

**Bureau of State Lottery, State of Michigan
(an Enterprise Fund of the State of Michigan)**

Financial Report
with Supplementary Information

For the six-month periods ended March 31, 2015 and 2014

Bureau of State Lottery, State of Michigan

Contents

Report Letter 1-3

Management’s Discussion and Analysis..... 4-14

Basic Financial Statements

 Statement of Net Position 15

 Statement of Revenues, Expenses, and Changes in
 Net Position..... 16

 Statement of Cash Flows 17-18

 Notes to Financial Statements 19-33

Supplementary Information

 Supplementary Schedule of Revenues and Expenses 34-35

 Supplementary Schedule of Other Operating Expenses..... 36

**Report on Internal Control Over Financial Reporting and on Compliance
and Other Matters Based on an Audit of Financial Statements
Performed in Accordance with *Government Auditing Standards***..... 37-38

Independent Auditor's Report

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Doug Ringler, CPA, CIA
Auditor General, State of Michigan

Report on the Financial Statements

We have audited the accompanying financial statements of the Bureau of State Lottery, State of Michigan, (the "Lottery"), an enterprise fund of the State of Michigan, as of and for the six-month periods ended March 31, 2015 and 2014, and the related notes to the financial statements, which collectively comprise the Bureau of State Lottery, State of Michigan's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express opinions 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 audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Doug Ringler, CPA, CIA
Auditor General, State of Michigan

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bureau of State Lottery, State of Michigan as of March 31, 2015 and 2014, and the changes in its financial position and cash flows for the six-month periods then ended, in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

We draw attention to Note I, which explains that these financial statements present only the Bureau of State Lottery, State of Michigan and do not purport to, and do not, present fairly the financial position of the State of Michigan as of March 31, 2015 and 2014, the changes in its financial position, and the changes in its cash flows thereof for the six-month periods then ended in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplemental Information

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

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Bureau of State Lottery, State of Michigan's basic financial statements. The other supplemental information, as identified in the table of contents, is presented for the purpose of additional analysis and is not a required part of the basic financial statements.

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Doug Ringler, CPA, CIA
Auditor General, State of Michigan

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

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated June 18, 2015 on our consideration of the Bureau of State Lottery, State of Michigan's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Bureau of State Lottery, State of Michigan's internal control over financial reporting and compliance.

Plante & Moran, PLLC

June 18, 2015

Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

The following discussion of the Michigan Bureau of State Lottery's (the "Lottery") financial performance provides an overview of the Lottery's financial activities for the six months ended March 31, 2015. Please read it in conjunction with the financial statements, which begin on page 15.

Using This Report

The Lottery is accounted for as an enterprise activity/proprietary fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting, much like a private business entity. As such, this semi-annual report consists of a series of financial statements, along with explanatory notes to the financial statements and supplementary schedules. The Statement of Net Position on page 15 and the Statement of Revenues, Expenses and Changes in Net Position on page 16, report the Lottery's net position and their changes.

By law, the Lottery is required to deposit all of its net income each fiscal year to either the State School Aid Fund (for income related to Lottery gaming activities) or the General Fund (for income related to Charitable Gaming activities). As a result, the net position of the Lottery consists largely of capital assets (leasehold improvements and equipment) and unrealized gains on investments held to fund future payments due on Lottery prizes that are annuities. To assess the Lottery's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth in the Statement of Net Position, and in changes in operating revenues, expenses, and disbursement expenses to other funds as set forth in the Statement of Revenues, Expenses, and Changes in Net Position. In addition, the reader should also refer to the accompanying notes to the financial statements.

Financial Highlights

- Operating revenues for Lottery gaming activities increased by \$85.0 million, or 6.5% from the comparable six-month period in the last fiscal year.
- Total revenues for all activities (including non-operating) increased \$94.4 million or 7.2% from the comparable six-month period in the last fiscal year.
- Non-operating revenues increased by \$9.4 million. The increase is attributable to the changing market values during this six-month period.
- Total operating expenses for the six-month period increased \$79.5 million or 8.7% over the comparable six-month period in the last fiscal year.
- Total expenses (including non-operating) for all activities increased \$84.6 million or 6.4%.
- Total non-operating expenses increased by \$5.1 million, or 1.3%. Of that amount, net income to be disbursed to the General Fund related to Charitable Gaming activities decreased by \$.4 million or 28.6%, while net income from Lottery gaming activities disbursed to the State School Aid Fund increased by \$6.1 million or 1.5%.

Bureau of State Lottery, State of Michigan
Management's Discussion and Analysis

Net Position

A summary of the Lottery's net position is presented below:

Table 1 - Net Position
(in millions)

| | March 2015 | March 2014 | March 2013 |
|---|----------------|----------------|----------------|
| Current and other assets | \$ 210.5 | \$ 207.4 | \$ 211.6 |
| Investments - noncurrent | 200.7 | 191.2 | 215.2 |
| Capital assets (net of accumulated depreciation) | 0.8 | 0.7 | 0.8 |
| Total assets | 412.0 | 399.3 | 427.6 |
| Current liabilities | 198.3 | 187.3 | 195.6 |
| Long-term liabilities | 178.0 | 195.0 | 201.7 |
| Total liabilities | 376.3 | 382.3 | 397.3 |
| Net position | | | |
| Net investment in capital assets | 0.8 | 0.7 | 0.8 |
| Restricted for unrealized gains on investments | 35.7 | 17.0 | 30.3 |
| Unrestricted (deficit) | (0.8) | (0.7) | (0.8) |
| Total net position | \$ 35.7 | \$ 17.0 | \$ 30.3 |

As shown in Table 1 above, the Lottery's net position increased since March 2014, from \$17.0 million to \$35.7 million, an increase of \$18.7 million. The change from March 2013 to March 2014 was a decrease of net position by \$13.3 million. The respective increase and decrease noted above are both primarily attributable to the restricted for unrealized gains or loss on investments due to changes in the market value of those investments that the Lottery holds to fund future payments due on annuitized lottery prizes. Additional detailed information on investments may be found in Note 3 in the accompanying financial statements.

Capital assets consist of equipment and leasehold improvements. For the six months ended March 2015, net capital assets increased by \$0.1 million since March 2014 and decreased by approximately \$0.1 million from March 2013 to March 2014. Additional detailed information on capital assets may be found in Note 4 in the accompanying financial statements.

Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

Accounting principles dictate that the Lottery record in the financial records the gain or loss related to the change in market value of investments. U. S. Treasury zero-coupon bonds and State of Michigan General Obligation Capital Appreciation Bonds have been purchased for the payment of installment prize awards and are generally held to maturity. The unrealized gain on investments is not available for disbursement to the School Aid Fund. Therefore, the difference between the market value of these investments and the amortized book value is recorded as a restriction for unrealized gains on investments.

A detail of the Lottery's liabilities is presented in Table 2 below:

Table 2 - Liabilities
(in millions)

| | March 2015 | March 2014 | March 2013 |
|--|---------------|---------------|---------------|
| Current: | | | |
| Warrants authorized and warrants outstanding | \$ 1.9 | \$ 4.0 | \$ 1.1 |
| Accounts payable and other liabilities | 20.3 | 19.9 | 17.5 |
| Due to other State Agencies | 77.8 | 77.0 | 75.4 |
| Prize awards payable (net of discount) | 98.3 | 86.4 | 101.6 |
| Total current | 198.3 | 187.3 | 195.6 |
| Non-current: | | | |
| Prize awards payable (net of discount) | 176.6 | 193.4 | 200.1 |
| Compensated absences | 1.4 | 1.5 | 1.4 |
| Supplemental retirement | - | 0.1 | 0.2 |
| Total non-current | 178.0 | 195.0 | 201.7 |
| Total liabilities | \$ 376.3 | \$ 382.3 | \$ 397.3 |

Non-current liabilities consist principally of prize liability for prizes paid in installments over several years. For the six months ended March 2015, long-term prize liability decreased by \$16.8 million or 8.7% from March 2014 and decreased by \$6.7 million or 3.3% from March 2013 to March 2014. The decrease from March 2014 to March 2015 and March 2013 to March 2014 are attributable to the maturing of some long-term prize liabilities as well as minimal additions to the pool of annuitized installment prizes. Refer to Note 6 in the accompanying financial statements for more information.

Bureau of State Lottery, State of Michigan
Management's Discussion and Analysis

A summary of the Lottery's change in net position for the six-month periods ended March 31 is presented in Table 3 below:

Table 3 - Changes in Net Position
(in millions)

| | March 2015 | March 2014 | March 2013 |
|--|-------------------|-------------------|-------------------|
| Operating revenues | <u>\$ 1,399.7</u> | <u>\$ 1,314.7</u> | <u>\$ 1,225.4</u> |
| Operating expenses: | | | |
| Prizes and direct game expenses | | | |
| Prizes less unclaimed prizes | (834.7) | (764.2) | (709.0) |
| Commissions and game related expenses | <u>(133.8)</u> | <u>(126.1)</u> | <u>(115.1)</u> |
| Total prizes and direct game expenses | <u>(968.5)</u> | <u>(890.3)</u> | <u>(824.1)</u> |
| Income before other operating expenses | 431.2 | 424.4 | 401.3 |
| Other operating expenses | <u>(28.3)</u> | <u>(27.0)</u> | <u>(25.0)</u> |
| Operating income | <u>402.9</u> | <u>397.4</u> | <u>376.3</u> |
| Non-operating revenues and (expenses): | | | |
| Investment and interest revenues | 4.3 | 4.7 | 5.1 |
| Investment and interest expenses | (4.5) | (5.1) | (6.0) |
| Unrealized gain (loss) on investments | 8.9 | (0.9) | (4.7) |
| School Aid Fund disbursement expense | (401.2) | (395.1) | (372.5) |
| General Fund disbursement expense | (1.0) | (1.4) | (2.4) |
| Community Health disbursement expense | <u>(0.5)</u> | <u>(0.5)</u> | <u>(0.5)</u> |
| Net non-operating revenue (expense) | <u>(394.0)</u> | <u>(398.3)</u> | <u>(381.0)</u> |
| Change in net position | 8.9 | (0.9) | (4.7) |
| Total net position beginning of period | <u>26.8</u> | <u>17.9</u> | <u>35.0</u> |
| Total net position end of period | <u>\$ 35.7</u> | <u>\$ 17.0</u> | <u>\$ 30.3</u> |

Because the Lottery is required by law to deposit all of its net income (excluding the unrealized gain or loss on investments discussed above) to the School Aid Fund or General Fund, change in net position does not reflect the result of the Lottery's operating activities. The \$401.2 million disbursement expense to the School Aid Fund reflects the Lottery's operating activities for the six months ended March 2015. There was an increase in disbursement expense to the School Aid Fund of \$6.1 million or 1.5% from March 2014. For the six months ended March 2014 there was an increase of \$22.6 million or 6.1% from March 2013. The disbursement expense to the General Fund reflects Charitable Gaming activities for the six months ended March 2015. Charitable Gaming activities experienced a decrease in net revenues for the six-month period ended March 2015 compared to March 2014 and March 2013. Charitable Gaming net income is disbursed annually to the General Fund.

Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

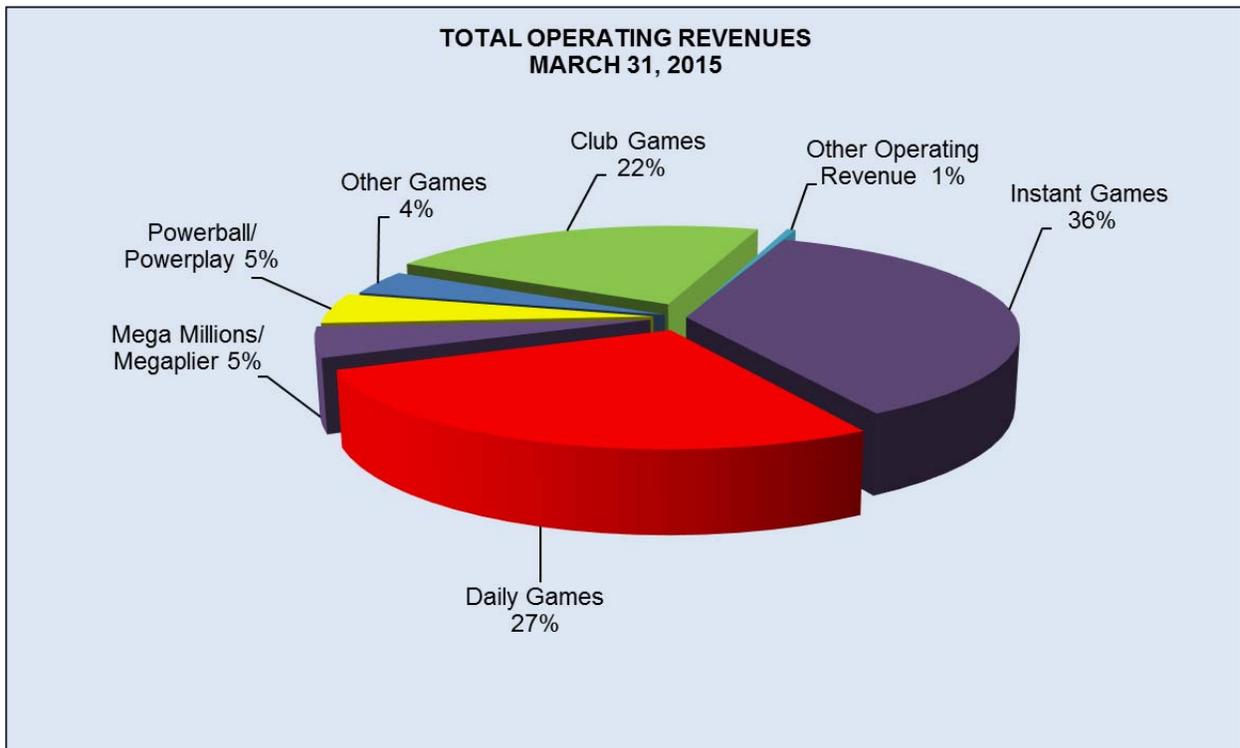
Disbursements to other funds for the six-month periods ended March 31 are detailed in Table 4 below:

Table 4 - Disbursements to Other Funds
(in millions)

| | March 2015 | March 2014 | March 2013 |
|---|-----------------|-----------------|-----------------|
| School Aid Fund | \$ 401.2 | \$ 395.1 | \$ 372.5 |
| General Fund | 1.0 | 1.4 | 2.4 |
| Community Health | 0.5 | 0.5 | 0.5 |
| Total Disbursements to Other Funds | \$ 402.7 | \$ 397.0 | \$ 375.4 |

Revenues

The following chart shows the major sources and the percentages of operating revenues for the six months ended March 2015:



Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

A detail of the Lottery's revenues for the six-month periods ended March 31 are presented in Table 5 below:

Table 5 - Revenues
(in millions)

| | March 2015 | March 2014 | March 2013 |
|---------------------------------------|-------------------|-------------------|-------------------|
| Operating revenues: | | | |
| Instant tickets | \$ 499.9 | \$ 446.7 | \$ 402.4 |
| iLottery Instants, Net Win | 6.4 | \$ - | \$ - |
| Daily games | 373.9 | 338.0 | 331.5 |
| Mega Millions/Megaplier | 68.8 | 90.3 | 45.9 |
| Powerball/Power Play | 65.2 | 55.7 | 90.4 |
| Monopoly | 1.8 | - | - |
| Lucky for Life | 4.9 | - | - |
| Club games | 308.9 | 292.9 | 289.3 |
| Other games | 63.7 | 84.8 | 58.4 |
| Other operating revenue | 6.2 | 6.3 | 7.5 |
| Total operating revenues | <u>1,399.7</u> | <u>1,314.7</u> | <u>1,225.4</u> |
| Non-operating revenues: | | | |
| Unrealized gain (loss) on investments | \$ 8.9 | \$ (0.9) | \$ (4.7) |
| Amortization on bonds | 4.3 | 4.7 | 5.1 |
| Total non-operating revenues | <u>13.2</u> | <u>3.8</u> | <u>0.4</u> |
| Total revenues | <u>\$ 1,412.9</u> | <u>\$ 1,318.5</u> | <u>\$ 1,225.8</u> |

Operating revenues, primarily Lottery ticket sales, for the six months ended March 2015, increased over March 2014. The increase in the six months ended March 2015 over March 2014 was \$85.0 million or 6.5%. The increase in the six months ended March 2014 from March 2013 was \$89.3 million or 7.3%.

Instant game ticket sales increased by \$53.2 million or 11.9% for the six months ended March 2015 over March 2014 and increased in the six months ended March 2014 over March 2013 by \$44.3 million or 11.0%. The instant sales increase can be attributed to enhanced prize structures to added price points which provide more prizes with increased odds of winning.

The new iLottery instants launched in August 2014 and include several electronic instant games and a keno game which are offered over the internet using web and mobile devices. For the six months ending March 2015 iLottery sales and prizes produced a net win of \$6.4 million.

Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

Mega Millions is a multi-state lotto game offering larger jackpots with an occasional "mega-jackpot". The states participating in Mega Millions with Michigan are California, Georgia, Illinois, Massachusetts, New Jersey, New York, Ohio, Virginia, Washington and the Multi-State Lottery Association (MUSL), an association of governmental lotteries. Sales, for the six months ended March 2015, decreased by \$21.5 million or 23.8% compared to the six months ended March 2014. Sales in March 2014 increased \$44.4 million or 96.7% over March 2013. The March 2015 decrease is primarily due to having a lower number of large jackpot pools compared to the same time period ending March 2014, which included a jackpot over \$600 million, the second highest jackpot in Mega Millions history. Megaplier, introduced in December 2010, is an add-on to Mega Millions whereby players have an opportunity to increase their non-jackpot winnings.

Powerball is a multi-state game, similar to Mega Millions, offering larger jackpots. Participating in Powerball is MUSL and the Mega Million's Lotteries for a total of 44 states, Washington D.C., Puerto Rico and the U.S. Virgin Islands. Sales for the six months ended March 2015 increased by \$9.5 million or 17.1% compared to the six months ended March 2014 and decreased in the six months ended March 2014 over March 2013 by \$34.7 million or 38.4%. Power Play is an add-on game to Powerball whereby players can multiply non-jackpot prizes from two to five times.

Monopoly Millionaires' Club (MMC), a new national premium game, launched in October 2014. This game offered top prizes ranging from \$15 to \$25 million and nine other ways to win. Sales for the six months ended March 2015 reached \$1.8 million. The game was discontinued in December 2014 primarily due to lack of player engagement.

Michigan began selling Lucky for Life, a new multi-state \$2 draw game, in January 2015. New England lotteries originally launched this game in March 2012. This game offers a top prize of \$1,000 a day for life and a second top prize of \$25,000 a year for life. Sales for the six months ended March 2015 were \$4.9 million.

Club games include Club Keno, Club Keno Kicker, Pull-Tabs, The Jack and Insta Tabs. The Club games sales for the first six months in 2015 increased by \$16.0 million or 5.5% from the six months ended March 2014. Sales in March 2014 increased \$3.6 million or 1.2% from the six months ended March 2013. The Club Keno Doubler promotion was held during March 2015 to engage players to play Club Keno and offer a chance to double their winnings. This promotion resulted in record weekly sales of Club Keno. Insta Tab games, a new type of pull tab product, was launched in March 2014 and has contributed to the growth in Club games sales.

Other games consist of Lotto 47, Lotto 47 EZ Match, Fantasy Five, Fantasy Five EZ Match, Keno, Raffle, and Poker Lotto. Poker Lotto was added to the Lottery's game portfolio on October 19, 2013. This game includes a nightly jackpot drawing plus a chance to win instantly all in one ticket. EZMatch was added to Lotto 47 and Fantasy Five games on April 13, 2014, which gives players a chance to win up to \$500 instantly. When a player selects EZmatch, a second set of numbers with corresponding prize amounts is printed under their regular Lotto 47 or Fantasy Five numbers. When the EZmatch number matches one or more of the player's regular numbers on their Lotto 47 or Fantasy Five ticket, they win the corresponding prize.

Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

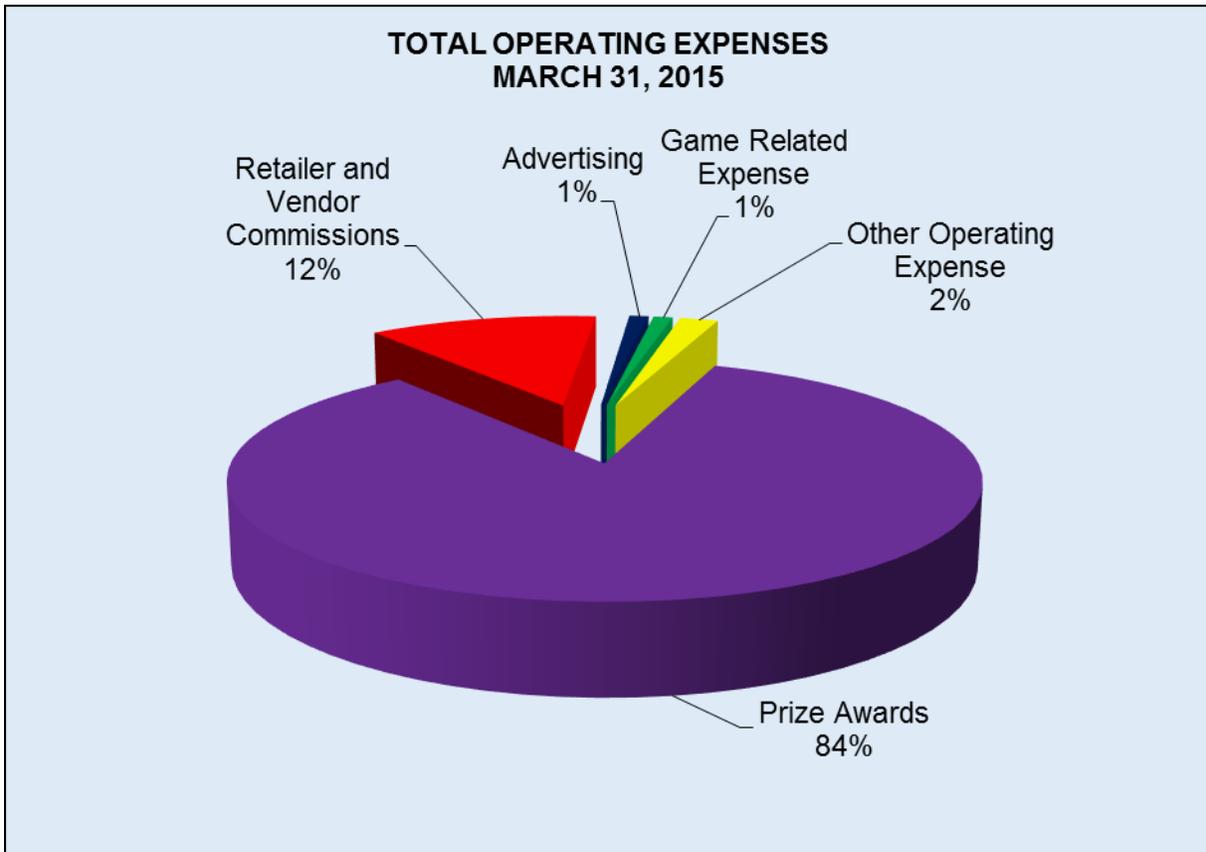
Other games sales experienced a decrease by \$21.1 million or 24.9% for the six months ended March 2015 over the six-months ended March 2014. Sales in March 2014 increased \$26.4 million or 45.2% from the six months ended March 2013. During the six-months ended March 2015, there were no Raffle games offered.

The increase in non-operating revenues for the six-month period ended March 2015 compared to March 2014 resulted from the unrealized gain on investments. As previously discussed, the unrealized gain or loss on investments is a reflection of the market value of the investments and does not impact the disbursement to the School Aid Fund.

The decrease in bond amortization from March 2014 to March 2015 and March 2013 to March 2014 is due to a decreasing bond portfolio from maturing investments, as well as the fact that most prize winners have elected the cash option instead of installment payments. Additional detailed information on investments may be found in Note 3 in the accompanying financial statements.

Expenses

The following chart shows prizes, game costs, and operating expenses as a percentage of total operating expenses for the six months ended March 2015:



Bureau of State Lottery, State of Michigan
Management's Discussion and Analysis

A detail of the Lottery's expenditures for the six-month periods ended March 31 are presented in Table 6 below:

Table 6 - Expenses
(in millions)

| | March 2015 | March 2014 | March 2013 |
|----------------------------------|-------------------|-------------------|-------------------|
| Prizes: | | | |
| Instant prizes | \$ 354.8 | \$ 311.5 | \$ 271.8 |
| Draw Game prizes | 290.3 | 277.8 | 264.1 |
| Club game prizes | 202.9 | 190.4 | 189.0 |
| Player's Club all Games | 1.0 | - | - |
| Total prizes | <u>849.0</u> | <u>779.7</u> | <u>724.9</u> |
| Less: unclaimed prizes | <u>14.3</u> | <u>15.5</u> | <u>15.9</u> |
| Net prize awards | <u>834.7</u> | <u>764.2</u> | <u>709.0</u> |
| Direct game expenses: | | | |
| Retailer commissions | 102.3 | 94.3 | 87.8 |
| Vendor commissions | 20.5 | 19.7 | 17.4 |
| Game related expenses | <u>11.0</u> | <u>12.1</u> | <u>9.9</u> |
| Total direct game expenses | <u>133.8</u> | <u>126.1</u> | <u>115.1</u> |
| Other operating expenses: | | | |
| Salaries, wages and benefits | 11.5 | 11.0 | 11.0 |
| Other professional services | 4.7 | 4.7 | 4.3 |
| Printing and supplies | 0.8 | 0.7 | 0.8 |
| Other general and administrative | 1.8 | 1.5 | 1.4 |
| Promotion and Advertising | <u>9.5</u> | <u>9.1</u> | <u>7.5</u> |
| Total other operating expenses | <u>28.3</u> | <u>27.0</u> | <u>25.0</u> |
| Total operating expenses | <u>996.8</u> | <u>917.3</u> | <u>849.1</u> |
| Non-operating expenses: | | | |
| Amortization of prize discount | 4.5 | 5.1 | 6.0 |
| School Aid Fund disbursement | 401.2 | 395.1 | 372.5 |
| General Fund disbursement | 1.0 | 1.4 | 2.4 |
| Community Health disbursement | <u>0.5</u> | <u>0.5</u> | <u>0.5</u> |
| Total non-operating expenses | <u>407.2</u> | <u>402.1</u> | <u>381.4</u> |
| Total expenses | <u>\$ 1,404.0</u> | <u>\$ 1,319.4</u> | <u>\$ 1,230.5</u> |

The Daily Games prize payout increased overall for the six months ended March 2015 over the six months ended March 2014. Daily 3 prize payout had increased to 50.8% for the six months ended March 2015, compared to 47.7% for March 2014 but decreased compared to 51.8% for March 2013. Daily 4 prize payout increased to 47.9% for the six months ended March 2015, compared to 45.0% for March 2014 and 46.4% for March 2013. Daily games are designed to yield an average prize payout of 50.0% and combined, the games averaged a payout of 49.3% for the six months ended March 2015.

Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

The Club games prize payout percentage increased for the six months ended March 2015 to 65.7% compared to 65.0% from March 2014 and 65.3% from March 2013. The higher Club games payout is an important part of the appeal of this style of game in this market. The other draw games have an anticipated payout between 50.0% and 60.9% which includes the new Lucky for Life draw game.

Instant games overall payout for the six months ended March 2015 is 71.0% from 69.7% for the six months ended March 2014, and 67.5% for the six months ended March 2013. The games vary in payout percentage depending on selling price of a ticket for a game. Instant game prize payouts range from 59.0% for a \$1 game to 77.9% for a \$30 game for the six month period ended March 2015.

Retailer commissions have increased commensurate with higher overall sales. Vendor commissions have increased commensurate with higher overall sales. Additionally, the new iLottery instant games have resulted in a new vendor commission. Game related expenses have decreased by \$1.1 million or 9.1% for the six months ended March 2015 compared to the six months ended March 2014 and increased by \$2.2 million or 22.2% for the six months ended March 2014 compared to the six months ended March 2013.

Other operating expenses have increased by \$1.3 million or 4.8% for the six months ended March 2015 compared to the six months ended March 2014 and increased by \$2.0 million or 8.0% for the six months ended March 2014 compared to the six months ended March 2013.

Unclaimed Prizes

By law, Lottery prizes not claimed within one year of their drawing date are to be disbursed to the State School Aid Fund.

The Lottery recognizes the value of unclaimed prizes using an allowance methodology. Under this method, historical averages are utilized to estimate the amount of prizes awarded during the current year that will not be paid out due to claims not being filed for those prizes. The amounts estimated under the allowance method are recorded as a reduction of current year prize expense to match true prize expense to related sales.

Unclaimed prizes for the six months ended March 2015 decreased by \$1.2 million compared to the six months ended March 2014 and decreased by \$.4 million compared to the six months ended March 2014 from the six months ended March 2013.

Bureau of State Lottery, State of Michigan Management's Discussion and Analysis

Charitable Gaming

A detail of the Lottery's charitable gaming revenues, expense, and net income for the six-month periods ended March 31 are presented in Table 7 below:

Table 7 - Charitable Gaming Revenue, Expense, and Net Income
(in millions)

| | March 2015 | March 2014 | March 2013 |
|--------------------|---------------|---------------|---------------|
| Gross revenue | \$ 5.7 | \$ 5.9 | \$ 6.9 |
| Operating expenses | (4.7) | (4.5) | (4.5) |
| Net income | <u>\$ 1.0</u> | <u>\$ 1.4</u> | <u>\$ 2.4</u> |

Charitable Gaming activities overseen by the Lottery include the licensing and regulation of charitable and certain other not-for-profit organizations that conduct bingo games and raffles for fund-raising purposes. By Executive Order 2012-4 dated April 2012, all millionaire party licensing and regulation activities were transferred from the Lottery to the Michigan Gaming Control Board. According to the Executive Order, Millionaire party licensing revenue shall be remitted to the Lottery and all necessary expenses shall be financed by the Lottery. Charitable Gaming revenues decreased by \$.2 million or 3.4% for the six months ended March 2015 compared to March 2014 and decreased by \$1.0 million or 14.5% from the six months ended March 2013 to March 2014.

The Lottery also oversees the distribution and sale of break-open tickets, (also for fund-raising purposes), to these same organizations. Charitable Gaming launched a pilot program in February 2015 to begin selling new charity tickets through specialized vending machines located at various not-for-profit organizations.

The Charitable Gaming mission of the Lottery is to examine the integrity of charitable gaming activities, ensure proceeds are accounted for and used for lawful purposes of qualified licensed non-profit organizations, encourage charity participation at licensed events and maximize proceeds for their charitable cause. Revenues received through the issuance of licenses, distribution of break-open tickets and charity tickets issued by new charity ticket vending machines are intended to cover the costs of overseeing the program activities and are not intended as a primary goal to generate revenue for the State. Any revenue in excess of program costs is disbursed annually to the State's General Fund.

Contacting the Lottery's Financial Management

This financial report is designed to provide the Legislature and the executive branch of government, the public, and other interested parties with an overview of the financial results of the Lottery's activities and to show the Lottery's accountability for the money it receives. Percentages presented in the Management's Discussion and Analysis are based on the rounded figures presented in the tables. If you have questions about this report or need additional financial information, contact the Deputy Commissioner for Administration at the Michigan Lottery, PO Box 30023, Lansing, Michigan 48909.

