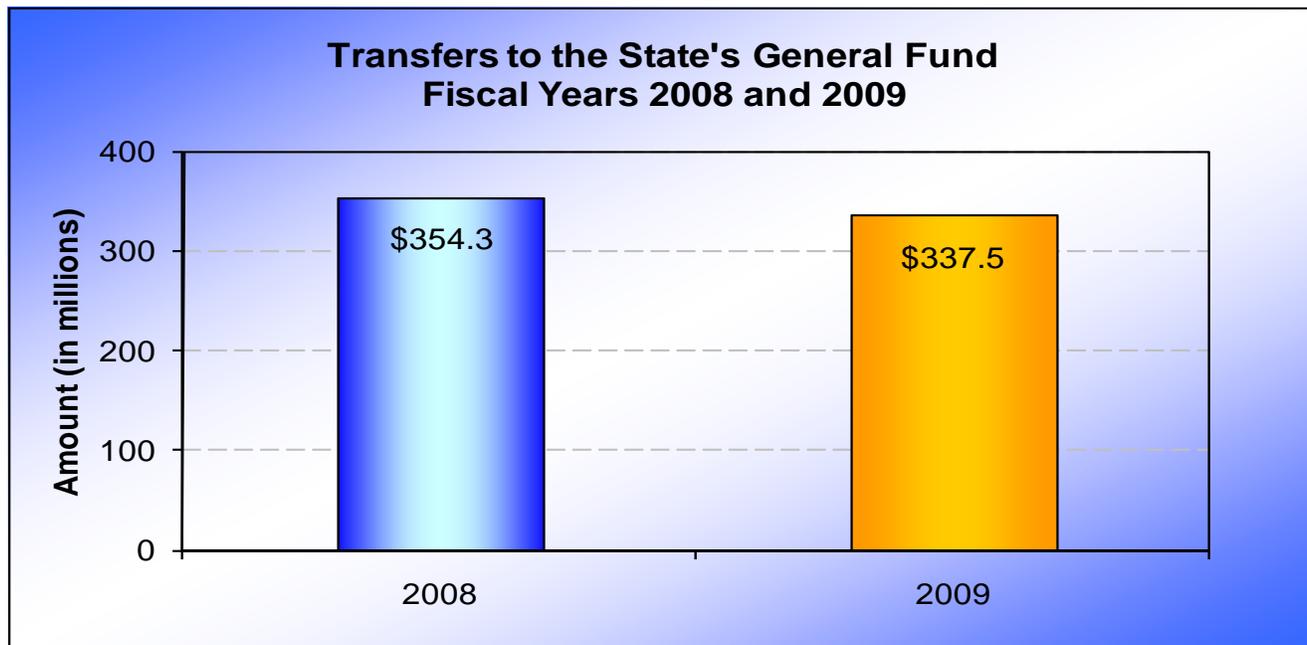
Transfers to the State's General Fund for the fiscal year ended June 30, 2009 decreased by \$16.8 million to a total of \$337.5 million for the period as compared to \$354.3 million for the fiscal year ended June 30, 2008. Transfers to the State's General Fund are estimated at \$338.0 million for the fiscal year ended June 30, 2010.

Overall economic conditions have deteriorated both regionally and nationally beginning with the recession starting in 2008. These economic conditions include layoffs and high unemployment, the banking and housing crises and general concern about the future. These factors had an adverse effect on overall consumer spending.

Net terminal income (defined as terminal cash-in minus terminal cash-out) resulting from expanded hours of video lottery operations, which began in May 2008 at the Twin River video lottery facility, totaled \$12.2 million for the 2009 fiscal year. RI General Law section 42-61.2-7, section 2, effective through June 30, 2009, mandates that the State's share of this income, less an additional .19% commission for the city or town where the video lottery facility resides, is to be allocated to the State's Permanent School Fund.

RHODE ISLAND LOTTERY

Management's Discussion and Analysis



Debt Administration

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

Capital Assets

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

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

Potential Factors Impacting Future Operations

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

- On June 23, 2009, the President and Chief Operating Officer of UTGR, Inc., the owner and operator of the Twin River video lottery facility, filed a petition for chapter 11 relief with the United States Bankruptcy Court for the State of Rhode Island. A preliminary agreement with the first and second lienholders was reached shortly before the bankruptcy filing. The agreement is subject to specific legislative actions which have not been formalized. UTGR, Inc., under the supervision of the bankruptcy court, continues to operate. The Lottery continues to obtain and allocate the video lottery net terminal income in accordance with established procedures.

