

**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, 2013 and 2012

Bureau of State Lottery, State of Michigan

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Independent Auditor's Report

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Thomas H. McTavish, Auditor General
State of Michigan

Report on the Financial Statements

We have audited the accompanying financial statements of the Bureau of State Lottery (the "Lottery"), an Enterprise Fund of the State of Michigan, as of and for the six-month periods ended March 31, 2013 and 2012, and the related notes to the financial statements, which collectively comprise the Bureau of State Lottery's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our 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.

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

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Thomas H. McTavish, Auditor General
State of Michigan

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 as of March 31, 2013 and 2012 and the changes in its financial position and its cash flows for the six-month periods then ended, in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matters

We draw attention to Note 1, which explains that these financial statements present only the Bureau of State Lottery and do not purport to, and do not, present fairly the financial position of the State of Michigan as of March 31, 2013 and 2012, 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.

As described in Note 1, the Lottery changed accounting policies related to GASB No. 63. Accordingly, the accounting change has been retrospectively applied to prior periods presented as if the policy had always been used. The effect of the new accounting policy is as follows: GASB No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, changed some of the existing terminology on the government-wide and proprietary balance sheets. As a result of adopting GASB No. 63, the Lottery has replaced “net assets” with “net position” on the balance sheet. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary 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 supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Thomas H. McTavish, Auditor General
State of Michigan

Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Bureau of State Lottery's basic financial statements. The other supplementary 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.

The other supplementary 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 supplementary 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 27, 2013 on our consideration of the Bureau of State Lottery'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's internal control over financial reporting and compliance.

Plante & Morse, PLLC

June 27, 2013

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, 2013. 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 supplemental 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 its 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 to 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 decreased by \$32.7 million, or 2.6% from the comparable six-month period in the last fiscal year.
- Total revenues for all activities (including non-operating) decreased \$33.4 million or 2.7% from the comparable six-month period in the last fiscal year.
- Non-operating revenues decreased by \$0.7 million. The decrease is attributable to the changing market values during this six-month period.
- Total operating expenses for the six-month period decreased \$2.2 million or 0.3% over the comparable six-month period in the last fiscal year.
- Total expenses (including non-operating) for all activities decreased \$33.3 million or 2.6%.
- Total non-operating expenses decreased by \$31.1 million, or 7.5%. Of that amount, net income to be disbursed to the General Fund related to Charitable Gaming activities decreased by \$1.5 million or 38.5%, while net income from Lottery gaming activities disbursed to the State School Aid Fund decreased by \$28.7 million or 7.2%.

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 2013	March 2012	March 2011
Current and other assets	\$ 211.6	\$ 257.0	\$ 234.8
Investments - noncurrent	215.2	228.2	239.7
Capital assets (net of accumulated depreciation)	<u>0.8</u>	<u>0.4</u>	<u>0.5</u>
Total assets	<u>427.6</u>	<u>485.6</u>	<u>475.0</u>
Current liabilities	195.6	239.7	223.7
Long-term liabilities	<u>201.7</u>	<u>220.0</u>	<u>247.4</u>
Total liabilities	<u>397.3</u>	<u>459.7</u>	<u>471.1</u>
Net position			
Net investment in capital assets	0.8	0.4	0.5
Restricted for unrealized gains on investments	30.3	25.9	3.9
Unrestricted (deficit)	<u>(0.8)</u>	<u>(0.4)</u>	<u>(0.5)</u>
Total net position	<u>\$ 30.3</u>	<u>\$ 25.9</u>	<u>\$ 3.9</u>

As shown in Table 1 above, the Lottery's net position increased since March 2012, from \$25.9 million to \$30.3 million, an increase of \$4.4 million. The change from March 2011 to March 2012 was an increase of net position by \$22.0 million. The increases are primarily attributable to the restricted for unrealized gains 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 2013, net capital assets increased by \$0.4 million since March 2012 and decreased by approximately \$0.1 million since March 2011. Additional detailed information on capital assets may be found in Note 4 in the accompanying financial statements.

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.