Bureau of State Lottery, State of Michigan
Statement of Net Position
March 31, 2015 and 2014

| | <u>2015</u> | <u>2014</u> |
|---|----------------------|----------------------|
| Assets | | |
| Current assets | | |
| Equity in State Treasurer's Common Cash Fund | \$ 41,944,092 | \$ 65,276,492 |
| Investments, at fair value | 26,994,019 | 30,969,636 |
| Accounts receivable - net | 129,454,511 | 101,516,409 |
| Inventory | 12,054,986 | 9,649,795 |
| Other current assets | 20,425 | 22,057 |
| Total current assets | <u>210,468,033</u> | <u>207,434,389</u> |
| Noncurrent assets | | |
| Investments, at fair value | <u>200,673,240</u> | 191,175,645 |
| Capital assets | | |
| Leasehold improvements and equipment | 5,005,039 | 4,628,569 |
| Accumulated depreciation | <u>(4,166,764)</u> | <u>(3,961,970)</u> |
| Total capital assets | <u>838,275</u> | 666,599 |
| Total noncurrent assets | <u>201,511,515</u> | <u>191,842,244</u> |
| Total assets | <u>411,979,548</u> | <u>399,276,633</u> |
| Liabilities | | |
| Current liabilities | | |
| Warrants outstanding | 1,020,323 | 3,006,723 |
| Warrants authorized | 893,213 | 1,009,927 |
| Accounts payable and other liabilities | 20,290,464 | 19,915,336 |
| Due to other State Agencies | 77,752,065 | 77,005,583 |
| Prize awards payable - net of discount | <u>98,347,349</u> | <u>86,357,033</u> |
| Total current liabilities | <u>198,303,414</u> | <u>187,294,602</u> |
| Noncurrent liabilities | | |
| Prize awards payable - net of discount | 176,619,950 | 193,465,032 |
| Accrual for compensated absences, less current portion | 1,402,659 | 1,471,261 |
| Accrual for supplemental retirement, less current portion | - | <u>77,733</u> |
| Total noncurrent liabilities | <u>178,022,609</u> | <u>195,014,026</u> |
| Total liabilities | <u>376,326,023</u> | <u>382,308,628</u> |
| Net Position | | |
| Net investment in capital assets | 838,275 | 666,599 |
| Restricted for unrealized gains on investments | 35,653,525 | 16,968,005 |
| Unrestricted (deficit) | <u>(838,275)</u> | <u>(666,599)</u> |
| Total net position | <u>\$ 35,653,525</u> | <u>\$ 16,968,005</u> |

See Accompanying Notes to the Financial Statements

Bureau of State Lottery, State of Michigan
Statement of Revenues, Expenses and Changes in Net Position
For the Six Months Ended March 31, 2015 and 2014

| | <u>2015</u> | <u>2014</u> |
|---|----------------------|----------------------|
| Operating revenues | | |
| Ticket sales | \$ 1,393,468,742 | \$ 1,308,449,574 |
| Charitable gaming and other | 6,237,651 | 6,277,308 |
| Total operating revenues | <u>1,399,706,393</u> | <u>1,314,726,882</u> |
| Operating expenses | | |
| Prize awards | 849,018,990 | 779,698,383 |
| Less - unclaimed prizes | <u>(14,343,083)</u> | <u>(15,508,586)</u> |
| Net prize awards | 834,675,907 | 764,189,797 |
| Retailer and vendor commission | 122,809,843 | 114,001,146 |
| Game related expenses | 10,980,217 | 12,069,946 |
| Depreciation expense | 100,522 | 107,386 |
| Other operating expenses | <u>28,227,054</u> | <u>26,898,515</u> |
| Total operating expenses | <u>996,793,543</u> | <u>917,266,790</u> |
| Operating income | <u>402,912,850</u> | <u>397,460,092</u> |
| Non-operating revenues | | |
| Investment revenue - net | 13,175,506 | 3,702,584 |
| Interest on equity in State Treasurer's Common Cash Fund | <u>36,880</u> | <u>41,501</u> |
| Total non-operating revenues | <u>13,212,386</u> | <u>3,744,085</u> |
| Non-operating expenses | | |
| Bank fees | (2,391) | (1,828) |
| Amortization of prize award obligation discount | (4,502,192) | (5,145,992) |
| Loss on disposal of assets | <u>0</u> | <u>(1,402)</u> |
| Total non-operating expenses before disbursements | <u>(4,504,583)</u> | <u>(5,149,222)</u> |
| Disbursements to School Aid Fund | (401,213,548) | (395,097,553) |
| Disbursements to General Fund | (1,043,518) | (1,413,030) |
| Disbursements to Community Health | <u>(495,000)</u> | <u>(495,000)</u> |
| Total disbursements | <u>(402,752,066)</u> | <u>(397,005,583)</u> |
| Total non-operating expenses | <u>(407,256,649)</u> | <u>(402,154,805)</u> |
| Net non-operating revenue (expense) | <u>(394,044,263)</u> | <u>(398,410,720)</u> |
| Change in net position | 8,868,587 | (950,628) |
| Total net position at beginning of period | <u>26,784,938</u> | <u>17,918,633</u> |
| Total net position at end of period | <u>\$ 35,653,525</u> | <u>\$ 16,968,005</u> |

See Accompanying Notes to the Financial Statements

Bureau of State Lottery, State of Michigan
Statement of Cash Flows
For the Six Months Ended March 31, 2015 and 2014

| | <u>2015</u> | <u>2014</u> |
|---|----------------------|----------------------|
| Cash Flows From Operating Activities | | |
| Cash collections from customers | \$ 1,366,450,813 | \$ 1,294,128,764 |
| Payments to employees | (11,188,378) | (10,868,767) |
| Payments to suppliers | (27,457,678) | (21,509,434) |
| Payments to prize winners | (850,685,230) | (798,018,634) |
| Payments for retailer and vendor commissions | (122,809,843) | (114,001,146) |
| | <u>354,309,684</u> | <u>349,730,783</u> |
| Cash Flows From Noncapital Financing Activities | | |
| Disbursements to other funds | <u>(333,759,197)</u> | <u>(320,000,000)</u> |
| Cash Flows From Capital and Related Financing Activities | | |
| Acquisition of capital assets | <u>(366,770)</u> | <u>(21,145)</u> |
| Cash Flows From Investing Activities | | |
| Proceeds from maturities of investment securities | 17,969,000 | 20,519,000 |
| Purchase of investments | - | - |
| Interest received | 16,455 | 19,444 |
| Bank fees | (2,391) | (1,828) |
| | <u>17,983,064</u> | <u>20,536,616</u> |
| Net increase in cash and cash equivalents | 38,166,781 | 50,246,254 |
| Cash and cash equivalents at beginning of period | <u>2,756,988</u> | <u>12,023,515</u> |
| Cash and cash equivalents at end of period | <u>\$ 40,923,769</u> | <u>\$ 62,269,769</u> |

Bureau of State Lottery, State of Michigan
Statement of Cash Flows
For the Six Months Ended March 31, 2015 and 2014

| | 2015 | 2014 |
|--|------------------------|------------------------|
| Reconciliation of operating income to net cash provided by operating activities | | |
| Operating income | \$ 402,912,850 | \$ 397,460,092 |
| Adjustments to reconcile operating income to net cash provided by operating activities | | |
| Depreciation expense | 100,522 | 107,386 |
| Bad debt expense | 92,946 | 30,430 |
| Amortization of prize award obligation discount | (4,502,192) | (5,145,992) |
| Net changes in assets and liabilities: | | |
| Inventory | (3,638,294) | (1,773,395) |
| Receivables from retailers | (33,255,579) | (20,598,118) |
| Warrants authorized, compensated absences, accounts payable and other liabilities | 4,106,562 | 8,333,225 |
| Prize awards payable - net | (11,507,131) | (28,682,845) |
| Net cash provided by operating activities | \$ 354,309,684 | \$ 349,730,783 |
| Reconciliation of cash and cash equivalents | | |
| Cash and cash equivalents at beginning of period | | |
| Equity in State Treasurer's Common Cash Fund | \$ 3,609,257 | \$ 12,909,672 |
| Warrants outstanding | (852,269) | (886,157) |
| Net cash and cash equivalents at beginning of period | \$ 2,756,988 | \$ 12,023,515 |
| Cash and cash equivalents at end of period | | |
| Equity in State Treasurer's Common Cash Fund | \$ 41,944,092 | \$ 65,276,492 |
| Warrants outstanding | (1,020,323) | (3,006,723) |
| Net cash and cash equivalents at end of period | \$ 40,923,769 | \$ 62,269,769 |
| Schedule of noncash investing, capital, and financing activities | | |
| Increase (decrease) in fair value of investments | \$ 8,868,587 | \$ (950,628) |
| Disbursements to other funds (accrual) | (68,992,869) | (77,005,583) |
| Total noncash investing, capital, and financing activities | \$ (60,124,282) | \$ (77,956,211) |

Bureau of State Lottery, State of Michigan

Notes to Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Reporting Entity

The Bureau of State Lottery (the "Lottery") was established by Michigan Compiled Laws Section 432.5 under authority of Article 5, Section 4, of the State Constitution.

Public Act 95 of 1996 allows the Lottery to participate in joint enterprises, such as multi-state lotteries, with other sovereignties. Michigan, a Mega Millions state, participates in Powerball and Power Play, Raffle and Lucky for Life multi-state lottery games, with the Multi-State Lottery Association (MUSL), an association of governmental lotteries. The association is comprised of a combination of MUSL Lotteries and Mega Millions Lotteries. Michigan also participates in Mega Millions, a jointly operated multi-state lottery comprised of 10 states: California, Georgia, Illinois, Massachusetts, Michigan, New Jersey, New York, Ohio, Virginia, Washington and MUSL. Net income from Mega Millions, Megaplier, Powerball Power Play, and Lucky for Life is disbursed to the School Aid Fund.

Basis of Presentation

The Lottery is classified as an enterprise fund of the State of Michigan. Accordingly, the Lottery's financial statements are included in the State's Comprehensive Annual Financial Report. The accompanying financial statements are not intended to present the financial position and results of operations of the State of Michigan or its enterprise funds.

Basis of Accounting

The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. The Lottery distinguishes operating revenue and expenses from non-operating items. The principal operating revenue of the Lottery is primarily comprised of sales from instant and draw game tickets and iLottery net wins. Operating expenses mainly consist of payments to instant and draw game prize winners and commissions to retailer agents and vendors. All other revenues and expenses are reported as non-operating. Excess revenue over expenses is designated for payment to the State School Aid Fund, except for unrealized gains on investments, excess of revenue over expenses from charitable gaming activities and up to \$1 million per year to the Department of Community Health for gambling addiction programs which are designated for payment to the State General Fund.

The accounting policies of the Lottery conform to accounting principles generally accepted in the United States of America (GAAP) as applicable to governmental units. The following is a summary of the significant accounting policies used by the Lottery.

Revenue Recognition

Revenue is recognized for instant and pull tab games when tickets are activated by retailers. For draw games, revenue is recognized and the related direct expenses of ticket sales are accrued based upon the known relationship of the amount of ticket sales to the amount of prizes for each game. This method of measuring revenue is necessary in order to properly match revenues and expenses. Revenues for iLottery games are recognized when sales to the public occur and are reported net of prizes awarded which are recognized as game play completes and prizes are known (refer to Note 7 for more information on iLottery revenue and expense). All revenues are reported net of free plays, discounts and allowances.