RHODE ISLAND LOTTERY

Management's Discussion and Analysis

- The Lottery's video lottery operations currently compete with Indian gaming casinos in nearby Connecticut. Proposals are sometimes made in Rhode Island, as well as neighboring Massachusetts, to seek approval from the voters to allow Indian gaming or other casinos in Rhode Island and Massachusetts. The Lottery's operations may be impacted by competition from other gaming interests that may be developed within Rhode Island or neighboring states.
- Revenues overall are down at many gaming venues throughout New England. Competition among gaming venues has increased resulting in more promotional allowances and player reward incentives being offered.

Contacting the Lottery's Financial Management

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

RHODE ISLAND LOTTERY

Statement of Net Assets

June 30, 2009

Assets

Current assets:

| | | |
|--|----|------------|
| Cash and cash equivalents (note 3) | \$ | 11,613,490 |
| Accounts receivable-less allowance for doubtful accounts of \$133,876 | | 4,692,368 |
| Deposits with Multi-State Lottery Association (MUSL) (note 1) | | 404,381 |
| Due from Permanent School Fund (note 5) | | 9,659 |
| Ticket inventory | | 737,604 |

Total current assets \$ 17,457,502

Capital assets, net (note 4) 808,117

Total assets \$ 18,265,619

Liabilities

Current liabilities:

| | | |
|--|----|-----------|
| Due to State's General Fund (note 5) | \$ | 1,561,685 |
| Due to State's General Fund - Operating Expenses | | 138,399 |
| Obligation for unpaid prize awards | | 6,036,852 |
| Accounts payable | | 8,767,673 |
| Accrued expenses | | 1,372,536 |
| Deferred revenue | | 313,374 |
| Unearned contract revenue (note 8) | | 625,000 |

Total current liabilities \$ 18,815,519

Long-term liabilities:

| | | |
|------------------------------------|----|-----------|
| Net OPEB obligation (note 10) | \$ | 75,100 |
| Unearned contract revenue (note 8) | | 8,125,000 |

Total long-term liabilities 8,200,100

Total liabilities \$ 27,015,619

Net Assets

| | | |
|-------------------------------------|----|-------------|
| Invested in capital assets (note 8) | | 808,117 |
| Unrestricted (note 8) | | (9,558,117) |
| Total net assets (deficiency) | \$ | (8,750,000) |

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Revenue, Expenses and Changes in Net Assets

Year Ended June 30, 2009

| | |
|---|------------------------------|
| Sales (schedule 1): | |
| On-line games | \$ 156,130,190 |
| Instant games | 82,348,042 |
| Video lottery | <u>2,320,451,966</u> |
| Total sales | <u>\$ 2,558,930,198</u> |
| Cost of sales: | |
| Commissions (note 6) | \$ 205,029,120 |
| Prize awards | 2,004,412,406 |
| Unclaimed prize recovery | (3,198,266) |
| Cost of tickets | <u>1,193,898</u> |
| Total cost of sales | <u>2,207,437,158</u> |
| Gross profit | <u>\$ 351,493,040</u> |
| Operating expenses: | |
| Personal services | \$ 4,764,132 |
| Advertising | 2,203,027 |
| Contract services | 58,480 |
| Depreciation | 240,281 |
| Other | <u>898,064</u> |
| Total operating expenses | <u>8,163,984</u> |
| Operating income | \$ 343,329,056 |
| Non-operating income (expense): | |
| Investment income | 663,749 |
| Other income | <u>\$ 925,000</u> |
| Income before Transfers | 344,917,805 |
| Transfers to State's General Fund (note 5) | (337,515,478) |
| Transfers to Permanent School Fund (note 5) | <u>(6,777,327)</u> |
| Change in net assets | \$ 625,000 |
| Total net assets (deficiency), beginning of year | <u>(9,375,000)</u> |
| Total net assets (deficiency), end of year (note 8) | <u><u>\$ (8,750,000)</u></u> |

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statement of Cash Flows

Year Ended June 30, 2009

| | |
|--|----------------------|
| Cash flows from operating activities: | |
| Cash received from lottery sales | \$ 2,558,769,834 |
| Cash received from MUSL for grand prize winners | 10,095,229 |
| Cash received from sale of other tickets | 171,072 |
| Cash received from rental income and other receipts | 390,203 |
| Cash paid for prizes other than MUSL grand prize winners | (2,000,809,236) |
| Cash paid to MUSL grand prize winners | (10,095,229) |
| Cash paid for commissions - retailers | (8,763,660) |
| Cash paid for commissions - video lottery | (176,354,565) |
| Cash paid for commissions - on-line games contractor | (21,232,654) |
| Cash paid to suppliers for goods and services | (4,551,759) |
| Cash paid to employees for services | (4,634,479) |
| Net cash provided by operating activities | <u>342,984,756</u> |
| Cash flows from noncapital financing activities: | |
| Transfers to State's General Fund | (336,474,883) |
| Transfers to State's Permanent School Fund | (7,939,748) |
| Net cash used for noncapital financing activities | <u>(344,414,631)</u> |
| Cash flows from capital and related financing activities: | |
| Purchase of capital assets | <u>(146,153)</u> |
| Net cash used for capital and related financing activities | <u>(146,153)</u> |
| Cash flows from investing activities: | |
| Interest income | <u>445,149</u> |
| Net cash provided by investing activities | <u>445,149</u> |
| Net increase in cash and cash equivalents | (1,130,879) |
| Cash and cash equivalents at July 1, 2008 | <u>12,744,369</u> |
| Cash and cash equivalents at June 30, 2009 | <u>\$ 11,613,490</u> |

