
RHODE ISLAND LOTTERY

Component Unit of the State of Rhode Island
and Providence Plantations

Financial Statements

Six Months Ended December 31, 2001 and 2000

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

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

July 15, 2002

JOINT COMMITTEE ON LEGISLATIVE SERVICES:

SPEAKER John B. Harwood, Chairman

Senator William V. Irons

Senator Dennis L. Algieri

Representative Gerard M. Martineau

Representative Robert A. Watson

We have completed our audit of the financial statements of the Rhode Island Lottery for the six months ended December 31, 2001 and 2000 in accordance with Rhode Island General Laws, Section 42-61-15.

Our report is contained herein as outlined in the Table of Contents.

Sincerely,

Ernest A. Almonte, CPA, CFE
Auditor General

RHODE ISLAND LOTTERY

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INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of the Rhode Island Lottery (Lottery), a component unit of the State of Rhode Island and Providence Plantations, as of and for the six months ended December 31, 2001 and 2000, 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 audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the Lottery as of December 31, 2001 and 2000, and the results of its operations and cash flows for the six months then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the financial statements, the Lottery adopted the provisions of the Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 24, 2002 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, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The Management’s Discussion and Analysis 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. 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. Such information has been subjected to the auditing procedures applied in the audits 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, CFE
Auditor General

May 24, 2002

RHODE ISLAND LOTTERY **MANAGEMENT'S DISCUSSION AND ANALYSIS**

Management of the Rhode Island Lottery (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 six-months ended December 31, 2001. 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 is a component unit of the State of Rhode Island and Providence Plantations (State), accounted for as an enterprise fund which reports all assets and liabilities using the accrual basis of accounting much like a private business entity. In accordance with generally accepted accounting principles, this report consists of a series of financial statements, along with explanatory notes to the financial statements and a supplementary schedule detailing sales, commissions and prize award expense for each lottery game. The financial statements immediately follow this discussion and analysis by management and are designed to highlight the Lottery's net assets and changes to those assets resulting from Lottery operations.

The most important relationship demonstrated within the Lottery's financial statements is the requirement that the Lottery transfer all net income to the State's General Fund. Accordingly, the primary focus of these financial statements is determining net income available for transfer 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 or indirect relationship to revenue. As lottery sales increase, the amount transferred 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. Schedule 1 to the financial statements demonstrates this relationship on a comparative basis.

Most assets included on the Statements of Net Assets represent current amounts such as cash and accounts receivable from lottery retailers. Most liabilities represent current prize awards payable and amounts due to the State's general fund. Current assets approximate the amounts required to satisfy current liabilities at December 31. Few capital assets are required for Lottery operations. Additionally, the Lottery reports minimal net assets since all net income is transferred to the State's general fund.

RHODE ISLAND LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

Financial Highlights

- ❑ Instant ticket sales for the six-months ended December 31, 2001 exceeded sales for the six-months ended December 31, 2000 by \$6.8 million or 20.1%.
- ❑ Powerball sales for the six-months ended December 31, 2001 have outpaced the sales for the six-months ended December 31, 2000 by \$11.4 million or 64%.
- ❑ Keno sales for the six-months ended December 31, 2001 increased \$4.5 million or 13.6% over the six-months ended December 31, 2000.
- ❑ Gross video lottery sales increased \$79 million with a resulting increase in net terminal income (sales less prize awards) of approximately \$25 million for the six-months ended December 31, 2001 as compared with the six-months ended December 31, 2000.
- ❑ Because of the increases in sales highlighted above, the Lottery increased its transfer to the General Fund by \$19 million to \$104.9 million for the six-months ending December 31, 2001 as compared to \$85.9 million for the six-months ending December 31, 2000.

Assets and Liabilities

	<u>December 31,</u> <u>2001</u>	<u>December 31,</u> <u>2000</u>
Assets:		
Cash and cash equivalents	\$ 22,618,814	\$ 17,051,277
Accounts receivable	5,323,682	6,201,552
Other assets	<u>3,279,009</u>	<u>4,246,542</u>
	\$ 31,221,505	\$ 27,499,371
Liabilities		
Due to State	\$ 16,952,893	\$ 13,868,980
Prizes payable	6,401,032	7,872,446
Accounts payable and other liabilities	<u>7,796,579</u>	<u>5,615,049</u>
	\$ 31,150,504	\$ 27,356,475
Net Assets	<u>\$ 71,001</u>	<u>\$ 142,896</u>

The majority of the Lottery's assets consist of cash (including amounts invested in cash equivalent type instruments) and accounts receivables derived from sales of the Lottery's games. At December 31, 2001, the Lottery's net assets included \$22.6 million (net of a cash overdraft of \$2.8 million in the Lottery's primary bank account) in cash and cash equivalents as compared with \$17.1 million at December 31, 2000. The Lottery's accounts receivable approximated \$5.3 and \$6.2 million, respectively, at December 31, 2001 and 2000.

RHODE ISLAND LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

The Lottery's liabilities included at the balance sheet date amounts owed to the State general fund for December's net operations, vendor payables, and prize obligations. The amount due to the general fund approximated \$17 million at December 31, 2001 as compared with \$13.9 million at December 31, 2000. Vendor payables made up largely of commissions due to video lottery participants and prize obligations attributable mostly to instant ticket games and Powerball were \$7.2 million and \$5.8 million, respectively. In comparison, vendor payables and prize obligations at December 31, 2000 were \$5.2 and \$6.7 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 general fund.

Investments for jackpot awards relating to the former Lot-O-Bucks game are sufficient to satisfy the outstanding prize liabilities (annual payments) owed to jackpot winners. Fixed assets reported on the Statement of Net Assets are not significant in relation to the Lottery's operations.