Bureau of State Lottery, State of Michigan

Notes to Financial Statements

Statement of Cash Flows

For the purposes of the Statement of Cash Flows, the Lottery considers equity in the State Treasurer's Common Cash pool, net of warrants outstanding, to be cash equivalents.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 revenues and expenses during the reporting period. Actual results could differ from those estimates.

Equity in State Treasurer's Common Cash Fund

The State Treasurer manages the State's Common Cash pool, which is used by the Lottery. The pooling of cash allows the Treasurer to invest monies not needed to pay immediate obligations so that investment earnings on available cash are maximized. Investments of the pool are not segregated by fund; rather, each contributing fund's balance is treated as equity in the pool and presented in this report as "Equity in State Treasurer's Common Cash."

Investment policies and risk categorization are included in the State of Michigan's Comprehensive Annual Financial Report.

Investments

Investments are reported at fair value. Investments are in U.S. Treasury zero-coupon bonds and State of Michigan General Obligation Capital Appreciation Bonds, Series 2009B (Michigan CAB Bonds). These investments are purchased to meet future installment payments to prize winners. Gains and losses are generally not realized on investments, as it is the Lottery's and State Treasurer's policy to hold the Lottery's investments to maturity or liquidation. The difference between the fair value and the amortized cost is reflected as a restriction of net position for unrealized gains on investments.

Inventory

Inventory consists of instant game tickets, pull tab game tickets and charity game tickets on hand and for sale at year end as well as merchandise prizes for games that have not started as of March 31, 2015 and 2014. The inventory is valued at cost, primarily using the weighted average method.

Provision for Doubtful Accounts

The Lottery establishes an allowance for bad debt for retailer receivables greater than 90 days old. A bad debt expense is recorded when the allowance is established for these receivables. The amount of the allowance for doubtful accounts totaled \$1,314,495 as of March 31, 2015 and \$1,323,390 as of March 31, 2014.

Bureau of State Lottery, State of Michigan

Notes to Financial Statements

Capital Assets

The Lottery has established a \$5,000 threshold for capitalization of purchases of assets, which include equipment and leasehold improvements, and are reported in the Statement of Net Position. Such assets are recorded at historical cost or estimated historical cost if purchased or constructed. Depreciation of equipment is computed using the straight-line method over five years, the estimated useful life of the assets. The Lottery has established a \$200,000 threshold for intangible assets such as constructed computer software.

Information technology equipment including constructed computer software is depreciated over three years, the estimated useful life of the assets. Building leasehold improvements are depreciated over the lesser of eight years, the estimated useful life of the improvements, or the lease term. The costs of normal maintenance and repairs that do not add to the value of assets or materially extend asset lives are not capitalized.

Advance Wagers

All draw games may be played on an advance wager basis. An associated liability is recognized for all wagers received for drawings to be conducted after the end of the reporting period.

Warrants Authorized and Warrants Outstanding

Most of the Lottery's disbursements are made through warrants issued by the State. Warrants requested by the Lottery are charged to the Lottery's equity in the State Treasurer's Common Cash Fund as they clear the State Treasurer's account. Therefore, warrants outstanding represent drafts issued against the State Treasurer's account, which have not cleared. Warrants requested by the Lottery, but not yet issued by the State, are reported as warrants authorized.

Unclaimed Prizes

Prizes not claimed within one year after the drawing date or after the expiration date indicated on the back of the instant and pull tab tickets, are forfeited by the ticket holder. The Lottery estimates the amount of winning draw game, instant, and pull tab tickets which will not be claimed within one year after the drawing date for draw tickets or after the expiration date for instant and pull tab tickets. All unclaimed prizes are disbursed to the State School Aid Fund as provided by State statute.

Net Position

Net position represents the difference between assets, deferred outflows of resources, liabilities and deferred inflows of resources in accordance with Governmental Accounting Standards Board (GASB) Statement No. 63 *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. The Lottery has no items that qualify as deferred inflows or outflows of resources. Net investment in capital assets consists of equipment and leasehold improvements. The difference between the fair value of investments and the amortized book value of investments is reported as restricted for unrealized gains on investments and is not available for disbursement to the School Aid Fund in accordance with Public Act 239.

Bureau of State Lottery, State of Michigan

Notes to Financial Statements

New Accounting Pronouncement

Effective October 1, 2014, the Lottery implemented the provisions of Governmental Accounting Standards Board (GASB) No. 68, *Accounting and Financial Reporting for Pensions*. Statement No. 68 requires governments providing defined benefit pensions to recognize their unfunded pension benefit obligation as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits. Based on the current funding policy for the defined benefit plan discussed in Note 9, the State of Michigan has determined that it is not required to allocate any of the net pension liability to the Lottery at this time.

NOTE 2 - EQUITY IN STATE TREASURER'S COMMON CASH

The Lottery participates in the State Treasurer's Common Cash pool. The investment authority for the pool is found in Michigan Compiled Laws Sections 21.141 – 21.147. The pooling of cash allows the State Treasurer to invest monies not needed to pay immediate obligations so the investment earnings on available cash are maximized. The State Treasurer may invest surplus funds belonging to the State in the bonds, notes, and other evidences of indebtedness of the United States Government, and its agencies and in prime commercial paper. The Treasurer invests excess cash in short-term investments or cash equivalents.

The following paragraphs provide disclosures about deposits and investments of the State Treasurer's Common Cash Fund:

Common Cash Deposits

Custodial Credit Risk

The custodial credit risk for deposits is the risk that, in the event of the failure of a depository financial institution, the State's deposits may not be recovered.

Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are:

- a. Uncollateralized
- b. Collateralized with securities held by the pledging financial institution, or
- c. Collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name.

The State Treasurer's policy requires the following criteria to lessen the custodial credit risk: all financial institutions holding the State's money must pledge collateral equal to the amount of the account balance for all demand and time deposits to secure the State's fund. A bank, savings and loan association or credit union holding State funds must be organized under the laws of Michigan or federal law and maintain a principal office or branch office in the State of Michigan. No deposit in any financial organization may be in excess of 50 percent of the net worth of the organization.

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates that will adversely affect the fair value of deposits.

Bureau of State Lottery, State of Michigan

Notes to Financial Statements

Michigan Compiled Laws Section 487.714 requires State deposits to be held in a financial institution which maintains a principal office or branch office located in the State of Michigan.

No deposits were exposed to foreign currency risk, as is precluded by State policy.

Common Cash Investments

Risk

In accordance with GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, investments also require certain disclosures regarding policies and practices with respect to the risks associated with them. Custodial credit risk, credit risk, and interest rate risk are discussed in the following paragraphs:

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty, the State will not be able to recover the value of the investment or collateral securities that are in the possession of the outside party.

Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government and are held by either:

The counterparty, or

The counterparty's trust department or agent but not in the government's name.

The State Treasurer does not have an investment policy for managing custodial credit risk. At March 31, 2015 and 2014, common cash investments were not exposed to custodial credit risk.

Credit Risk

Credit risk is the risk that an issuer or another counterparty to an investment will not fulfill its obligations.

Prime commercial paper investments must be rated A-1 or P-1 at the time of purchase as rated by the two major rating services: Standard and Poor's (A-1); and Moody's (P-1). Borrowers must have at least \$400 million in commercial paper outstanding, and the State Treasurer may not invest in more than 10% of the borrower's outstanding debt. The investments are further limited to \$200 million in any borrower, unless the borrower has an A-1+ rating in which case the investment is not to exceed \$300 million. As of March 31, 2015 and 2014, the Lottery does not hold any investments in commercial paper.

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment.

The State Treasurer's policy states that cash equivalents are invested in short-term fixed income securities with an average weighted maturity of less than one year to provide liquidity and safety of principal from capital market and default risk.

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

NOTE 3 - INVESTMENTS

Investments totaling \$227,667,259 at March 31, 2015, and \$222,145,281 at March 31, 2014 are in the form of U. S. Treasury zero-coupon bonds and State of Michigan General Obligation Capital Appreciation Bonds, series 2009B (Michigan CAB bonds).

These investments were purchased to fund future payments due to annuity prize winners. The bonds are reported at fair value. The corresponding liability to the prize winners is recorded in prizes payable and is disclosed in Note 6. Cash receipts from the maturity of investments totaled \$17,969,000 in the six-month period ended March 31, 2015 and \$20,519,000 in the six-month period ended March 31, 2014.

Investments at March 31 consist of the following:

| | 2015 | 2014 |
|----------------------------------|----------------|----------------|
| U. S. Treasury zero-coupon bonds | \$ 173,165,572 | \$ 162,009,991 |
| Michigan CAB bonds | 54,501,687 | 60,135,290 |
| Total investments | \$ 227,667,259 | \$ 222,145,281 |

As reported on the Statement of Net Position:

| | 2015 | 2014 |
|------------------------|----------------|----------------|
| Current investments | \$ 26,994,019 | \$ 30,969,636 |
| Noncurrent investments | 200,673,240 | 191,175,645 |
| Total Investments | \$ 227,667,259 | \$ 222,145,281 |

Policy Disclosures

Investment authority with regard to the State Lottery Fund is delegated to the State Treasurer per the Michigan Compiled Laws Section 432.41. This authority is the same investment authority with regard to the State's pension (and other employee benefit) trust funds which is found in Michigan Compiled Laws Section 38.1133. The law allows the State Treasurer, as investment fiduciary, to make diverse investments in stocks, corporate and government bonds and notes, mortgages, real estate, venture capital, and other investments.

The law has prudence standards and requires that the assets shall be invested solely in the interest of the participants and beneficiaries. The Lottery's policy is to invest solely in U. S. Treasury zero-coupon bonds and Michigan CAB bonds and hold them to maturity.