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

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

Table 2 - Liabilities
(in millions)

	<u>March 2013</u>	<u>March 2012</u>	<u>March 2011</u>
Current:			
Warrants authorized and warrants outstanding	\$ 1.1	\$ 1.2	\$ 2.7
Accounts payable and other liabilities	17.5	16.3	17.0
Due to other state agencies	75.4	100.6	81.8
Prize awards payable (net of discount)	<u>101.6</u>	<u>121.6</u>	<u>122.2</u>
Total current	<u>195.6</u>	<u>239.7</u>	<u>223.7</u>
Non-current:			
Prize awards payable (net of discount)	200.1	218.5	246.3
Compensated absences	1.4	1.2	1.1
Supplemental retirement	<u>0.2</u>	<u>0.3</u>	<u>-</u>
Total non-current	<u>201.7</u>	<u>220.0</u>	<u>247.4</u>
Total liabilities	<u><u>\$ 397.3</u></u>	<u><u>\$ 459.7</u></u>	<u><u>\$ 471.1</u></u>

Non-current liabilities consist principally of prize liability for prizes paid in installments over several years. For the six months ended March 2013, long-term prize liability decreased by \$18.4 million or 8.4% from March 2012 and decreased by \$27.8 million or 11.3% from March 2011. The decrease from March 2012 to March 2013 and March 2011 to March 2012 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)

	<u>March 2013</u>	<u>March 2012</u>	<u>March 2011</u>
Operating revenues	<u>\$ 1,225.4</u>	<u>\$ 1,258.1</u>	<u>\$ 1,216.9</u>
Operating expenses:			
Prizes and direct game expenses			
Prizes less unclaimed prizes	(709.0)	(709.6)	(686.9)
Commissions and game related expenses	<u>(115.1)</u>	<u>(116.6)</u>	<u>(115.0)</u>
Total prizes and direct game expenses	<u>(824.1)</u>	<u>(826.2)</u>	<u>(801.9)</u>
Income before other operating expenses	401.3	431.9	415.0
Other operating expenses	<u>(25.0)</u>	<u>(25.1)</u>	<u>(26.1)</u>
Operating income	<u>376.3</u>	<u>406.8</u>	<u>388.9</u>
Non-operating revenues and expenses:			
Investment and interest revenues	5.1	5.6	5.8
Investment and interest expenses	(6.0)	(6.9)	(7.9)
Unrealized loss on investments	(4.7)	(4.5)	(10.4)
School Aid Fund disbursement expense	(372.5)	(401.2)	(381.4)
General Fund disbursement expense	(2.4)	(3.9)	(4.9)
Community Health disbursement expense	<u>(0.5)</u>	<u>(0.5)</u>	<u>(0.5)</u>
Net non-operating revenue (expense)	<u>(381.0)</u>	<u>(411.4)</u>	<u>(399.3)</u>
Change in net position	(4.7)	(4.6)	(10.4)
Total net position beginning of period	<u>35.0</u>	<u>30.5</u>	<u>14.3</u>
Total net position end of period	<u>\$ 30.3</u>	<u>\$ 25.9</u>	<u>\$ 3.9</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 \$372.5 million disbursement expense to the School Aid Fund reflects the Lottery's operating activities for the six months ended March 2013. There was a decrease in disbursement expense to the School Aid Fund of \$28.7 million or 7.2% from March 2012. For the six months ended March 2012, there was an increase of \$19.8 million or 5.2% from March 2011. The disbursement expense to the General Fund reflects Charitable Gaming activities for the six months ended March 2013. Charitable Gaming activities experienced a decrease in net revenues for the six-month period ended March 2013 compared to March 2012 and March 2011. Charitable Gaming net income is disbursed annually to the General Fund.