Lottery Operations

	<u>Six-months ended</u> <u>December 31, 2001</u>	<u>Six-months ended</u> <u>December 31, 2000</u>
Sales	\$ 568,906,792	\$ 467,965,973
Prize Awards Expense (net)	(385,490,477)	(318,175,410)
Commissions	(75,378,849)	(61,285,411)
Operating and other expenses	<u>(3,810,591)</u>	<u>(3,447,972)</u>
Operating income	104,226,875	85,057,180
Other income	590,071	775,853
Transfer to State general fund	<u>(104,852,893)</u>	<u>(85,868,980)</u>
Change in net assets	<u>\$ (35,947)</u>	<u>\$ (35,947)</u>

Sales

Lottery sales are categorized as On-line, Instant, and Video Lottery games. The first category is On-line games which consisted of Powerball, Keno, Daily Numbers, and Money Roll at December 31, 2001. In total, on-line sales increased by \$15.1 million mostly attributable to the growth of Powerball and Keno sales.

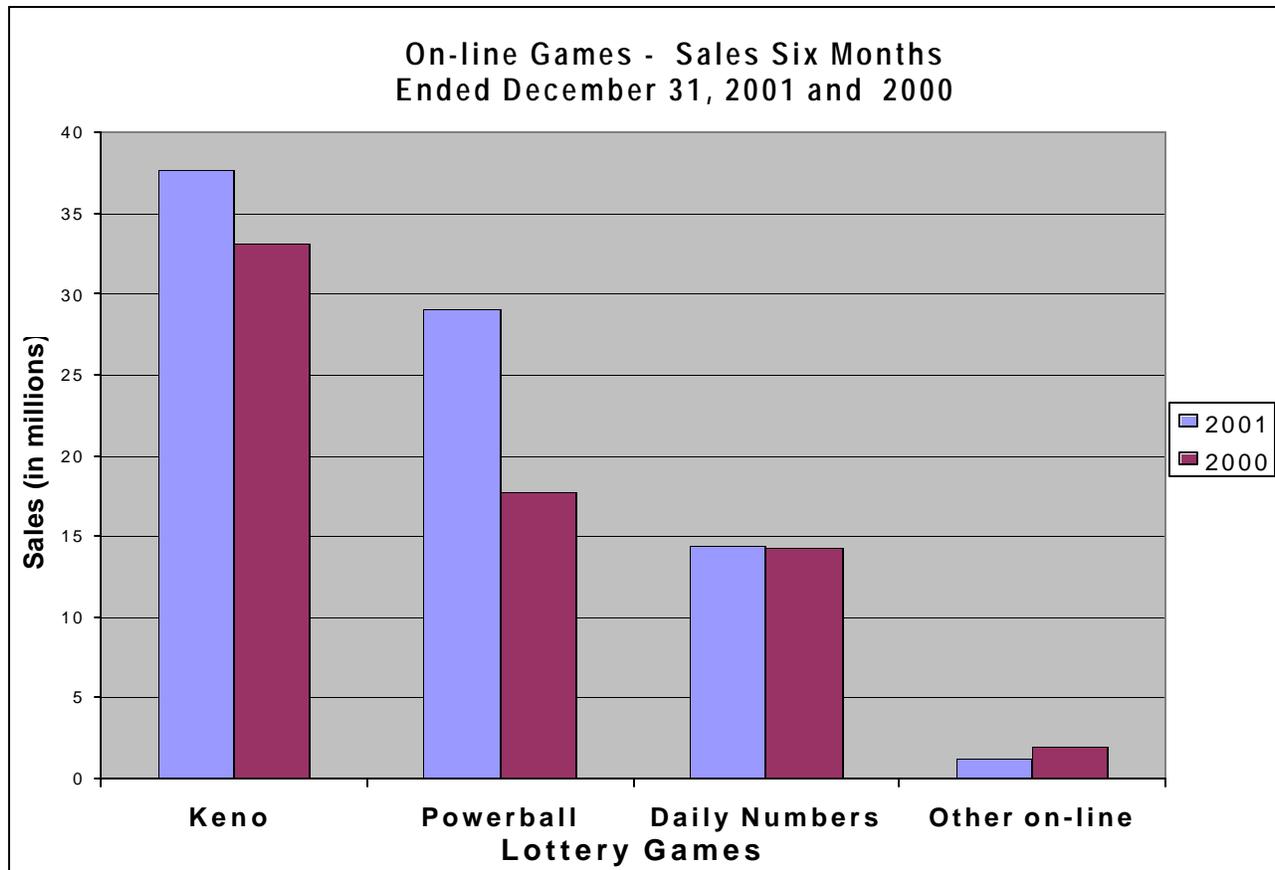
Powerball sales for the six-months ended December 31, 2001 increased \$11.4 million or 64% over the six-months ended December 31, 2000. This increase was largely attributable to a near record jackpot of \$295 million during August 2001 which generated sales for the month of \$14.9 million as compared with average monthly Powerball sales of under \$3

RHODE ISLAND LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

million. There were no unusually large jackpots for the six-months ended December 31, 2000.

Keno sales for the six-months ended December 31, 2001 increased \$4.5 million or 13.6% over the six-months ended December 31, 2000. This increase was largely attributable to the Lottery's implementation of the Keno Plus feature for the game on April 1, 2001. This feature allows the player to wager another dollar per game in the hopes of multiplying their winnings by a factor determined before the start of each game. The Keno plus multiplier ranges between 0 and 10 times the single wager payout for each game.

The following graph depicts the Lottery's on-line sales for the six-months ended December 31, 2001 and 2000.