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

Interest Rate Risk

Investments in prize annuities at March 31, 2015 and 2014 consist of the following:

March 31, 2015

| Maturities In Years | Investments in United | Interest Rate Low to High | Investments in | Interest Rate Low to High |
|------------------------|--------------------------------------|------------------------------|-----------------------|------------------------------|
| | States Treasury Zero-Coupon Bonds | | Michigan CAB Bonds | |
| Less than 1 | \$ 16,237,072 | 0.30% to 7.19% | \$ 10,756,947 | 5.57% to 6.20% |
| 1-5 | 55,645,111 | 0.49% to 7.14% | 25,732,720 | 6.28% to 7.88% |
| 6-10 | 43,565,552 | 2.37% to 4.98% | 8,846,585 | 8.05% to 8.29% |
| 11-15 | 29,692,464 | 4.13% to 4.78% | 9,165,435 | 8.31% to 8.39% |
| 16-20 | 20,620,439 | 4.35% to 4.79% | - | - |
| 21-25 | 4,537,181 | 3.57% to 4.58% | - | - |
| 26-29 | 2,867,753 | 3.63% to 3.68% | - | - |
| Fair Market Value | <u>\$ 173,165,572</u> | | <u>\$ 54,501,687</u> | |

March 31, 2014

| Maturities In Years | Investments in United | Interest Rate Low to High | Investments in | Interest Rate Low to High |
|------------------------|--------------------------------------|------------------------------|-----------------------|------------------------------|
| | States Treasury Zero-Coupon Bonds | | Michigan CAB Bonds | |
| Less than 1 | \$ 15,207,188 | 0.19% to 7.16% | \$ 15,762,448 | 4.97% to 5.36% |
| 1-5 | 55,934,611 | 0.30% to 7.19% | 29,539,630 | 5.57% to 7.65% |
| 6-10 | 42,896,781 | 1.50% to 4.99% | 8,656,454 | 7.88% to 8.25% |
| 11-15 | 27,029,621 | 3.99% to 4.84% | 2,884,011 | 8.29% to 8.39% |
| 16-20 | 17,714,939 | 4.35% to 4.75% | 3,292,747 | 8.39% to 8.39% |
| 21-25 | 3,226,851 | 4.58% to 4.79% | - | - |
| Fair Market Value | <u>\$ 162,009,991</u> | | <u>\$ 60,135,290</u> | |

Interest rate risk is the risk that changes in interest rates of debt investments will adversely affect the fair value of those investments. The State does not have a policy regarding interest rate risk for long-term debt investments. The investments are subject to fluctuations in fair value due to interest rate risk, but these bonds are held to maturity to satisfy the annual installment obligations to the prize winners. The fair value at maturity is the face value of the bonds regardless of the fluctuations in value during the time period that the investments are outstanding, thus minimizing the interest rate risk, if held to maturity.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Investment grade, as defined in MCL Section 38.1132, includes investments in the top four major grades, as determined by two national rating services. The State Treasurer's policy is to use Standard & Poor's (AAA, AA, A, BBB) and Moody's (Aaa, Aa, A, Baa). The Lottery's policy is that all long-term fixed income investments, unless unrated, must be investment-grade at the time of purchase unless specific requirements are met.

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

U. S. Treasury zero-coupon bonds are explicitly guaranteed by the U. S. government and credit quality ratings are therefore not required. The Lottery's procedure to invest in this type of bond does not require a specific credit rating, but credit quality is inherently high as the bonds are explicitly guaranteed by the U. S. government. As of March 31, 2015 and March 31, 2014, the Lottery's investments in Michigan CAB bonds were rated AA- by Standard and Poor and Aa2 by Moody's.

Concentration of Credit Risk

Investments are in U. S. Treasury zero-coupon bonds and Michigan CAB bonds. U. S. Treasury zero-coupon bonds are guaranteed by the United States government. Therefore, there is no concentration of credit risk for those types of bonds. As of March 31, 2015, Investments in Michigan CAB bonds account for 23.9% of the total investments as compared to 27.1% as of March 31, 2014. This decrease is due to the maturities of Michigan CAB bonds in the past year.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the Lottery will not be able to recover the value of the investments that are in the possession of an outside party.

Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the entity, and are held by either the counterparty or by the counterparty's trust department or agent, but not in the entity's name. The Lottery does not have any of these types of investments.

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of investments or deposits. As of March 31, 2015 and 2014 the Lottery had no investments subject to foreign currency risk.

NOTE 4 - CAPITAL ASSETS

A summary of capital asset activity for the six months ended March 31, 2015 and 2014 was as follows:

| <u>Period Ending</u> | <u>Beginning Balance</u> | <u>Additions</u> | <u>Deletions</u> | <u>Ending Balance</u> |
|---|------------------------------|-------------------|------------------|---------------------------|
| <u>March 31, 2015</u> | | | | |
| Capital assets being depreciated: | | | | |
| Leasehold improvements | \$ 1,955,989 | \$ - | \$ - | \$ 1,955,989 |
| Equipment | 2,682,280 | 366,770 | - | 3,049,050 |
| Total capital assets being depreciated | 4,638,269 | 366,770 | - | 5,005,039 |
| Less: accumulated depreciation | | | | |
| Leasehold improvements | 1,942,533 | 1,602 | - | 1,944,135 |
| Equipment | 2,123,709 | 98,920 | - | 2,222,629 |
| Total accumulated depreciation | 4,066,242 | 100,522 | - | 4,166,764 |
| Total capital assets being depreciated, net | <u>\$ 572,027</u> | <u>\$ 266,248</u> | <u>\$ -</u> | <u>\$ 838,275</u> |

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

| Period Ending | Beginning Balance | Additions | Deletions | Ending Balance |
|---|----------------------|--------------------|-----------------|-------------------|
| <u>March 31, 2014</u> | | | | |
| Capital assets being depreciated: | | | | |
| Leasehold improvements | \$ 1,955,989 | \$ - | \$ - | \$ 1,955,989 |
| Equipment | 3,175,510 | 21,145 | 524,075 | 2,672,580 |
| Total capital assets being depreciated | <u>5,131,499</u> | <u>21,145</u> | <u>524,075</u> | <u>4,628,569</u> |
| Less: accumulated depreciation | | | | |
| Leasehold improvements | 1,939,329 | 1,602 | - | 1,940,931 |
| Equipment | 2,437,928 | 105,784 | 522,673 | 2,021,039 |
| Total accumulated depreciation | <u>4,377,257</u> | <u>107,386</u> | <u>522,673</u> | <u>3,961,970</u> |
| Total capital assets being depreciated, net | <u>\$ 754,242</u> | <u>\$ (86,241)</u> | <u>\$ 1,402</u> | <u>\$ 666,599</u> |

NOTE 5 - DISAGGREGATION OF PAYABLE BALANCE

Accounts payable and other liabilities at March 31, 2015 and 2014, were as follows:

| | <u>2015</u> | <u>2014</u> |
|---|----------------------|----------------------|
| Accounts payable vendors | \$ 13,418,674 | \$ 13,953,750 |
| Retailer security deposits/accounts payable | 3,272,640 | 2,680,499 |
| Accrued intragovernmental expenses | 2,057,135 | 1,768,799 |
| Accrued salaries | 993,887 | 909,233 |
| Compensated absences | 470,395 | 500,495 |
| Supplemental Retirement | 77,733 | 102,560 |
| Total | <u>\$ 20,290,464</u> | <u>\$ 19,915,336</u> |

NOTE 6 - PRIZE AWARDS

Installment prize awards are recorded at their present value using discount rates ranging from 3.5% to 7.0%. U. S. Treasury zero-coupon bonds and State of Michigan General Obligation Capital Appreciation Bonds have been purchased to provide for the payment of installment prize awards in addition to cash maintained in the State's common cash fund. Prize awards payable as of March 31, were as follows:

| | <u>2015</u> | <u>2014</u> |
|------------------------------|-----------------------|-----------------------|
| Current - at face amount | \$ 99,041,170 | \$ 87,200,404 |
| Less - unamortized discount | <u>(693,821)</u> | <u>(843,371)</u> |
| Current - at present value | <u>98,347,349</u> | <u>86,357,033</u> |
| Long-term - at face amount | 265,664,200 | 290,776,800 |
| Less - unamortized discount | <u>(89,044,250)</u> | <u>(97,311,768)</u> |
| Long-term - at present value | <u>176,619,950</u> | <u>193,465,032</u> |
| Total | <u>\$ 274,967,299</u> | <u>\$ 279,822,065</u> |

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

Installment prize awards payable as of March 31, 2015 are summarized as follows:

| | |
|---|------------------------------|
| 2016 | \$ 26,686,600 |
| 2017 | 19,733,200 |
| 2018 | 16,591,200 |
| 2019 | 14,629,200 |
| 2020 | 14,629,200 |
| 2021-2025 | 67,358,200 |
| 2026-2030 | 54,678,000 |
| 2031-2035 | 48,445,500 |
| 2036-2040 | 14,493,100 |
| 2041-2045 | 5,289,000 |
| 2046-2050 | 3,513,000 |
| 2051-2055 | 2,789,000 |
| 2056-2060 | 1,726,600 |
| 2061-2065 | 645,000 |
| 2066-2070 | 520,000 |
| 2071-2075 | 520,000 |
| 2076-2080 | 104,000 |
| Total | <u>292,350,800</u> |
| Less - unamortized discount | <u>(89,738,071)</u> |
| Total installment prize awards payable at present value | 202,612,729 |
| Noninstallment prize awards payable | <u>72,354,570</u> |
| Total prize awards payable | <u><u>\$ 274,967,299</u></u> |

Long-term liability activity of installment prize awards payable for the six-month periods ended March 31 was as follows:

| Period Ending March 31 | Beginning Balance | Additions | Reductions | Ending Balance | Due Within One Year at Present Value |
|------------------------------|----------------------|--------------|---------------|-------------------|--|
| 2015 | \$ 216,520,157 | \$ 4,930,972 | \$ 18,838,400 | \$ 202,612,729 | \$ 25,992,779 |
| 2014 | \$ 238,362,595 | \$ 7,856,999 | \$ 22,583,233 | \$ 223,636,361 | \$ 30,171,329 |

NOTE 7 – iLOTTERY NET WIN

iLottery revenue is reported in ticket sales net of discounts and prize expense in the Statement of Revenues, Expenses, and Changes in Net Position (refer to Supplementary Schedule of Revenue and Expenses for details of sales and prize awards of each Lottery game). The following schedule details the iLottery sales and prize activity for the six month period ending March 31, was as follows:

| iLottery | Period Ended March 31, 2015 |
|------------------|--------------------------------|
| Sales | \$ 52,908,825 |
| Prizes | (46,477,747) |
| iLottery Net Win | <u><u>\$ 6,431,078</u></u> |

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

NOTE 8 - COMPENSATED ABSENCES

The Lottery records as a liability estimated vested vacation, sick pay and longevity. Employees are granted vacation pay in varying amounts based on length of service. Accumulated unused vacation pay is paid to employees or their beneficiaries upon death, retirement or resignation. Sick leave accrues for all employees at the rate of four hours for each two week period worked. Up to 50% of accumulated, unused sick leave of employees hired prior to October 1, 1980, is paid to the employees or their beneficiaries upon death, retirement or resignation. For employees hired after September 30, 1980, unused sick leave is forfeited upon termination of employment. In accordance with state Civil Service Rules, longevity compensation payments, which are separate from regular compensation, are paid based on employee years of service. The Lottery accrues for vacation, vested sick leave of employees hired prior to October 1, 1980, and longevity to be paid upon death, retirement or resignation during the period of active employment.