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

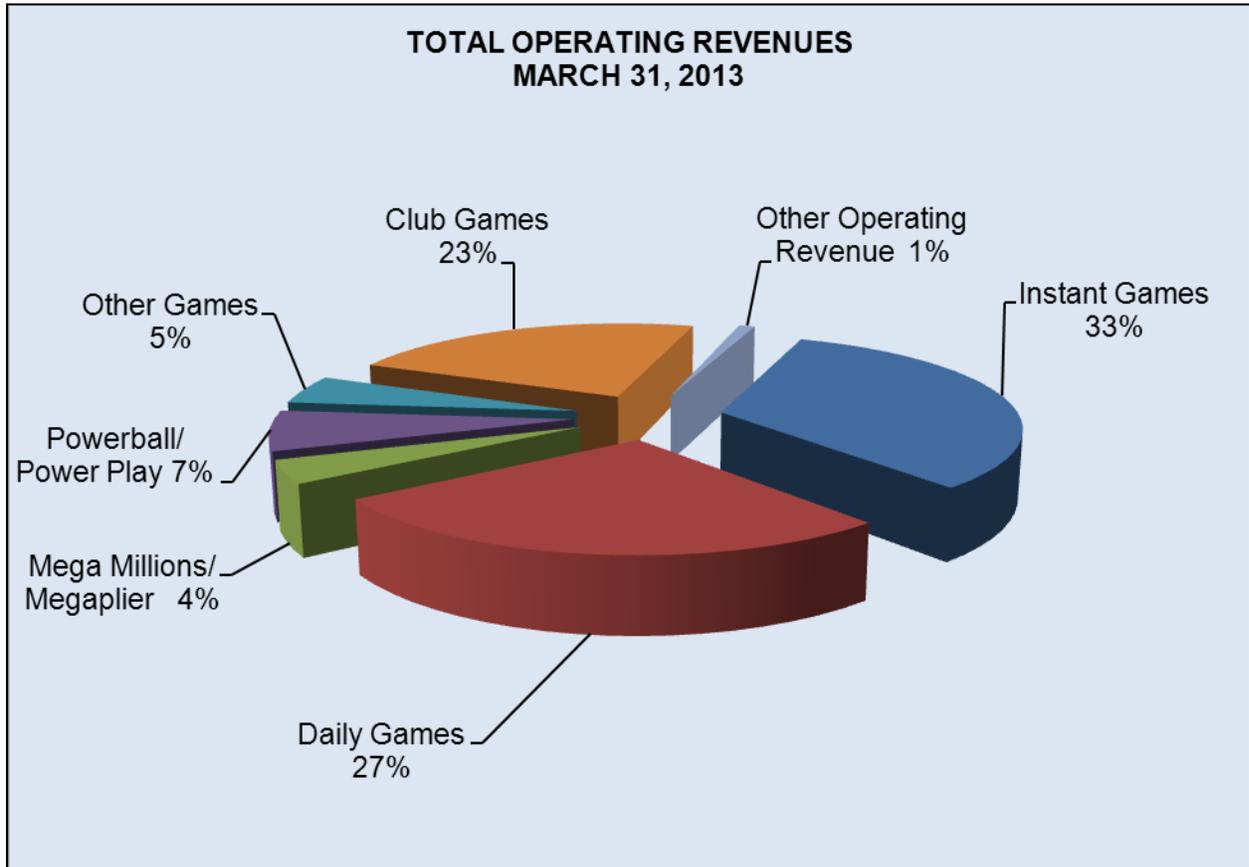
Disbursements to other funds for the six-month periods ended March 31 are detailed in Table 4 below:

Table 4 - Disbursements to Other Funds
(in millions)

	<u>March 2013</u>	<u>March 2012</u>	<u>March 2011</u>
School Aid Fund	\$ 372.5	\$ 401.2	\$ 381.4
General Fund	2.4	3.9	4.9
Community Health	0.5	0.5	0.5
 Total Disbursements to Other Funds	 <u>\$ 375.4</u>	 <u>\$ 405.6</u>	 <u>\$ 386.8</u>

Revenues

The following chart shows the major sources and the percentages of operating revenues for the six months ended March 2013:



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 2013	March 2012	March 2011
Operating revenues:			
Instant tickets	\$ 402.4	\$ 390.8	\$ 384.9
Daily games	331.5	345.3	341.8
Mega Millions/Megaplier	45.9	109.3	103.1
Powerball/Power Play	90.4	56.5	38.9
Club games	289.3	280.3	268.9
Other games	58.4	66.5	70.1
Other operating revenue	7.5	9.4	9.2
Total operating revenues	<u>1,225.4</u>	<u>1,258.1</u>	<u>1,216.9</u>
Non-operating revenues:			
Unrealized gain (loss) on investments	(4.7)	(4.5)	(10.4)
Amortization on bonds	5.1	5.6	5.7
Other income	-	-	0.1
Total non-operating revenues	<u>0.4</u>	<u>1.1</u>	<u>(4.6)</u>
Total revenues	<u>\$ 1,225.8</u>	<u>\$ 1,259.2</u>	<u>\$ 1,212.3</u>

Operating revenues, primarily Lottery ticket sales, for the six months ended March 2013 decreased over March 2012. The decrease in the six months ended March 2013 over March 2012 was \$32.7 million or 2.6%. The increase in the six months ended March 2012 from March 2011 was \$41.2 million or 3.4%.