See accompanying notes to financial statements.

Continued.

RHODE ISLAND LOTTERY
Statement of Cash Flows (continued)
Year Ended June 30, 2009

| | |
|--|------------------------------|
| Reconciliation of operating income to net cash provided by operating activities: | |
| Operating income | <u>\$ 343,329,056</u> |
| Adjustments to reconcile operating income to net cash provided by (used for) operating activities: | |
| Depreciation | 240,281 |
| Miscellaneous receipts classified as operating activities | 124,511 |
| Rental income and other receipts | 400,061 |
| (Increase) decrease in assets: | |
| Accounts receivable | (186,619) |
| Inventory | (53,265) |
| Deposits with MUSL | (9,858) |
| Increase (decrease) in liabilities: | |
| Obligation for unpaid prize awards | 404,898 |
| Accounts payable | (1,322,996) |
| Due to State's General Fund - Operating Expense | 138,399 |
| Accrued expenses | (97,767) |
| Deferred revenue | <u>18,055</u> |
| Total adjustments | <u>(344,300)</u> |
| Net cash provided by operating activities | <u><u>\$ 342,984,756</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:

- On-line games that include: Daily Numbers, Keno, Wild Money, PowerBall[®], which is operated by the Multi-State Lottery Association (MUSL) and Raffle;
- Instant tickets sold through licensed lottery retailers, and
- Video lottery games which are located at two licensed facilities.

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

| <u>Game</u> | <u>Prize Payout</u> | <u>Mandated Payments to the State</u> |
|--|---|--|
| Daily Numbers Raffle Instant Ticket Games MUSL – PowerBall [®] Wild Money | Not less than 45% or more than 65% of sales | Payments to the General Fund - not less than 25% of ticket sales |
| Keno | Not less than 45% or more than 72% of sales | Payments to the General Fund - not less than 15% of ticket sales |
| Video Lottery | Prize payout not established by law | Payments to the General Fund - net terminal income (video lottery credits purchased less credits redeemed or redeemable, including prize contributions to multi-state video lottery progressive jackpots) minus commission payments Payments to the Permanent School Fund – video lottery net terminal income derived from expanded hours of operation as defined by the General Laws |

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization – (Continued)

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, the Narragansett Indian Tribe and the State's Permanent School Fund. All residual net terminal income after mandated commission payments, and other transfers, is remitted to the State's General Fund.

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

The prize pool for PowerBall[®] is 50% of each drawing period's ticket sales. MUSL has placed 2% of each drawing period's ticket sales for PowerBall[®], included as part of each member's prize liability, in prize reserve funds. The maximum balance on the prize reserve funds for PowerBall[®] is \$100.0 million. Once the prize reserve funds exceed this designated cap, the excess becomes part of the prize pool. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities, and these reserve funds are to be used at the discretion of the MUSL Board of Directors. The prize reserve funds are refundable to MUSL members if the MUSL disbands or if a member leaves MUSL. Members leaving MUSL must wait one year before receiving their remaining share, if any, of prize reserve funds. At June 30, 2009, the prize reserve funds for the PowerBall[®] game reported a balance of \$77.2 million of which the Lottery's share was \$1.5 million. The Lottery has charged amounts placed into the prize reserve funds to prize awards expense as the related sales have occurred.

All investment earnings relating to the prize reserve funds are credited to an unreserved account for each member state. This account can be utilized to offset operating costs or for the promotion of any MUSL game as approved by the MUSL Board of Directors. During fiscal year 2009, MUSL reduced the Lottery's unreserved account by \$48,278 for a pro rata share of annual operating expenses. The Lottery has recorded all income and operating expenses related to its unreserved account and has reported the balance of \$404,381 at June 30, 2009 on the Statement of Net Assets in "Deposits with MUSL".

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

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.

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

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

(b) *Reporting Entity*

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

(c) *Revenues and Expenses*

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

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

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

RHODE ISLAND LOTTERY

Notes to Financial Statements

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

credits purchased and the amount of credits redeemable or allocated to progressive jackpots. These amounts are net of credits won and played.