The State instituted a banked leave time program October 12, 2003 through November 5, 2005 whereby eligible employees worked a regular schedule but received pay for a reduced number of hours. The banked leave time program was reinstated February 21, 2010 through September 4, 2010 for non-represented employees. Upon an employee's separation, death or retirement from State service, unused banked leave time hours shall be contributed by the State to the employee's account within the State's 401(k) plans, and if applicable to the State's 457 plans. The banked leave liability is valued at the pay rates in effect as of March 31, 2015.

Long-term liability activity of these benefits for the six-month periods ended March 31, was as follows:

| Period | | | | | | |
|----------|--------------|------------|------------|--------------|------------|--------------|
| Ending | Beginning | | | Ending | Due Within | Long-term |
| March 31 | Balance | Additions | Reductions | Balance | One Year | Liability |
| 2015 | \$ 1,643,984 | \$ 800,085 | \$ 571,016 | \$ 1,873,053 | \$ 470,394 | \$ 1,402,659 |
| 2014 | \$ 1,849,911 | \$ 497,410 | \$ 375,565 | \$ 1,971,756 | \$ 500,495 | \$ 1,471,261 |

NOTE 9 – PENSION AND POST-EMPLOYMENT BENEFITS

Lottery employees are included in either the Defined Benefit Plan (Plan 1) or Defined Contribution Plan (Plan 2) as described below.

Defined Benefit Plan (Plan 1)

The Lottery's employees hired prior to March 31, 1997, are enrolled in a noncontributory defined benefit plan through the State Employees' Retirement System upon meeting certain eligibility requirements. Changes in Public Act 264 of 2011 to the defined benefit plan granted members a choice regarding their future retirement plan. Members could voluntarily pay 4% of compensation to remain in this pension plan for future service or become a participant in the defined contribution plan for future years of service. Member elections were implemented on April 26, 2012. Generally, qualified participants in the defined benefit plan are eligible for pension, dental, vision and major medical coverage. A member may retire with an age and service allowance after completing: (1) at least 10 years of credited service and (2) attaining the minimum retirement age of 60, or at least age 55 with 30 years of service credit. Pension benefits are determined using 1.5% times a member's final average compensation, calculated as the average of a member's monthly pay during the period of 36 consecutive months of credited service producing the highest monthly average multiplied by length of service. Employees become vested for retiree health insurance benefits with 10 or more years of service.

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

Total employees covered by Plan 1 as of March 31 are as follows:

| | <u>2015</u> | <u>2014</u> | <u>2013</u> |
|----------|-------------|-------------|-------------|
| Active | 48 | 53 | 57 |
| Inactive | 3 | 3 | 2 |
| Retired | 67 | 62 | 59 |
| Total | 118 | 118 | 118 |

Defined Contribution Plan (Plan 2)

The Lottery's employees hired after March 31, 1997, are enrolled in a defined contribution plan through the State Employee's Retirement System upon meeting certain eligibility requirements. Changes in Public Act 264 of 2011 included an option for former vested and non-vested members of the defined benefit plan to voluntarily elect to enroll in the defined contribution plan including those former employees returning to state employment between January 1, 2012 and January 1, 2014. Also, those currently in the defined contribution plan were given the option to change their retirement health care. Members could keep the graded premium subsidy to accrue credit towards insurance premiums in retirement, or choose the Personal Healthcare Fund plan to pay healthcare expenses in retirement. Generally, qualified participants in the defined contribution plan are eligible to retire at age 55, with 30 years of service or at age 60 with 10 years of service. The Lottery contributes a mandatory 4% of the employees' salary and matches up to an additional 3% of the employees' contributions. Participants in this plan are 100% vested for any employee contributions. Participants become vested for 50% of the employer contributions after two years of service, 75% after three years of service and 100% after four years of service. Employees become vested for retiree health insurance benefits with ten or more years of service.

The cost of these pension and other post-employment benefits are allocated to the Lottery as a percentage of gross payroll. Beginning with the October 25, 2012 pay date, the contribution rate to fund the unfunded actuarial accrued liability (UAAL) of Other Post-Employment Benefits (OPEB) was applied to combined payrolls of the defined benefit and defined contribution plans in accordance with MCL 38.38(3). The payroll for the Lottery employees covered by the Plan 1 and Plan 2 was \$6,016,662, \$5,805,743, and \$5,846,466, for the six months ended March 31, 2015, 2014 and 2013 respectively. The Lottery's allocated contribution requirements and contributions actually made were \$3,755,827, \$3,605,313, and \$3,407,698, for the six months ended March 31, 2015, 2014, and 2013, respectively. Contributions represent approximately 62.4%, 62.1%, and 58.3% of covered payroll during 2015, 2014, and 2013, respectively.

Public Act 185 of 2010 established a supplemental pension for all State of Michigan employees who qualified and retired under the 2010 incentive.

Supplemental Retirement

State of Michigan employees who retired under this incentive agreed to forfeit the lump sum payment of their accumulated annual, sick, and other deferred leave time payouts and will instead receive an equal amount through a supplemental pension payment over 60 monthly installments beginning January 1, 2011. The amount of the 60 monthly charges, once calculated, should remain constant unless a) the retiree dies without a designated pension beneficiary in which case a lump sum of the remaining balance will be paid out to the refund beneficiary, (b) the retiree returns to work in which case the supplemental pension benefit will be suspended, or (c) there was an error in the initial calculation which required correction after benefit payments began.

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

Long-term liability activity of these benefits for the six-month period ended March 31, was as follows:

| Period Ending March 31 | Beginning Balance | Additions | Reductions | Ending Balance | Due Within One Year | Long- Term Liability |
|------------------------------|----------------------|-----------|------------|-------------------|---------------------------|----------------------------|
| 2015 | \$ 129,013 | | \$ 51,280 | \$ 77,733 | \$ 77,733 | \$ - |
| 2014 | \$ 231,573 | | \$ 51,280 | \$ 180,293 | \$ 102,560 | \$ 77,733 |

Additional detail and data regarding Plan 1 and Plan 2 descriptions, vesting and eligibility requirements, actuarial cost methods and assumptions, funding requirements, accounting policies, three-year historical trend information, and other postemployment benefits is provided in the State of Michigan Comprehensive Annual Financial Report and detailed financial reports issued by the Office of Retirement Systems. The reports may be obtained by writing to the Department of Technology, Management and Budget, Office of Retirement Services, 7150 Harris Dr., P.O. Box 30171, Lansing, MI 48909 or by calling (517) 322-5103.

NOTE 10 - LEASE AND RENTAL COMMITMENTS

The total operating lease payments on long-term lease commitments for the six months ended March 31, 2015 and 2014 were \$105,315. These leases represent leases for buildings. There were no capital lease obligations.

A summary of remaining minimum building lease commitments follows:

| Year | Operating Leases | | |
|-----------|--------------------------------|------------------------------------|------------------------------|
| | Six Months Ending March 31, | Six Months Ending September 30, | Year Ending September 30, |
| 2015 | 105,315 | 82,065 | 187,380 |
| 2016 | 77,415 | 77,415 | 154,830 |
| 2017 | 77,415 | 77,415 | 154,830 |
| 2018 | 47,005 | 31,800 | 78,805 |
| 2019 | 31,800 | 31,800 | 63,600 |
| 2020 | 31,800 | 31,800 | 63,600 |
| 2021-2024 | 31,800 | 10,600 | 42,400 |
| | <u>\$ 402,550</u> | <u>\$ 342,895</u> | <u>\$ 745,445</u> |

The total rent and lease expenses paid for all buildings for the six months ended March 31, 2015 and 2014 were \$553,032 and \$548,422 respectively.

NOTE 11 - RISK MANAGEMENT

The Lottery is exposed to various risks related to torts: property damage and destruction, errors and omissions, workers' compensation and unemployment compensation. The State of Michigan has elected not to purchase commercial insurance for many of the risks of losses to which the Lottery is exposed, but to self-insure for such risks. More detailed information on risk management is available in the State of Michigan's Comprehensive Annual Financial Report.

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

NOTE 12 - TRANSACTIONS WITH OTHER STATE AGENCIES

As a State agency, the Lottery is required to utilize services, supplies, and equipment provided by other State agencies. The following is a summarization of these charges for the six months ended March 31, 2015 and 2014:

March 31, 2015

Department of Technology, Management and Budget:

Information Technology

| | |
|--|--------------|
| Direct costs | \$ 2,371,189 |
| Lansing Metropolitan Area Network (LMAN) | 10,442 |
| Michigan.gov portal web charges | 47,728 |
| Overhead | 176,190 |
| Total Information Technology Charges | \$ 2,605,549 |

| | |
|--|---------|
| Support services (including Internal audit) | 174,200 |
| Space rental - Lottery Central, Detroit, Saginaw offices | 445,377 |
| Vehicle and travel services | 351,872 |
| Other - Telephone, mailing and other offices services | 224,993 |

| | |
|--|---------------------|
| Total Department of Technology, Management and Budget | \$ 3,801,991 |
|--|---------------------|

| | |
|-----------------------------|------------------|
| Gaming Control Board | 1,021,055 |
|-----------------------------|------------------|

| | |
|---------------------------------|----------------|
| Civil Service Commission | 192,958 |
|---------------------------------|----------------|

| | |
|-------------------------------|----------------|
| Department of Treasury | 229,378 |
|-------------------------------|----------------|

| | |
|-------------------------|----------------|
| Attorney General | 169,550 |
|-------------------------|----------------|

| | |
|-----------------------|---------------|
| Other Agencies | 11,730 |
|-----------------------|---------------|

| | |
|--------------------------|---------------------|
| Total all State agencies | \$ 5,426,662 |
|--------------------------|---------------------|

March 31, 2014

Department of Technology, Management and Budget:

Information Technology:

| | |
|--|--------------|
| Direct costs | \$ 2,282,094 |
| Lansing Metropolitan Area Network (LMAN) | 10,442 |
| Michigan.gov portal web charges | 117,687 |
| Overhead | 156,434 |
| Total Information Technology Charges | \$ 2,566,657 |

| | |
|--|---------|
| Support services (including Internal audit) | 183,950 |
| Space rental - Lottery Central, Detroit, Saginaw offices | 448,639 |
| Vehicle and travel services | 328,639 |
| Other - Telephone, mailing and other offices services | 185,752 |

| | |
|--|---------------------|
| Total Department of Technology, Management and Budget | \$ 3,713,637 |
|--|---------------------|

| | |
|-----------------------------|------------------|
| Gaming Control Board | 1,174,808 |
|-----------------------------|------------------|

| | |
|---------------------------------|----------------|
| Civil Service Commission | 184,138 |
|---------------------------------|----------------|

| | |
|-------------------------------|----------------|
| Department of Treasury | 381,348 |
|-------------------------------|----------------|

| | |
|-------------------------|----------------|
| Attorney General | 164,350 |
|-------------------------|----------------|

| | |
|-----------------------|--------------|
| Other Agencies | 4,868 |
|-----------------------|--------------|

| | |
|--------------------------|---------------------|
| Total all State agencies | \$ 5,623,149 |
|--------------------------|---------------------|

Bureau of State Lottery, State of Michigan
Notes to Financial Statements

NOTE 13 - COMMITMENTS AND CONTINGENCIES

The Lottery has contracted with a third party to provide for the operation of the gaming system through January 19, 2017. The contract rate was 1.2757% of sales through July 31, 2012. Per an amendment effective August 1, 2012, additional equipment was acquired, increasing this rate to 1.32587% through January 19, 2014 and to 1.23017% from January 20, 2014 through January 19, 2015. After this date, per an amendment, the contract was extended for an additional two years through January 19, 2017 with a new rate of 1.18% and incorporating a monthly equipment maintenance fee of \$33,333 per year for designated equipment during the extended contract term. Per an addendum signed December 31, 2011, a gaming service was contracted for a player card loyalty prepaid debit card program known as the WonCard which was implemented on July 30, 2013. The compensation for this program is 2.0% for the WonCard validations of \$600 or less that are automatically credited to the WonCard.