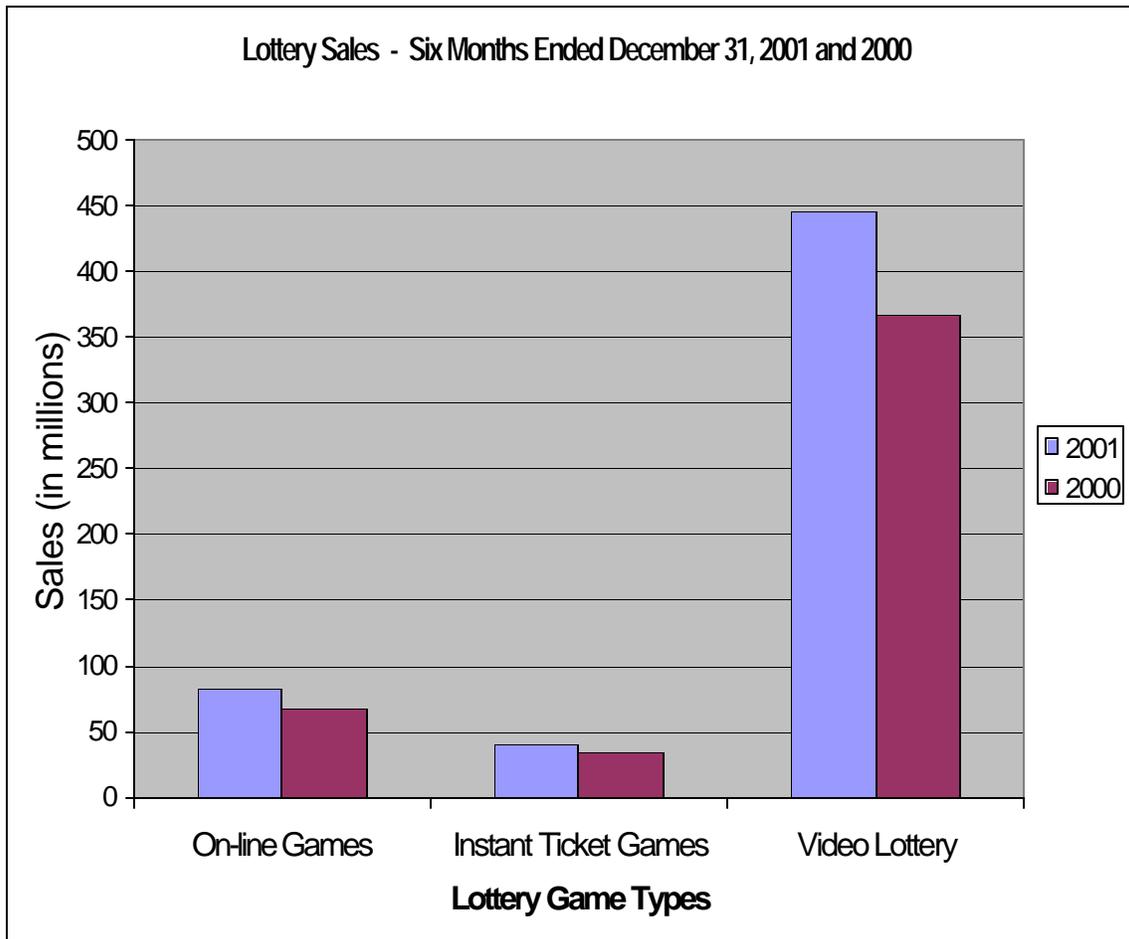
Instant tickets or “scratch” tickets are the second type of Lottery game offered to the public. Instant ticket sales for the six-months ended December 31, 2001 increased \$6.8 million or 20.1% over the six-months ended December 31, 2000. In addition to offering more popular and expensive games (\$10 and \$5 tickets) to the public, the Lottery also launched a retailer incentive program in July 2001 that rewards bonus commissions to retailers who

RHODE ISLAND LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

surpass their prior year instant sales volume by 12.4%. This bonus was implemented to enhance sales at each retail location.

The third type of game offered by the Lottery is video lottery. Gross video lottery sales increased \$79 million with a resulting increase in Net Terminal Income (sales minus prize awards) of approximately \$25 million for the six-months ended December 31, 2001 as compared with the previous year's six-months ended December 31, 2000. Beyond the increasing popularity of video lottery within the State, the Lottery attributes increased sales to two main reasons. The Lottery has continued to base video terminal allocation among technology providers based on terminal play (sales). This periodic reallocation of terminals has resulted in a competitive environment among the technology providers to continually introduce newer and more popular games to the public. The second reason attributable to the increase in video sales has been the completed renovations at the State's two video lottery facilities. The new renovations have made for a more appealing and comfortable setting for video lottery patrons and have enhanced the popularity of video lottery in the State.

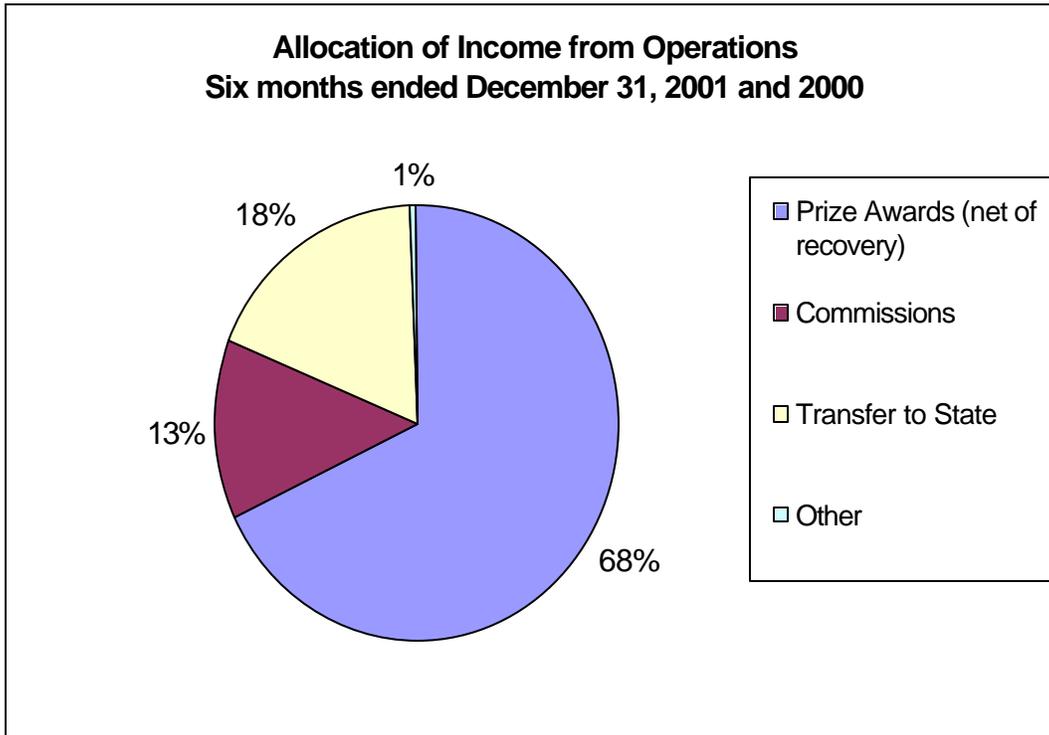
The following graph depicts the Lottery's on-line, instant, and video lottery sales for the six-months ended December 31, 2001 in comparison to the six-months ended December 31, 2000.