The Lottery accrues for the maximum prizes payable. Prize obligations, other than those relating to prizes payable in installments, that remain unclaimed one year after the drawing date are reported as a reduction to the cost of sales.

(d) *Capital Assets*

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

(e) *Cash Equivalents*

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

(f) *Ticket Inventory*

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

(g) *Deferred Revenue*

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

(h) *Unearned Contract Revenue*

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

(i) *Use of Estimates*

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

RHODE ISLAND LOTTERY

Notes to Financial Statements

(3) Deposits and Investment Risk

(a) *Deposits*

The Lottery's cash deposit balances at June 30, 2009 totaled \$6,442,810, with corresponding bank balances totaling \$6,457,296. The bank balances consisted of \$73,456 in a demand deposit account, a cash overdraft of \$14,986 in a demand deposit account within the same financial institution, and \$6,383,840 in collateralized deposit investment accounts.

All deposits were in the custody of the State General Treasurer. The institution holding the Lottery's cash deposits totaling \$73,456 in a demand deposit account has elected to participate in the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program which fully guarantees all non-interest bearing transaction accounts for the entire amount in the account. For the Lottery's interest bearing accounts, all General Treasurer accounts at a single institution are aggregated for purposes of determining federal depository insurance coverage. Of the total bank deposit balance, \$6,383,840 was collateralized.

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 one hundred percent of deposits, regardless of maturity. None of the cash deposits of the Lottery were required to be collateralized at June 30, 2009 pursuant to Chapter 35-10.1 of the General Laws.

(b) *Investments*

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

At June 30, 2009, the Lottery's investment balance consisted of money market mutual funds as follows:

RHODE ISLAND LOTTERY

Notes to Financial Statements

(3) Deposits and Investment Risk – (Continued)

| Investment Description | Fair Value at June 30, 2009 | Credit Rating | Average Maturity |
|--|--------------------------------|-----------------------------|---------------------|
| BlackRock Liquidity Funds – FedFund Institutional Shares | \$ 4,501,176 | AAAm (S&P) Aaa (Moody’s) | 30 days |
| Federated Government Obligations Fund – Institutional Shares | \$ 366,637 | AAAm (S&P) Aaa (Moody’s) | 47 days |
| Wells Fargo Advantage Funds – Government Money Market Fund | \$ 302,867 | AAAm (S&P) Aaa (Moody’s) | 38 days |
| Total Investments | \$ 5,170,680 | | |

Custodial Credit Risk: 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: 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 State invests the Lottery’s available cash in short-term investments limiting its exposure to fair value losses arising from rising interest rates. The Lottery’s investments are typically overnight, 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 State Investment Commission’s minimum rating criteria policy, collateralization requirements, and limiting the maximum participation by any one issuer to 35% of the State’s total short-term investment portfolio. Credit risk policies have been developed for investments in commercial paper.

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

(c) Cash and Cash Equivalents

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

| | |
|--|----------------------|
| Cash deposit balance per books | \$ 6,442,810 |
| Investments classified as cash equivalents | <u>5,170,680</u> |
| Cash and cash equivalents | <u>\$ 11,613,490</u> |

RHODE ISLAND LOTTERY

Notes to Financial Statements

(4) Capital Assets

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

A summary of capital assets follows:

| | Estimated Useful Life | 2008 Balance | 2009 Additions | 2009 Disposals | 2009 Balance |
|---------------------------------------|--------------------------|---------------------|--------------------|---------------------|---------------------|
| <u>Cost</u> | | | | | |
| Building | 20 | \$ 1,468,983 | \$ - | \$ - | \$ 1,468,983 |
| Building improvements | 10 | 1,875,846 | - | - | 1,875,846 |
| Ticket production equipment | 10 | 14,938 | - | - | 14,938 |
| Office equipment | 10 | 69,906 | 85,129 | (31,838) | 123,197 |
| Furniture and fixtures | 10 | 92,500 | - | (168) | 92,332 |
| Lottery drawing equipment | 3 | 87,023 | - | - | 87,023 |
| Automobiles | 3 | 261,665 | 61,024 | (51,645) | 271,044 |
| Computer equipment | 3 | 308,792 | - | (63,521) | 245,271 |
| Trucks | 3 | 22,445 | - | - | 22,445 |
| Total | | <u>\$ 4,202,098</u> | <u>\$ 146,153</u> | <u>\$ (147,172)</u> | <u>\$ 4,201,079</u> |
| <u>Less: Accumulated Depreciation</u> | | | | | |
| Building | | \$ 1,448,349 | \$ 1,552 | \$ - | \$ 1,449,901 |
| Building improvements | | 1,102,007 | 175,430 | - | 1,277,437 |
| Ticket production equipment | | 14,848 | 91 | - | 14,939 |
| Office equipment | | 56,568 | 6,318 | (25,865) | 37,021 |
| Furniture and fixtures | | 58,075 | 7,394 | (168) | 65,301 |
| Lottery drawing equipment | | 87,023 | - | - | 87,023 |
| Automobiles | | 196,677 | 49,321 | (51,645) | 194,353 |
| Computer equipment | | 307,888 | 175 | (63,521) | 244,542 |
| Trucks | | 22,445 | - | - | 22,445 |
| Total | | <u>\$ 3,293,880</u> | <u>\$ 240,281</u> | <u>\$ (141,199)</u> | <u>\$ 3,392,962</u> |
| Capital assets, net | | <u>\$ 908,218</u> | <u>\$ (94,128)</u> | <u>\$ (5,973)</u> | <u>\$ 808,117</u> |