Instant game ticket sales increased by \$11.6 million or 3.0% for the six months ended March 2013 over March 2012 and increased in the six months ended March 2012 over March 2011 by \$5.9 million or 1.5%. The Instant sales increase can be attributed to enhanced prize structures which provide more prizes with increased odds of winning.

Powerball is a multi-state game, similar to Mega Millions, offering larger jackpots. Participating in Powerball is the Multi-State Lottery Association (MUSL), an association of governmental lotteries, and the Mega Million's Lotteries for a total of 43 states, Washington D.C., and the U.S. Virgin Islands. Sales for the six months ended March 2013 increased by \$33.9 million or 60.0% compared to the six months ended March 2012 and increased in the six months ended March 2012 over March 2011 by \$17.6 million or 45.2%. Power Play is an add-on game to Powerball whereby players can multiply non-jackpot prizes from two to five times.

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, Maryland, Massachusetts, New Jersey, New York, Ohio, Texas, Virginia, Washington, and MUSL.

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

Sales for the six months ended March 2013 decreased by \$63.4 million or 58.0% compared to the six months ended March 2012. Sales in March 2012 increased \$6.2 million or 6.0% over March 2011. The March 2013 decrease is primarily due to having smaller jackpots compared to March 2012 when the largest Mega Millions jackpot in the history of the game occurred. Megaplier, introduced in December 2010, is an add-on to Mega Millions whereby players have an opportunity to increase their non-jackpot winnings.

Club games include Club Keno, Club Keno Kicker, Pull-Tabs and The Jack. The Club Games sales for the first six months in 2013 increased by \$9.0 million or 3.2% from the six months ended March 2012. Sales in March 2012 increased \$11.4 million or 4.2% from the six months ended March 2011. The 2012 sales increase is attributable to efforts being focused on increasing awareness of Club Keno "To Go" and further supported by the promotion of the Lottery mobile applications for iPhone and Android enabling players to be able to watch Club Keno drawings anywhere.

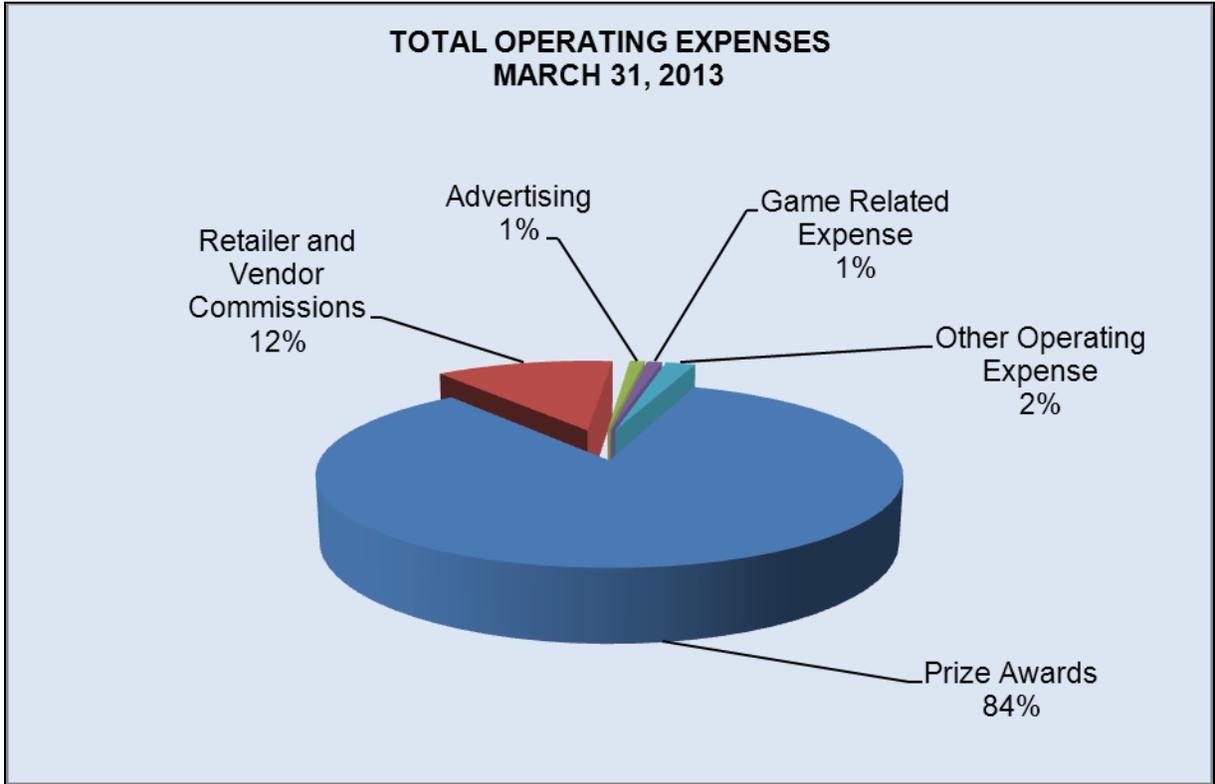
Other games consist of Classic Lotto 47, Fantasy Five, Keno, and Raffle. Other games sales experienced a decrease by \$8.1 million or 12.2% for the six months ended March 2013 over the six months ended March 2012. Sales in March 2012 decreased \$3.6 million or 5.1% from the six months ended March 2011. During the six months ended March 2013, Raffle consisted of one Tax Free Raffle, a \$10 game, which included lower tier prizes for more chances to win. The Lucky Lines game was discontinued in January 2012.