RHODE ISLAND LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

Commissions and Prize Awards Expense

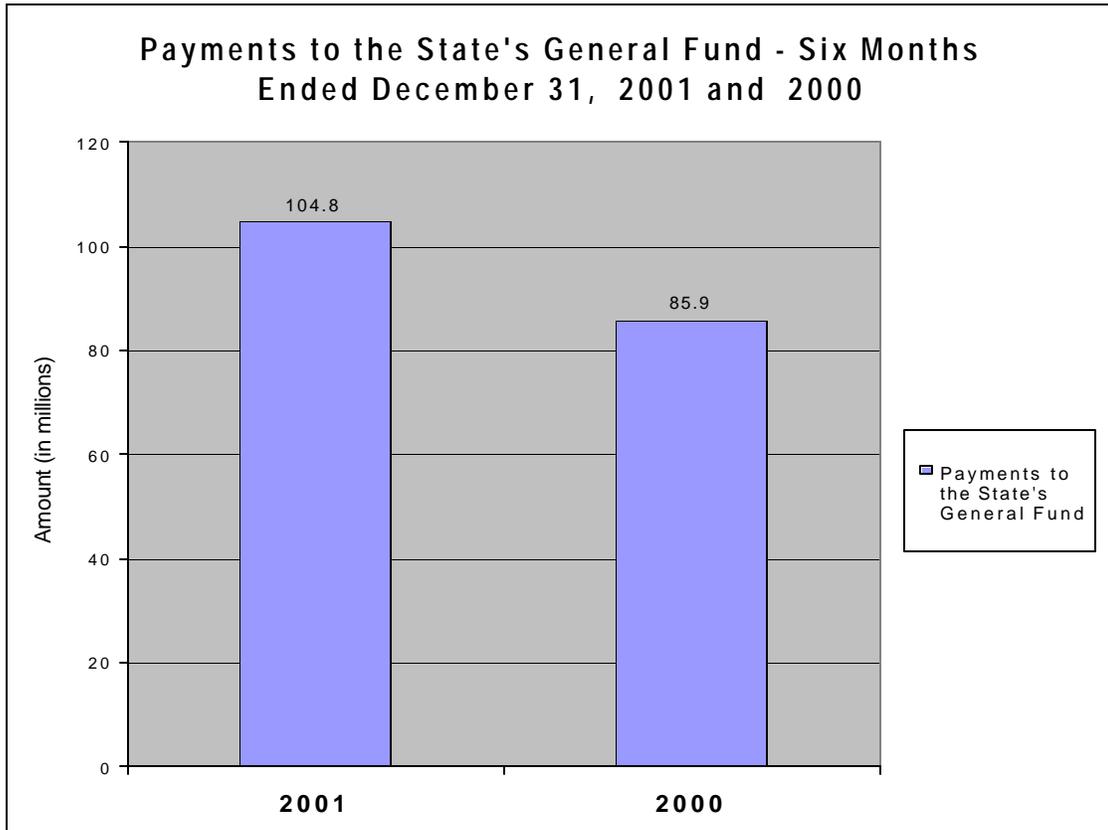
The Lottery's most significant expenses (commissions and prize awards) are predictable because they have a direct correlation to sales. As lottery sales increase, so do the related prizes and commissions paid by the Lottery. While each Lottery game has a designed prize pay-out structure the overall amount paid as prize award expense is consistent. As shown in the following graph prize award expense has been 68% of Lottery sales for the six months ended December 31, 2001 and 2000. Amounts paid to the State, commissions and operating expenses are similarly consistent between operating periods.



Payments to the State's General Fund

The Lottery has continued its overall sales growth during the six-months ended December 31, 2001 allowing its payments to the General Fund to increase by \$19 million to \$104.9 million for the period as compared to \$85.9 million for the six-months ended December 31, 2000.

RHODE ISLAND LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS



The Lottery's continued success should enable it to achieve a record payment in excess of \$200 million to the State's general fund for the fiscal year.

Potential Factors Impacting Future Operations

The Lottery's mission is to maximize revenues for the purpose of maximizing transfers to the State's general fund. A continuous assessment of the State's financial environment and the Lottery's own product lines and operations is 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;

- The State of Rhode Island is currently projecting budgetary shortfalls for fiscal years 2002 and 2003. This caused the State to reevaluate the current commission percentages paid to video lottery participants with the intent of enhancing the Lottery's net income and payments to the State General Fund.

RHODE ISLAND LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

- ❑ The Lottery Commission has been requested to increase the number of authorized terminals at the video lottery facilities. An increase in the number of terminals normally results in an increase in video lottery revenues. In the past, an increase in the number of video terminals awarded to a facility has been a catalyst for facility renovations.
- ❑ The Lottery began paying a 1% bonus commission to instant ticket retailers at May 1, 2002. The Lottery is offering this bonus to give retailers incentive to offer as many games as possible to the public hoping to continue the growth of instant ticket sales.
- ❑ The Lottery's video lottery operations currently compete with Indian gaming casinos in nearby Connecticut. Proposals are continually made in Rhode Island, as well as neighboring Massachusetts, to seek approval from the voters to allow Indian Gaming Casinos in Rhode Island and Massachusetts. The Lottery's operations may be impacted by competition from other gaming interests that may be developed both within Rhode Island or neighboring states.

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 Financial Administrator, Rhode Island Lottery, 1425 Pontiac Avenue, Cranston, Rhode Island, 02920.