(5) Transfers to the State

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

(a) Transfers to the State's General Fund for fiscal 2009 are reported as follows in the Lottery's financial statements:

| | |
|--|----------------------|
| Due to State's General Fund, beginning of year | \$ 521,090 |
| Transfers to State's General Fund | 337,515,478 |
| Cash paid during fiscal year | <u>(336,474,883)</u> |
| Due to State's General Fund, end of year | <u>\$ 1,561,685</u> |

RHODE ISLAND LOTTERY

Notes to Financial Statements

(5) Transfers to the State – (Continued)

- (b) Transfers to the State's Permanent School Fund for the net proceeds derived from expanded video operating hours for fiscal 2009 are reported as follows in the Lottery's financial statements:

| | |
|---|--------------------|
| Due to Permanent School Fund, beginning of year | \$ 1,152,762 |
| Transfers to Permanent School Fund | 6,777,327 |
| Cash paid during fiscal year | <u>(7,939,748)</u> |
| Due from Permanent School Fund, end of year | <u>\$ (9,659)</u> |

The law authorizing transfers to the Permanent School Fund expired on June 30, 2009.

(6) Commissions

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

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

(7) Compensated Absences

The Lottery accrues an estimated liability for vested benefits relating to future compensated absences. This includes an expected obligation in connection with vacation credits and accumulated vested sick pay for those employees eligible for retirement. As of June 30, 2009, the estimated liability, reported within accrued expenses on the Statement of Net Assets, was \$284,839. The liability is calculated using the current hourly rates of pay.

(8) Net Assets - (Deficiency)

On May 12, 2003, the Lottery entered into a 20-year contract, effective July 1, 2003, with its current gaming system provider. The contract granted the provider the right to be the Lottery's exclusive vendor of hardware and software, together with the related services necessary for the operation of the Lottery's computerized games, through June 30, 2023. In return, the provider made a one-time payment of \$12.5 million to the Lottery as consideration for this exclusive contract right. The Lottery recorded unearned contract revenue in the amount of \$12.5 million and transferred the cash to the State's General Fund on June 30, 2003. This prior year transfer of unearned contract revenue resulted in a deficiency in net assets at June 30, 2009 of \$8.8

RHODE ISLAND LOTTERY

Notes to Financial Statements

(8) Net Assets - (Deficiency) – (Continued)

million. As the contract revenue is recognized over the twenty-year life of the contract, the deficiency in net assets will be reduced by \$625,000 per year.

Net assets reported by the Lottery also include its investment in capital assets, net of accumulated depreciation. The Lottery had no debt related to capital assets at June 30, 2009.

(9) Retirement Plan

Plan Description:

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

Funding Policy:

The funding policy, as set forth in the General Laws, Section 36-10-2, provides for actuarially determined periodic contributions to the plan. Lottery employees are required to contribute 8.75% of their annual covered salary. The Lottery is required to contribute at an actuarially determined rate; the rate was 21.13% of annual covered payroll for the fiscal year ended June 30, 2009. The Lottery contributed \$586,324, \$605,223 and \$508,684 for the fiscal years ended June 30, 2009, 2008 and 2007, respectively, equal to 100% of the required contributions for each year.

(10) Postemployment Healthcare Plan

Plan Description:

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

The RIRHCBP is reported in an internal service fund of the State using the accrual basis of accounting. The fund reports all employer and retiree (plan member) contributions to the plan. Contributions are recognized when made. Benefits (health care claims) and refunds are recognized when due and payable in accordance with the terms of the plan. A liability for incurred but not reported claims is determined based on past claims payment trends and is included in the State's financial statements. Working premium rates are determined by the

RHODE ISLAND LOTTERY

Notes to Financial Statements

(10) Postemployment Benefits – (Continued)

State each fiscal year after consultation with an employee benefits consultant and are designed to fund current claims incurred during the fiscal year as well as the costs of administering the plan. For the year ended June 30, 2009, the plan operated on a pay as you go basis and no provision has been made to fund future benefits to be provided to RIRHCBP members. The RIRHCBP does not issue a stand-alone financial report.