The Lottery contracted with another third party to provide the development, implementation, operational support and maintenance of an iLottery System and iLottery Instant Games through August 2018. This contract was amended February 2014 to add a draw based games component and additional reimbursable staffing and operational expenses. The contract rate is 19.60% of total gross profit.

From time to time, the Lottery is party to lawsuits and claims arising in the normal course of business. The Lottery has defended and intends to continue to defend these actions vigorously and believes, based on currently available information, that adverse settlements, if any, will not be material to its financial position or results of operations

Bureau of State Lottery, State of Michigan
Supplementary Schedule of Revenues and Expenses
For the Six Months Ended March 31, 2015 and 2014

| | | 2015 | | 2014 | |
|--|----------------------------|----------------------|---------------------|----------------------|---------------------|
| | | Amount | Percent of Sales | Amount | Percent of Sales |
| Lottery ticket sales: | Daily 3 | \$ 172,810,107 | 12.4% | \$ 161,069,542 | 12.3% |
| | Daily 4 | 201,103,985 | 14.4% | 176,974,502 | 13.5% |
| | Lotto 47 | 20,375,126 | 1.5% | 21,311,722 | 1.6% |
| | Lotto 47 EZ Match | 1,158,355 | 0.1% | - | 0.0% |
| | Mega Millions | 64,831,982 | 4.7% | 86,063,379 | 6.6% |
| | Megaplier | 3,921,735 | 0.3% | 4,225,757 | 0.3% |
| | Powerball | 62,618,643 | 4.5% | 53,282,316 | 4.1% |
| | Power Play | 2,615,282 | 0.2% | 2,391,862 | 0.2% |
| | Monopoly | 1,775,955 | 0.1% | - | 0.0% |
| | Keno | 4,990,877 | 0.4% | 5,235,810 | 0.4% |
| | Fantasy Five | 25,711,982 | 1.8% | 27,717,573 | 2.1% |
| | Fantasy Five EZ Match | 2,849,380 | 0.2% | - | 0.0% |
| | Raffle | - | 0.0% | 4,094,230 | 0.3% |
| | Club Keno | 211,610,170 | 15.2% | 201,190,826 | 15.4% |
| | Club Keno Kicker | 75,384,909 | 5.4% | 70,517,792 | 5.4% |
| | The Jack | 4,787,892 | 0.3% | 5,251,163 | 0.4% |
| | Poker Lotto | 8,653,229 | 0.6% | 26,397,416 | 2.0% |
| | Lucky for Life | 4,872,235 | 0.3% | - | 0.0% |
| | Pull-Tab tickets | 17,100,362 | 1.2% | 16,024,638 | 1.2% |
| | Instant tickets | 499,865,458 | 35.9% | 446,701,046 | 34.2% |
| | iLottery Instants, Net Win | 6,431,078 | 0.5% | - | 0.0% |
| Total lottery ticket sales | | <u>1,393,468,742</u> | <u>100.0%</u> | <u>1,308,449,574</u> | <u>100.0%</u> |
| Prize awards: | Daily 3 | 87,769,390 | 6.3% | 76,745,496 | 5.9% |
| | Daily 4 | 96,419,963 | 6.9% | 79,567,785 | 6.1% |
| | Lotto 47 | 11,522,469 | 0.8% | 12,168,129 | 0.9% |
| | Lotto 47 EZ Match | 730,841 | 0.1% | - | 0.0% |
| | Mega Millions/Megaplier | 33,645,948 | 2.4% | 45,719,810 | 3.5% |
| | Powerball/Power Play | 32,772,686 | 2.4% | 27,978,818 | 2.1% |
| | Monopoly | 2,113,199 | 0.2% | - | 0.0% |
| | Keno | 2,066,529 | 0.1% | 2,084,347 | 0.2% |
| | Fantasy Five | 13,605,548 | 1.0% | 14,205,125 | 1.1% |
| | Fantasy Five EZ Match | 1,800,926 | 0.1% | - | 0.0% |
| | Raffle | - | 0.0% | 2,505,575 | 0.2% |
| | Club Keno/Kicker/Jack | 190,753,386 | 13.7% | 178,451,275 | 13.6% |
| | Players Club all games | 735,492 | 0.1% | 735,492 | 0.1% |
| | Merchandise | 13,991 | 0.0% | 4,498 | 0.0% |
| | Poker Lotto | 5,294,781 | 0.4% | 16,115,723 | 1.2% |
| | Lucky for Life | 2,712,298 | 0.2% | - | 0.0% |
| | Pull-Tab tickets | 12,227,547 | 0.9% | 11,963,330 | 0.9% |
| | Instant tickets | <u>354,833,996</u> | <u>25.3%</u> | <u>311,452,980</u> | <u>23.8%</u> |
| Total prize awards | | <u>849,018,990</u> | <u>60.9%</u> | <u>779,698,383</u> | <u>59.6%</u> |
| Less: unclaimed prizes | | <u>(14,343,083)</u> | <u>-1.0%</u> | <u>(15,508,586)</u> | <u>-1.2%</u> |
| Net prize awards | | <u>834,675,907</u> | <u>59.9%</u> | <u>764,189,797</u> | <u>58.4%</u> |
| Gross margin | | <u>558,792,835</u> | <u>40.1%</u> | <u>544,259,777</u> | <u>41.6%</u> |
| Retailer and vendor commission expense | | <u>(122,809,843)</u> | <u>-8.8%</u> | <u>(114,001,146)</u> | <u>-8.7%</u> |
| Game related expense | | <u>(10,980,217)</u> | <u>-0.8%</u> | <u>(12,069,946)</u> | <u>-0.9%</u> |
| Net ticket revenue | | <u>425,002,775</u> | <u>30.5%</u> | <u>418,188,685</u> | <u>32.0%</u> |
| Other operating expense | | <u>(23,586,345)</u> | <u>-1.7%</u> | <u>(22,475,664)</u> | <u>-1.7%</u> |
| Other miscellaneous revenue | | <u>452,902</u> | <u>0.0%</u> | <u>334,041</u> | <u>0.0%</u> |
| Net lottery operating income | | <u>401,869,332</u> | <u>28.8%</u> | <u>396,047,062</u> | <u>30.3%</u> |

Continued

Bureau of State Lottery, State of Michigan
Supplementary Schedule of Revenues and Expenses
For the Six Months Ended March 31, 2014 and 2013

| | 2015 | | 2014 | |
|--|----------------------|---------------------|----------------------|---------------------|
| | Amount | Percent of Sales | Amount | Percent of Sales |
| Charitable gaming | | | | |
| Charitable gaming revenue | 5,784,749 | 0.4% | 5,943,267 | 0.5% |
| Charitable gaming expense | (4,741,231) | -0.3% | (4,530,237) | -0.3% |
| Net charitable gaming income | <u>1,043,518</u> | <u>0.1%</u> | <u>1,413,030</u> | <u>0.2%</u> |
| Non-operating revenues (expenses) | | | | |
| Amortization expense - prize discount | (4,502,192) | -0.3% | (5,145,992) | -0.4% |
| Amortization revenue - investment discount | 4,306,919 | 0.3% | 4,653,212 | 0.4% |
| Unrealized (loss) on investments | 8,868,587 | 0.6% | (950,628) | -0.1% |
| Interest revenue - common cash fund | 36,880 | 0.0% | 41,501 | 0.0% |
| Bank fees | (2,391) | 0.0% | (1,828) | 0.0% |
| Loss on disposal of assets | - | 0.0% | (1,402) | 0.0% |
| Disbursement to School Aid Fund | (401,213,548) | -28.8% | (395,097,553) | -30.2% |
| Disbursement to General Fund | (1,043,518) | -0.1% | (1,413,030) | -0.1% |
| Disbursement to Community Health | (495,000) | 0.0% | (495,000) | 0.0% |
| Net non-operating revenues (expenses) | <u>(394,044,263)</u> | <u>-28.3%</u> | <u>(398,410,720)</u> | <u>-30.4%</u> |
| Change in net position | <u>\$ 8,868,587</u> | <u>0.6%</u> | <u>\$ (950,628)</u> | <u>0.1%</u> |

Concluded

Bureau of State Lottery, State of Michigan
Supplementary Schedule of Other Operating Expenses
For the Six Months Ended March 31, 2015 and 2014

| | <u>2015</u> | <u>2014</u> |
|---|----------------------|----------------------|
| Salaries and wages | \$ 6,148,240 | \$ 5,877,663 |
| Employee benefits and taxes | 5,371,873 | 5,144,933 |
| Promotion and advertising | 9,538,080 | 9,126,173 |
| Printing and supplies, including purchase of charitable gaming tickets | 792,463 | 747,672 |
| Other contractual services | 4,696,328 | 4,655,161 |
| Building rent and leases | 553,032 | 548,422 |
| Travel | 456,303 | 439,417 |
| Utilities | 176,958 | 137,454 |
| Postage | 131,113 | 122,467 |
| Equipment maintenance and rental | 268,435 | 67,955 |
| Bad debt expense | 92,946 | 30,430 |
| Interest paid on security deposits | <u>1,283</u> | <u>768</u> |
| Total | <u>\$ 28,227,054</u> | <u>\$ 26,898,515</u> |

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

Independent Auditor's Report

To Management and Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Doug Ringler, CPA, CIA
Auditor General, State of Michigan

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the of the Bureau of State Lottery, State of Michigan (the "Lottery"), an enterprise fund of the State of Michigan, as of and for the six-month periods ended March 31, 2015 and 2014, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements, and have issued our report thereon dated June 18, 2015.

Internal Control Over Financial Reporting

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

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

To Management and Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Doug Ringler, CPA, CIA
Auditor General, State of Michigan

Compliance and Other Matters

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

Purpose of this Report

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

Plante & Moran, PLLC

June 18, 2015