RHODE ISLAND LOTTERY

Statements of Net Assets

December 31, 2001 and 2000

<u>Assets</u>	<u>2001</u>	<u>2000</u>
Current assets:		
Cash and cash equivalents (note 3)	\$ 25,393,625	\$ 19,381,607
Investments for jackpot awards (note 3)	725,000	1,012,000
Accounts receivable-less allowance for doubtful accounts of \$365,417 in 2001 and \$320,329 in 2000	5,323,682	6,201,552
Deposits with Multi-State Lottery Association (MUSL) (note 1)	339,152	436,111
Ticket inventory	998,127	894,002
Deferred charges	114,400	141,865
	<hr/>	<hr/>
Total current assets	32,893,986	28,067,137
Investments for jackpot awards (note 3)	627,401	1,227,055
Property, plant and equipment, net (note 4)	474,929	535,509
	<hr/>	<hr/>
Total assets	33,996,316	29,829,701
	<hr/>	<hr/>
<u>Liabilities</u>		
Current liabilities:		
Cash overdraft (note 3)	2,774,811	2,330,330
Due to State's General Fund (note 5)	16,952,893	13,868,980
Current obligation for unpaid prize awards	5,773,631	6,645,391
Accounts payable	7,154,034	5,160,192
Accrued expenses	379,164	285,287
Deferred revenue	263,381	169,570
	<hr/>	<hr/>
Total current liabilities	33,297,914	28,459,750
Long-term obligation for unpaid prize awards	627,401	1,227,055
	<hr/>	<hr/>
Total liabilities	33,925,315	29,686,805
	<hr/>	<hr/>
<u>Net Assets</u>		
Investment in capital assets (note 8):	71,001	142,896
	<hr/>	<hr/>
Total net assets	\$ 71,001	\$ 142,896
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See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statements of Revenue, Expenses and Changes in Net Assets

Six Months Ended December 31, 2001 and 2000

	2001	2000
Sales (schedule 1):		
On-line games	\$ 82,279,737	\$ 67,156,183
Instant games	40,484,839	33,724,031
Video lottery	446,142,216	367,085,759
Total sales	568,906,792	467,965,973
Cost of sales:		
Commissions (note 6)	75,378,849	61,285,411
Prize awards	386,945,335	319,705,902
Unclaimed prize recovery	(1,454,858)	(1,530,492)
Cost of tickets	694,620	534,931
Total cost of sales	461,563,946	379,995,752
Gross profit	107,342,846	87,970,221
Operating expenses:		
Personal services	1,629,676	1,471,591
Advertising	775,422	662,915
Contract services	47,161	192,838
Equipment leasing (note 13)	130,831	129,613
Depreciation	105,711	114,480
Other	427,170	341,604
Total operating expenses	3,115,971	2,913,041
Operating income	104,226,875	85,057,180
Nonoperating income (expenses):		
Interest and miscellaneous income	590,071	775,853
Payments to the State's General Fund (note 5)	(104,852,893)	(85,868,980)
Change in net assets (note 8)	(35,947)	(35,947)
Total net assets, July 1	106,948	178,843
Total net assets, December 31	\$ 71,001	\$ 142,896

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statements of Cash Flows

Six Months Ended December 31, 2001 and 2000

	2001	2000
Cash flows from operating activities:		
Cash received from sales	\$ 569,661,793	\$ 466,498,556
Cash received from MUSL for grand prize winners	4,685,601	4,659,000
Cash received from sale of other tickets	160,637	150,012
Cash received from other sources	277,660	85,231
Cash paid for prizes other than MUSL grand prize winners	(385,110,282)	(318,811,697)
Cash paid to MUSL grand prize winners	(4,685,601)	(4,659,000)
Cash paid for commissions - retailers	(8,709,105)	(7,052,938)
Cash paid for commissions - video lottery	(61,731,490)	(52,641,818)
Cash paid for commissions - on-line games contractor	(4,063,986)	(4,032,618)
Cash paid to suppliers for goods and services	(1,931,528)	(1,422,354)
Cash paid to employees for services	(1,639,396)	(1,490,106)
Net cash provided by operating activities	106,914,303	81,282,268
Cash flows from noncapital financing activities:		
Payments to State's General Fund	(89,343,897)	(84,883,635)
Negative cash balance implicitly financed	2,774,811	2,330,330
Net cash used for noncapital financing activities	(86,569,086)	(82,553,305)
Cash flows from capital and related financing activities:		
Purchase of fixed assets	(137,739)	(31,442)
Net cash used for capital and related financing activities	(137,739)	(31,442)
Cash flows from investing activities:		
Proceeds from maturity of investments for jackpot awards	541,132	738,477
Interest income	278,847	540,562
Net cash provided by investing activities	819,979	1,279,039
Net increase (decrease) in cash and cash equivalents	21,027,457	(23,440)
Cash and cash equivalents, July 1	4,366,168	19,405,047
Cash and cash equivalents, December 31	\$ 25,393,625	\$ 19,381,607

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Statements of Cash Flows (Continued)

Six Months Ended December 31, 2001 and 2000

	2001	2000
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 104,226,875	\$ 85,057,180
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	105,711	114,480
Installment payments for jackpot awards	(541,132)	(738,477)
Other receipts classified as operating activities	119,503	108,707
Rental income and other receipts	262,064	126,789
Provision for doubtful accounts	50,824	31,331
(Increase) decrease in assets:		
Investment for jackpot awards	487,179	634,393
Accounts receivable	630,176	(1,382,247)
Inventory	(262,431)	(90,201)
Deposits with MUSL	15,596	(41,558)
Deferred charges	(41,802)	(714)
Increase (decrease) in liabilities:		
Obligation for unpaid prize awards	434,148	(532,203)
Accounts payable	1,401,889	(1,897,345)
Accrued expenses	(96,542)	(22,027)
Deferred revenue	122,245	(85,840)
Total adjustments	2,687,428	(3,774,912)
Net cash provided by operating activities	\$ 106,914,303	\$ 81,282,268

See accompanying notes to financial statements.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(1) Organization

The Rhode Island Lottery (Lottery) was created in 1974 under the General Laws of the State of Rhode Island to establish and operate lottery games for the purpose of generating resources for the State’s general fund. It is governed by the nine-member Rhode Island Lottery Commission (Commission).