Funding Policy:

RIGL Sections 36-10-2, 36-12.1, 36-12.2.2 and 36-12-4 govern the provisions of the RIRHCBP. The contribution requirements of plan members, the State and other participating employers are established and may be amended by the General Assembly.

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

For those who retired on or before September 30, 2008, the fiscal 2009 contributions are as follows:

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

(1) The monthly premium rate was \$789.76 for fiscal year 2009 for the individual plan. The retiree's cost is then calculated based on a maximum of \$481.28 (the active plan rate).

(2) The monthly premium rates are the same as indicated above for the Retiree Age Below 60 category.

(3) The monthly premium rate for the Medicare Supplemental plan is \$201.16 for the individual plan, and the monthly premium for the Medicare HMO plan was \$107 for the first six months of fiscal year 2009 and \$115 thereafter. Retirees can choose between the two plans. The retiree's cost is then calculated based on their years-of-service subsidy above.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(10) Postemployment Benefits – (Continued)

For anyone who retired on or after October 1, 2008, age 59 through 64, with a minimum of 20 years of service, the State will pay 80% of the actual cost of health care coverage. The State contributed \$631.81 per month for these retirees during fiscal 2009. For eligible retirees ages 65 or older, the State pays 80% of the cost of the Medicare supplement products as described in note (3) above.

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

As required by GASB Statement 45, the Lottery recognized an expense equal to; a.) the annual required contribution of the employer (ARC), which was actuarially determined to be 6.01% of covered payroll for all State employees for fiscal year 2009, plus b.) interest on the net OPEB obligation at the beginning of the fiscal year, and less c.) the ARC adjustment (discounted present value of the OPEB liability at the beginning of the fiscal year). The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal costs each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years. The ARC for fiscal 2009 was determined based on an actuarial valuation performed as of June 30, 2005. This actuarial valuation determined a single ARC percentage, 6.01%, for all participants of the plan and did not determine specific employer ARCs for the participating component unit employers. For fiscal year 2009, the ARC, based on the Lottery's covered payroll of \$2,809,616 totaled \$168,858. The Lottery actually contributed \$155,856, which was 5.62% of annual covered payroll for fiscal 2009. The Lottery's annual OPEB cost and the net OPEB obligation for fiscal 2009, were as follows:

| | |
|--|-------------------|
| Annual required contribution (ARC) | \$ 168,858 |
| Plus: Interest on net OPEB obligation at beginning of year | 2,210 |
| Less: Adjustment to ARC | (2,088) |
| Annual OPEB cost | \$ 168,980 |
| Contributions made | (\$155,856) |
| Increase in OPEB obligation | 13,124 |
| Net OPEB obligation at beginning of year | \$ 61,976 |
| Net OPEB obligation at end of year | \$ 75,100 |

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

| Fiscal Year Ended | Annual OPEB Cost | Percentage of Annual OPEB Cost Contributed | Net OPEB Obligation |
|-------------------|------------------|--|---------------------|
| June 30, 2008 | \$176,982 | 65.0% | \$61,976 |
| June 30, 2009 | \$168,980 | 92.2% | \$75,100 |

RHODE ISLAND LOTTERY

Notes to Financial Statements

(10) Postemployment Benefits – (Continued)

Funded Status and Funding Progress:

The State has obtained an actuarial valuation for the RIRHCBP, which determined the collective Actuarial Accrued Liabilities (AAL) and Unfunded Actuarial Accrued Liabilities for all State employees participating in the plan and separate liability amounts for each discretely presented component unit with employees participating in the plan. The liabilities relating to the Lottery's employees, as part of the primary government, are included in the collective amounts reported for all State employees. The AAL and UAAL for the RIRHCBP at June 30, 2009 will be reported in the State's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2009.

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Amounts determined regarding the funded status of the plan and the annual required contributions of the employer are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The Schedule of Funding Progress for RIRHCBP shows whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liabilities for benefits. This schedule will be included in the State's Comprehensive Annual Financial Report for the fiscal year ended June 30, 2009.

Actuarial Methods and Assumptions:

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

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

Plan changes effective for employees retiring after October 1, 2008 have been reflected in the actuarial valuations performed as of June 30, 2007 and June 30, 2005.