The decrease in non-operating revenues for the six-month period ended March 2013 compared to March 2012 resulted from the decrease in unrealized gain on investments and bond amortization. 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 2012 to March 2013 and March 2011 to March 2012 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. There was no change in other income from March 2012 to March 2013. Other income decreased from March 2011 to March 2012 due to declining interest rates on common cash investments. Additional detailed information on investments may be found in Note 3 in the accompanying financial statements.

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

Expenses

The following chart shows prizes, game costs, and operating expenses as a percentage of total operating expenses for the six months ended March 2013:



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 2013	March 2012	March 2011
Prizes:			
Instant prizes	\$ 271.8	\$ 259.2	\$ 255.8
Online prizes	264.1	280.0	267.0
Club game prizes	189.0	183.4	175.9
Total prizes	724.9	722.6	698.7
Less: unclaimed prizes	15.9	13.0	11.8
Net prize awards	709.0	709.6	686.9
Direct game expenses:			
Retailer commissions	87.8	88.6	86.7
Vendor commissions	17.4	17.2	16.8
Game related expenses	9.9	10.8	11.5
Total direct game expenses	115.1	116.6	115.0
Other operating expenses:			
Salaries, wages and benefits	11.0	9.8	8.3
Other professional services	4.3	3.5	3.3
Printing and supplies	0.8	0.9	0.9
Other general and administrative	1.4	1.4	1.4
Promotion and advertising	7.5	9.5	12.2
Total other operating expenses	25.0	25.1	26.1
Total operating expenses	849.1	851.3	828.0
Non-operating expenses:			
Amortization of prize discount	6.0	6.9	7.9
School Aid Fund disbursement	372.5	401.2	381.4
General Fund disbursement	2.4	3.9	4.9
Community Health disbursement	0.5	0.5	0.5
Total non-operating expenses	381.4	412.5	394.7
Total expenses	\$ 1,230.5	\$ 1,263.8	\$ 1,222.7

The Daily Games prize payout increased overall for the six months ended March 2013 over the six months ended March 2012. Daily 3 prize payout had an increase to 51.8% for the six months ended March 2013, compared to 48.7% for March 2012 and 45.9% for March 2011. Daily 4 prize payout increased to 46.4% for the six months ended March 2013, compared to 44.3% for March 2012 and 44.7% for March 2011. Daily games are designed to yield an average prize payout of 50.0% and combined, the games averaged a payout of 49.0% for the six months ended March 2013.

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

The Club Games prize payout percentage slightly decreased for the six months ended March 2013 to 65.3% compared to 65.4% from March 2012 and March 2011. The higher Club Games payout is an important part of the appeal of this style of game in this market. The other online games have an anticipated payout between 50.0% and 60.0%.