The Lottery offers various on-line games which include: a daily numbers game, Keno, Money Roll, and PowerBall, which is operated by the Multi-State Lottery Association (MUSL). The Lottery also sells instant lottery tickets, which do not involve prize drawings. All tickets are sold through licensed lottery retailers. In addition, the Lottery conducts video lottery games at two licensed facilities.

Prize payout percentages and amounts required to be paid to the State’s general fund as stipulated in the Rhode Island General Laws (General Laws) are summarized below for the various games operated by the Lottery.

<u>Game</u>	<u>Prize Payout</u>	<u>State’s General Fund Share</u>
Daily Numbers Instant Ticket Games MUSL - PowerBall Money Roll	not less than 45% nor more than 65% of sales	not less than 25% of ticket sales
Keno	not less than 45% nor more than 72% of sales	not less than 15% of ticket sales
Video Lottery	Prize payout not established by law	51% of net terminal income (video lottery credits purchased less credits redeemed or redeemable) less pro rata share of Lottery’s operating expenses

Chapter 42-61.2 of the General Laws authorizes the Commission 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). The Commission’s share for deposit in the Lottery fund shall be no less than 51% of net terminal income. The remaining net terminal income is divided among licensed video lottery retailers, the technology

RHODE ISLAND LOTTERY

Notes to Financial Statements

providers (video lottery terminal providers), the central communications system provider, the city or town in which the video retailer is

(1) Organization - (Continued)

licensed, and the owners of dog kennels under contract with a licensed video lottery retailer.

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 \$77,000,000. 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 December 31, 2001 and 2000, the prize reserve funds for the PowerBall game had reached a maximum balance of \$77,000,000 of which the Lottery's share was \$2,126,422. The Lottery has charged amounts placed into the prize reserve funds to prize awards expense as the related sales have occurred.

All investment earnings relating to the prize reserve funds are credited to an unreserved account for each member state. This account can be utilized to offset operating costs or for the promotion of any MUSL game as approved by the MUSL Board of Directors. The Lottery's unreserved account is reported on the balance sheets as "Deposits with MUSL." The Lottery is assessed its pro rata share of MUSL's annual operating expenses. MUSL reduced the Lottery's unreserved account by \$77,757 and \$40,318 for operating expenses for the six months ended December 31, 2001 and 2000, respectively.

MUSL's independent auditors issue a publicly available annual financial report which may be obtained by writing to the Multi-State Lottery Association, 1701 48th Street, Suite 200, West Des Moines, Iowa 50266-6723.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(2) Summary of Significant Accounting Policies

(a) *Basis of Accounting*

The financial records of the Lottery, a proprietary 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.

(b) *Reporting Entity*

The Lottery is a component unit of the State of Rhode Island and Providence Plantations (State) for financial reporting purposes. Accordingly, its annual financial statements are included in the State's Comprehensive Annual Financial Report (CAFR).

(c) *Revenues and Expenses*

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

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

RHODE ISLAND LOTTERY

Notes to Financial Statements

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

(d) *Depreciation*

Property, plant, and equipment are stated at historical cost. Depreciation is computed using the straight-line method based on the estimated useful lives of the assets.

(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 which approximates fair value.

(f) *Investments for Jackpot Awards and Obligations for Unpaid Prize Awards*

Jackpot awards for the Lot-O-Bucks game, which is no longer active, are paid in annual installments. The Lottery satisfied these obligations by purchasing investments with maturities corresponding to the jackpot award annual installments. Investments for jackpot awards purchased since November 15, 1983 are in the name of the Lottery. Accordingly, the Lottery has a direct obligation to make future installment payments to the jackpot winner. These investments and related obligations are recorded at fair value. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The fair value of investments for jackpot awards are generally based on published market prices and quotations from national security exchanges and securities pricing services.

For certain other games, annuity contracts were purchased in the name of, and paid directly to, the jackpot winner. Accordingly, the Lottery has not recorded an obligation for prize awards satisfied through annuity contracts purchased in the name of the winner.

(g) *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.

(h) *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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

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

(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.

(j) *Adoption of Governmental Accounting Standards Board Pronouncements*

The Lottery adopted the provisions of the GASB Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis- for State and Local Governments*. Statement No. 34 establishes new financial reporting requirements for all state and local governments. For the Lottery, adoption of this pronouncement required inclusion of management’s discussion and analysis to provide an overview of the Lottery’s financial activities. Also, Statement 34 required changes to the format and terminology used in the Lottery’s financial statements.

(k) *Reclassifications*

Certain prior period amounts have been reclassified to conform with the current period presentation.

(3) Deposits and Investment Risk

(a) *Deposits*

A cash overdraft of \$2,774,811 existed at December 31, 2001; the bank balance at that date was \$471,977. The primary difference between the book and bank balances was outstanding checks. The entire bank balance at December 31, 2001 is held by the State General Treasurer. All General Treasurer accounts at a single institution are aggregated for purposes of determining Federal Depository Insurance coverage.

A cash overdraft of \$2,330,330 existed at December 31, 2000; the bank balance was \$77,228. The primary difference between the book and bank balances was outstanding checks. The entire bank balance at December 31, 2000 was held by the State General Treasurer.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(3) Deposits and Investment Risk - (Continued)

(b) *Investments*

The Lottery's investments are categorized below to provide an indication of the level of market and credit risk assumed by the Lottery at December 31, 2001 and 2000. Investments for jackpot awards were made by the Lottery in accordance with guidelines established by the Commission. All other investments, principally cash equivalent type investments, are made by the State General Treasurer in accordance with guidelines established by the State Investment Commission, which is responsible for the investment of all State funds. Pursuant to Chapter 35-10 of the R.I. General Laws, the State Investment Commission 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."

- Category 1 includes investments that are insured or registered, or are held by the Lottery or its agent in the Lottery's name.
- Category 2 includes investments that are uninsured and unregistered for which the securities are held by the counterparty's trust department or agent in the Lottery's name.
- Category 3 includes investments that are uninsured and unregistered, and are held by the counterparty, or by its trust department or agent but not in the Lottery's name.