The individual entry-age actuarial cost method is used to determine the annual required contribution amounts and the annual net OPEB obligation. The actuarial assumptions include a 3.566% discount rate based upon the average rate of return during the 10 years ended June 30, 2008 for short term investments of the State's General Fund; an annual healthcare cost trend rate of 12% progressively declining to 4.50% after 10 years for the 2005 valuation; and a salary

RHODE ISLAND LOTTERY

Notes to Financial Statements

(10) Postemployment Benefits – (Continued)

growth rate ranging from 8.25% in the first year to 4.75% in year 15 and beyond for the 2005 valuation. In the June 30, 2007 valuation, the health care cost trend assumption was changed to a rate of 10% progressively declining to 4.50% after 8 years and the salary growth assumption was changed to a rate of 9.00% in the first year of service to 4.50% in year 15 and beyond. Other changes in assumptions between the 2005 and 2007 valuations include changes in the assumed rates of termination, rates of retirement, percent married, and retiree health care election rates. These changes in assumptions were based on the experience study for the Employees' Retirement System of Rhode Island as well as anticipated experience changes in conjunction with the adopted plan changes.

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

(11) Deferred Compensation

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

(12) Commitments

(a) Gaming Systems Provider – GTECH (a combined company with Lottomatica 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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments – (Continued)

| 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 19th, 2007 and the square footage leased is 5,101 square feet. The annual lease amount for the first year approximated \$87,000 and the four (4) remaining years will increase by four percent (4%) per annum, effective October 19. The tenant has two (2) renewal options; an additional five (5) year term and an additional four (4) year term. The base rate for the renewal options will be an increase of four percent (4%) per annum unless a mutually acceptable rate is negotiated.

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

On July 18, 2005, the Lottery entered into a five (5) year Master Video Lottery Terminal Contract with UTGR, Inc., the owners of Twin River, to operate one of the State's licensed video lottery facilities. The agreement entitles UTGR, Inc. to compensation ranging from 26% to 28.85% of video lottery net terminal income at the facility. At the time of the agreement, the Lottery authorized an additional 1,750 video lottery terminals to be installed at Twin River and UTGR, Inc. agreed to invest no less than \$125 million in the construction and development of its gaming facility during the first three (3) years of the agreement.

UTGR, Inc. has the right and option to extend the term of the agreement for two (2) successive five (5) year periods by giving notice to the Lottery at least ninety (90) days prior to the expiration of the agreement. The option can be exercised if UTGR, Inc. is not in default of any major term or condition of the agreement and the full-time employee requirement at Twin River has been met. See Note 13 Contingencies.

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

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

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments – (Continued)

video lottery facilities. The agreement entitles Newport Grand to 26% of video lottery net terminal income at the facility. At the time of the agreement, the Lottery authorized an additional 800 video lottery terminals to be installed at Newport Grand, which has agreed to invest no less than \$20 million in the construction and development of its gaming facility during the first three (3) years of the agreement.

Newport Grand has the right and option to extend the term of the agreement for one (1) additional five (5) year period by giving notice to the Lottery at least ninety (90) days prior to the expiration of the agreement. The option can be exercised if Newport Grand is not in default of any major term or condition of the agreement and the full-time employee requirement at Newport Grand has been met.

(13) Contingencies

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

(b) In March 2008, UTGR, Inc., the owner and operator of Twin River, one of two licensed video lottery facilities of the State, defaulted on loan payments to its lenders who provided a \$565 million loan package to UTGR, Inc. and its parent companies to buy and expand the Twin River facility. As a result of defaulting on loan payments, UTGR entered into a forbearance agreement with its lenders. In September 2008, both Standard & Poor's and Moody's Investors Service downgraded their rating of the company that owns Twin River, and Moody's issued a statement warning of a "high probability of bankruptcy." The forbearance agreement expired January 31, 2009 and has not been formally extended.

On or about June 23, 2009, UTGR, Inc., d/b/a Twin River, BLB Management Services, Inc., and BLB Worldwide Holdings, Inc. ("Debtors") commenced a chapter 11 proceeding by filing voluntary petitions for relief under chapter 11 in the United States Bankruptcy Court for the District of Rhode Island (Case No. 09-12418). The filing was made when – after months of discussions and negotiations – the Debtors, their lenders and the State reached an agreement with respect to a consensual reorganization plan. The State is represented in the bankruptcy proceedings by outside legal counsel. Since the filing, the Debtors have continued in the management and operation of the business as debtors in possession pursuant to sections 1107 and 1108 of the Bankruptcy Code and Twin River has continued to remain open as usual. It is not anticipated that the bankruptcy will have a significant impact on the lottery revenues the State expects to continue to receive from the facility. The Rhode Island Lottery continues to control and regulate the video lottery operations at the facility, including cash receipts, cash transfers and cash deposits.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(13) Contingencies – (Continued)

The Department of Revenue Division of Lotteries and the Department of Business Regulation continue to closely monitor the situation. Any proposal to have a new operator of the facility and/or any proposal to transfer ownership of the facility would need regulatory approval.