Instant games overall payout for the six months ended March 2013 is 67.5% from 66.3% for the six months ended March 2012, and 66.5% for the six months ended March 2011. The games vary in payout percentage depending on selling price of a ticket for a game. Instant game prize payouts range from 60% for a \$1 game to 77% for a \$20 game.

Retailer commissions have decreased commensurate with lower overall sales. Vendor commissions have slightly increased due an interest in interactive games commission. Interactive games are play for fun games that are played on the web and mobile devices. Game related expenses have decreased by \$.9 million or 8.3% for the six months ended March 2013 compared to the six months ended March 2012 and decreased by \$.7 million or 6.1% for the six months ended March 2012 compared to the six months ended March 2011.

Other operating expenses have decreased by \$.1 million or .4% for the six months ended March 2013 compared to the six months ended March 2012 and decreased by \$1.0 million or 3.8% for the six months ended March 2012 compared to the six months ended March 2011.

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 2013 increased by \$2.9 million compared to the six months ended March 2012 and increased by \$1.2 million compared to the six months ended March 2012 from the six months ended March 2011.

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 2013	March 2012	March 2011
Gross revenue	\$ 6.9	\$ 7.5	\$ 8.3
Operating expenses	(4.5)	(3.6)	(3.4)
Net income	\$ 2.4	\$ 3.9	\$ 4.9

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

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. 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 \$0.6 million or 8.0% for the six months ended March 2013 compared to March 2012 and decreased by \$0.8 million or 9.6% from the six months ended March 2011 to March 2012. The Lottery also oversees the distribution and sale of break-open tickets (also for fund-raising purposes) to these same organizations. The decrease in revenues is primarily due to a decrease in sales of break-open tickets.