All of the Lottery's investments are Category 1 investments, which are summarized below.

	December 31, 2001	December 31, 2000
Zero coupon U.S. Treasury bonds	\$ 1,352,401	\$ 2,239,055
US Government Agency Notes	4,797,825	4,492,812
Repurchase Agreements	10,100,000	7,402,434
Certificates of Deposit	1,500,300	-
Commercial Paper	8,995,500	7,486,361
Total investments	26,746,026	21,620,662
Less amounts classified as cash equivalents	25,393,625	19,381,607
Total investments for jackpot awards	1,352,401	2,239,055
Less short-term investments for jackpot awards	725,000	1,012,000
Long-term investments for jackpot awards	\$ 627,401	\$ 1,227,055

RHODE ISLAND LOTTERY

Notes to Financial Statements

(3) Deposits and Investment Risk - (Continued)

(c) Cash and Cash Equivalents

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

	<u>Fair Value December 31, 2001</u>	<u>Fair Value December 31, 2000</u>
Cash balance per books	\$ -	\$ -
Investments classified as cash equivalents	<u>25,393,625</u>	<u>19,381,607</u>
Cash and cash equivalents	<u>\$ 25,393,625</u>	<u>\$ 19,381,607</u>

(4) Property, Plant and Equipment

A summary of property, plant and equipment follows:

	<u>Estimated Useful Life</u>	<u>December 31, 2001</u>	<u>December 31, 2000</u>
Buildings	20	\$ 1,464,894	\$ 1,437,912
Building improvements	10	129,763	282,820
Ticket production and computer equipment	10	19,612	19,612
Office equipment	10	140,202	120,265
Furniture and fixtures	10	26,265	39,484
Lottery drawing equipment	3	68,861	68,861
Computer equipment	3	368,307	292,629
Automobiles	3	282,582	295,838
Trucks	3	22,445	22,445
Construction in progress		<u>62,021</u>	<u>-</u>
		2,584,952	2,579,866
Less: Accumulated depreciation		<u>2,110,023</u>	<u>2,044,357</u>
Property, plant and equipment (net)		<u>\$ 474,929</u>	<u>\$ 535,509</u>

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.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(5) Due to State's General Fund

Due to State's General Fund represents the balance of net income for the period (after adjustment for depreciation expense on the Lottery's headquarters - see note 8) that is to be paid to the State's General Fund. The amounts paid and amounts due to the State's General Fund are summarized below:

	2001	2000
Payments to State's General Fund for the six months ended December 31	\$104,852,893	\$ 85,868,980
Cash paid for six months ended December 31	(89,343,897)	(84,883,635)
Amount due to State's General Fund, July 1	1,443,897	12,883,635
Due to State's General Fund, December 31	\$ 16,952,893	\$ 13,868,980

(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 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 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 December 31, 2001 and 2000, the estimated liability was \$182,558 and \$129,827 respectively. The liability is calculated using the current hourly rates of pay.

(8) Net Assets – Investment in Capital Assets

The Lottery retained \$1,458,275 of its earnings during the years 1980 to 1983 to finance construction of a new office headquarters. It adopted the policy of reducing investment in capital assets by the annual building depreciation expense of \$71,895.

RHODE ISLAND LOTTERY

Notes to Financial Statements

(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 Rhode Island General Laws, Section 36-10-2, provides for actuarially determined periodic contributions to the plan. However, the actuarially determined contribution rates can be statutorily changed by the legislature. 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 Lottery contributed 5.59% and 7.99% of annual covered payroll for the six months ended December 31, 2001 and 2000, respectively. The Lottery contributed \$81,372, \$99,720, and \$96,143 for the six months ended December 31, 2001, 2000, and 1999, respectively, equal to the required contributions for each period.

(10) Postemployment Benefits

In accordance with the General Laws, postemployment healthcare benefits are provided to all state employees who retire on or after July 1, 1989. The benefits in general cover medical and hospitalization costs for pre-Medicare eligible retirees and a Medicare supplement for Medicare eligible retirees. The retiree is required to pay a portion of the monthly premium. This payment varies with years of service and ranges from 50% for retirees with 10-15 years of service to 0% for retirees with 35 years of service. The Lottery contributed .86% of covered payroll for the six months ended December 31, 2001 and 2000 to fund the cost of these benefits. This benefit program is administered by the State, therefore all required disclosures are included in the State's CAFR.

(11) Deferred Compensation

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

RHODE ISLAND LOTTERY

Notes to Financial Statements

(12) Commitments

The Lottery has contracted with a vendor to furnish computer hardware and software together with the related services necessary for the operation of the Lottery's computerized games. Commissions range from 4% to 4.8% of sales from the on-line games. The Lottery leases a portion of its headquarters to the vendor to house computer hardware necessary for the on-line games. The term of the lease coincides with the vendor contract and provides for a rent of \$41,520 per annum. This contract is effective through October 31, 2005 and allows the Lottery the option of extending the agreement for five one-year terms.

The Lottery has also contracted with this vendor to install, operate and maintain a central communications system for the operation of its video lottery games. This contract is effective through August 27, 2007. Commissions, currently mandated by General Laws at 2.5% of net terminal income from video lottery sales, are paid from the technology provider's share of net terminal income.

(13) Equipment Leasing

Leases that do not meet the criteria for capitalization are classified as operating leases with related rentals charged to operations as incurred. The following is a schedule, by year, of future minimum lease payments under operating leases as of December 31, 2001, that have initial or remaining lease terms in excess of one year.

<u>Fiscal Year Ending June 30</u>	<u>Lease Payments</u>
2002	\$ 129,940
2003	<u>131,666</u>
Total future minimum lease payments	<u>\$ 261,606</u>

(14) Contingencies

Litigation

A suit was filed by a former Lottery employee against the members of the Commission in their official capacity, the Governor and the Director of Administration. The litigation concerns the former employee's claim that his termination on March 25, 1996 was unlawful. In February 2001, a judge decided that the Commission was in violation of the Open Meetings Act at its meeting on March 25, 1996, however, the employee was not reinstated to his former position. The Commission was fined and the plaintiffs were awarded attorney's fees and costs. These amounts have been accrued by the Lottery but continue to be appealed by both parties.