- (c) Subsequent to June 30, 2009, it was discovered that an immaterial amount of unauthorized promotional play had been awarded by an employee of the Twin River facility. This resulted in unauthorized bonus play and cash winnings (prize awards) being redeemed. The immaterial prize awards associated with this potentially fraudulent action are reflected in reported prize awards in the Lottery's financial statements for the year ended June 30, 2009. Based on internal and external investigations, it was estimated the potential recovery to the State of Rhode Island in relation to this issue ranges between \$136,000 and \$250,000. This range of potential recovery includes the State's portion of the net terminal income from unauthorized promotional dollars allowed and estimated cash won. Upon recovery, the Lottery will give consideration to the impact of this incident on the commissions due the central system provider, the technology providers, the Town of Lincoln and the Narragansett Indian Tribe. The Lottery is taking appropriate measures to ensure that controls over the administration of promotional play programs at its video lottery facilities is improved.

(14) Risk Management

The Lottery is exposed to various types of risk related to its operations. These risks can result in losses incurred from property damage or destruction, inability to operate gaming activities and worker compensation claims. The Lottery manages these risks through the purchase of commercial insurance. During fiscal year 2009, the Lottery has maintained its amount of purchased insurance coverage. Claims and settlements incurred for fiscal years 2009, 2008 and 2007 have not exceeded the Lottery's insurance coverage.

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

Supplementary Information

RHODE ISLAND LOTTERY

Sales, Commissions and Prize Awards Expense

Year Ended June 30, 2009

Schedule 1

| | Sales | Commissions | Prize Awards Expense | Unclaimed Prize Recovery | Cost of Tickets | Cost of Sales | Gross Profit |
|---|-------------------------|-----------------------|----------------------------|--------------------------------|---------------------|-------------------------|-----------------------|
| Lottery games: | | | | | | | |
| On-line games | | | | | | | |
| Keno | \$ 76,036,908 | \$ 9,877,154 | \$ 49,768,255 | \$ (309,445) | \$ - | \$ 59,335,964 | \$ 16,700,944 |
| PowerBall® | 46,583,080 | 6,051,117 | 23,299,583 | (847,053) | - | 28,503,647 | 18,079,433 |
| Daily Numbers | 25,814,615 | 3,353,305 | 12,592,628 | (225,677) | - | 15,720,256 | 10,094,359 |
| Rhody Poker™ | 109,943 | 14,282 | 74,274 | (4,080) | - | 84,476 | 25,467 |
| Wild Money | 5,185,904 | 673,646 | 2,843,761 | (122,232) | - | 3,395,175 | 1,790,729 |
| Raffle | 2,399,740 | 318,725 | 1,200,000 | - | - | 1,518,725 | 881,015 |
| | <u>156,130,190</u> | <u>20,288,229</u> | <u>89,778,501</u> | <u>(1,508,487)</u> | <u>-</u> | <u>108,558,243</u> | <u>47,571,947</u> |
| Instant tickets | 82,348,042 | 8,756,661 | 55,077,672 | (1,522,740) | 1,193,898 | 63,505,491 | 18,842,551 |
| Video Lottery | | | | | | | |
| Regular Operating Hours | 2,212,932,586 | 170,564,039 | 1,764,234,371 | (167,039) | - | 1,934,631,371 | 278,301,215 |
| Expanded Operating Hours | <u>107,519,380</u> | <u>5,420,191</u> | <u>95,321,862</u> | <u>-</u> | <u>-</u> | <u>100,742,053</u> | <u>6,777,327</u> |
| | <u>2,320,451,966</u> | <u>175,984,230</u> | <u>1,859,556,233</u> | <u>(167,039)</u> | <u>-</u> | <u>2,035,373,424</u> | <u>285,078,542</u> |
| Totals | <u>\$ 2,558,930,198</u> | <u>\$ 205,029,120</u> | <u>\$ 2,004,412,406</u> | <u>\$ (3,198,266)</u> | <u>\$ 1,193,898</u> | <u>\$ 2,207,437,158</u> | <u>\$ 351,493,040</u> |
| <u>Video Lottery Commissions - Detail</u> | | | | | | | |
| Facilities | | 125,820,242 | | | | | |
| Technology Providers | | 31,628,000 | | | | | |
| Central Communications Provider | | 11,521,004 | | | | | |
| City/Town | | 6,340,854 | | | | | |
| Narragansett Indian Tribe | | 674,130 | | | | | |
| Total | | <u>\$ 175,984,230</u> | | | | | |