RHODE ISLAND LOTTERY

Notes to Financial Statements

Damage to Lottery Headquarters

On March 6, 2001, due to a severe storm, a significant portion of the roof collapsed at the Lottery headquarters. The Lottery has contracted to repair the building and expand the existing warehouse facility. The cost of the construction contract is \$1.37 million of which the Lottery has incurred construction in progress costs of \$62,021 as of December 31, 2001. The Lottery estimates that construction will be completed during August 2002.

As a result of the roof collapse, the Lottery entered into a sublease agreement for temporary office space located at 1210 Pontiac Avenue, Cranston, Rhode Island. The terms of the arrangement require the Lottery to pay an annual rent of \$103,950. The Lottery is also responsible for its pro rata share of all other amounts required to be paid as additional rent under the master lease agreement. The Lottery expects the majority of the building repairs and rent to be covered by insurance proceeds.

RHODE ISLAND LOTTERY

Schedule 1

Sales, Commissions and Prize Awards Expense

Six Months Ended December 31, 2001 and 2000

Six Months Ended December 31, 2001

	<u>Sales</u>	<u>Commissions</u>	<u>Prize Awards Expense</u>	<u>Unclaimed Prize Recovery</u>	<u>Cost of Tickets</u>	<u>Cost of Sales</u>	<u>Gross Profit</u>
Lottery games:							
On-line games							
Keno	\$ 37,662,877	4,638,975	24,450,262	(290,893)	-	28,798,344	8,864,533
Powerball	29,094,751	3,583,630	14,550,781	(492,727)	-	17,641,684	11,453,067
Daily Numbers	14,355,030	1,768,124	7,358,693	(140,645)	-	8,986,172	5,368,858
Easy Win	-	-	-	(36,174)	-	(36,174)	36,174
Money Roll	1,167,079	143,750	586,651	(11,045)	-	719,356	447,723
	<u>82,279,737</u>	<u>10,134,479</u>	<u>46,946,387</u>	<u>(971,484)</u>	-	<u>56,109,382</u>	<u>26,170,355</u>
Instant tickets	40,484,839	2,771,992	26,819,477	(456,747)	694,620	29,829,342	10,655,497
Video Lottery	446,142,216	62,472,378	313,179,471	(26,627)	-	375,625,222	70,516,994
Totals	<u>\$ 568,906,792</u>	<u>\$ 75,378,849</u>	<u>\$ 386,945,335</u>	<u>\$ (1,454,858)</u>	<u>\$ 694,620</u>	<u>\$ 461,563,946</u>	<u>\$ 107,342,846</u>

Video Commissions - Detail

Facilities	\$ 40,638,322
Technology Providers	10,986,426
Central Communications Provider	3,323,764
Dog Kennel Owners	6,194,360
City/Town	1,329,506
Total	<u>\$ 62,472,378</u>

Six Months Ended December 31, 2000

	<u>Sales</u>	<u>Commissions</u>	<u>Prize Awards Expense</u>	<u>Unclaimed Prize Recovery</u>	<u>Cost of Tickets</u>	<u>Cost of Sales</u>	<u>Gross Profit</u>
Lottery games:							
On-line games							
Keno	\$ 33,144,106	4,094,101	21,706,589	(181,794)	-	25,618,896	7,525,210
Powerball	17,743,245	2,191,721	8,871,623	(534,536)	-	10,528,808	7,214,437
Daily Numbers	14,252,673	1,760,551	7,069,563	(116,588)	-	8,713,526	5,539,147
Easy Win	1,545,704	190,932	693,697	(43,998)	-	840,631	705,073
Rolldown	470,455	58,112	233,808	-	-	291,920	178,535
	<u>67,156,183</u>	<u>8,295,417</u>	<u>38,575,280</u>	<u>(876,916)</u>	-	<u>45,993,781</u>	<u>21,162,402</u>
Instant tickets	33,724,031	2,229,795	22,129,543	(625,437)	534,931	24,268,832	9,455,199
Video Lottery	367,085,759	50,760,199	259,001,079	(28,139)	-	309,733,139	57,352,620
Totals	<u>\$ 467,965,973</u>	<u>\$ 61,285,411</u>	<u>\$ 319,705,902</u>	<u>\$ (1,530,492)</u>	<u>\$ 534,931</u>	<u>\$ 379,995,752</u>	<u>\$ 87,970,221</u>

Video Commissions - Detail

Facilities	\$ 32,993,981
Technology Providers	8,890,398
Central Communications Provider	2,707,285
Dog Kennel Owners	5,085,621
City/Town	1,082,914
Total	<u>\$ 50,760,199</u>

See independent auditor's report.



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STATE OF RHODE ISLAND and PROVIDENCE PLANTATIONS

GENERAL ASSEMBLY

OFFICE of the AUDITOR GENERAL

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

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING

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

We have audited the financial statements of the Rhode Island Lottery (Lottery), a component unit of the State of Rhode Island and Providence Plantations, as of and for the six months ended December 31, 2001 and have issued our report thereon dated May 24, 2002. 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.

Compliance

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 that are required to be reported under *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted a matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Lottery's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Reportable Condition

Logical access security to the computer systems used to operate the Lottery's games should be improved by (1) fully utilizing certain designed functions of the systems, (2) strengthening other system security aspects, and (3) implementing a comprehensive security plan for these computer systems that includes delegating certain aspects of security to the Lottery and monitoring by the Lottery of the overall system security function. As of December 31, 2001, the Lottery continued its implementation of a formal comprehensive security plan. The Lottery plans to complete implementation and obtain independent verification of its security plan during fiscal year 2003. Complete implementation and testing of this plan is necessary to ensure that access is appropriately restricted to authorized individuals and any unauthorized access is detected by the Lottery on a timely basis with appropriate follow-up.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we do not believe that the reportable condition described above is a material weakness.

This report is intended solely for the information and use of the Joint Committee on Legislative Services, the Rhode Island Lottery Commission and Lottery 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

May 24, 2002