The mission of the Lottery with respect to charitable gaming activities is to ensure that only qualified organizations are licensed to conduct fund-raising activities and that said activities are conducted in accordance with existing laws, rules and regulations. Revenues received through the issuance of licenses and from the distribution of break-open tickets 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, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Assets		
Current assets		
Equity in State Treasurer's Common Cash Fund	\$ 89,892,897	\$ 95,783,806
Investments, at fair value	37,739,733	44,467,083
Accounts receivable - net	75,988,812	110,552,360
Inventory	8,026,379	6,221,613
Other current assets	13,407	25,270
Total current assets	<u>211,661,228</u>	<u>257,050,132</u>
Noncurrent assets		
Investments, at fair value	<u>215,183,512</u>	<u>228,221,080</u>
Capital assets		
Leasehold improvements and equipment	5,025,026	4,398,529
Accumulated depreciation	<u>(4,242,918)</u>	<u>(4,046,273)</u>
Total capital assets	<u>782,108</u>	<u>352,256</u>
Total noncurrent assets	<u>215,965,620</u>	<u>228,573,336</u>
Total assets	<u>427,626,848</u>	<u>485,623,468</u>
Liabilities		
Current liabilities		
Warrants outstanding	54,882	487,922
Warrants authorized	1,042,872	833,791
Accounts payable and other liabilities	17,523,454	16,289,377
Due to other State Agencies	75,405,436	100,598,850
Prize awards payable - net of discount	<u>101,583,115</u>	<u>121,512,226</u>
Total current liabilities	<u>195,609,759</u>	<u>239,722,166</u>
Noncurrent liabilities		
Prize awards payable - net of discount	200,160,716	218,464,842
Accrual for compensated absences, less current portion	1,369,689	1,168,629
Accrual for supplemental retirement, less current portion	<u>180,293</u>	<u>334,132</u>
Total noncurrent liabilities	<u>201,710,698</u>	<u>219,967,603</u>
Total liabilities	<u>397,320,457</u>	<u>459,689,769</u>
Net Position		
Net investment in capital assets	782,108	352,256
Restricted for unrealized gains on investments	30,306,391	25,933,699
Unrestricted (deficit)	<u>(782,108)</u>	<u>(352,256)</u>
Total net position	<u>\$ 30,306,391</u>	<u>\$ 25,933,699</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, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Operating revenues		
Ticket sales	\$ 1,217,863,128	\$ 1,248,659,877
Charitable gaming and other	7,517,577	9,399,608
Total operating revenues	<u>1,225,380,705</u>	<u>1,258,059,485</u>
Operating expenses		
Prize awards	724,919,066	722,545,520
Less - unclaimed prizes	<u>(15,949,863)</u>	<u>(12,985,863)</u>
Net prize awards	708,969,203	709,559,657
Retailer and vendor commission	105,246,148	105,751,977
Game related expenses	9,856,403	10,812,139
Depreciation expense	102,650	94,863
Other operating expenses	<u>24,934,917</u>	<u>25,017,143</u>
Total operating expenses	<u>849,109,321</u>	<u>851,235,779</u>
Operating income	<u>376,271,384</u>	<u>406,823,706</u>
Non-operating revenues		
Investment revenue - net	390,901	1,105,193
Interest on equity in State Treasurer's Common Cash Fund	<u>58,073</u>	<u>46,688</u>
Total non-operating revenues	<u>448,974</u>	<u>1,151,881</u>
Non-operating expenses		
Bank fees	(2,163)	(2,510)
Amortization of prize award obligation discount	<u>(5,981,448)</u>	<u>(6,903,840)</u>
Total non-operating expenses before disbursements	<u>(5,983,611)</u>	<u>(6,906,350)</u>
Disbursements to School Aid Fund	(372,548,426)	(401,224,141)
Disbursements to General Fund	(2,362,010)	(3,879,709)
Disbursements to Community Health	<u>(495,000)</u>	<u>(495,000)</u>
Total disbursements	<u>(375,405,436)</u>	<u>(405,598,850)</u>
Total non-operating expenses	<u>(381,389,047)</u>	<u>(412,505,200)</u>
Net non-operating revenue (expense)	<u>(380,940,073)</u>	<u>(411,353,319)</u>
Change in net position	(4,668,689)	(4,529,613)
Total net position at beginning of period	<u>34,975,080</u>	<u>30,463,312</u>
Total net position at end of period	<u>\$ 30,306,391</u>	<u>\$ 25,933,699</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, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Cash Flows From Operating Activities		
Cash collections from customers	\$ 1,224,491,870	\$ 1,213,224,671
Payments to employees	(10,679,122)	(9,462,023)
Payments to suppliers	(17,999,756)	(24,444,134)
Payments to prize winners	(726,120,003)	(716,247,099)
Payments for retailer and vendor commissions	(105,246,148)	(105,751,977)
	<u>364,446,841</u>	<u>357,319,438</u>
Cash Flows From Noncapital Financing Activities		
Disbursements to other funds	<u>(300,000,000)</u>	<u>(305,000,000)</u>
Cash Flows From Capital and Related Financing Activities		
Acquisition of capital assets	<u>(626,497)</u>	<u>-</u>
Cash Flows From Investing Activities		
Proceeds from maturities of investment securities	23,519,000	27,944,000
Purchase of investments	(10,354,812)	-
Interest received	44,666	21,418
Bank fees	(2,163)	(2,510)
	<u>13,206,691</u>	<u>27,962,908</u>
Net cash provided by investing activities	<u>13,206,691</u>	<u>27,962,908</u>
Net increase in cash and cash equivalents	<u>77,027,035</u>	<u>80,282,346</u>
Cash and cash equivalents at beginning of period	<u>12,810,980</u>	<u>15,013,538</u>
Cash and cash equivalents at end of period	<u>\$ 89,838,015</u>	<u>\$ 95,295,884</u>

Continued
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, 2013 and 2012

	2013	2012
Reconciliation of operating income to net cash provided by operating activities		
Operating income	\$ 376,271,384	\$ 406,823,706
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation expense	102,650	94,863
Bad debt expense	76,640	21,464
Amortization of prize award obligation discount	(5,981,448)	(6,903,840)
Net changes in assets and liabilities:		
Inventory	(1,234,423)	(1,165,294)
Receivables from retailers	(888,834)	(44,834,814)
Warrants authorized, compensated absences, accounts payable and other liabilities	7,270,224	3,066,955
Prize awards payable - net	(11,169,352)	216,398
Net cash provided by operating activities	\$ 364,446,841	\$ 357,319,438
Reconciliation of cash and cash equivalents		
Cash and cash equivalents at beginning of period		
Equity in State Treasurer's Common Cash Fund	\$ 12,974,439	\$ 15,934,334
Warrants outstanding	(163,459)	(920,796)
Net cash and cash equivalents at beginning of period	\$ 12,810,980	\$ 15,013,538
Cash and cash equivalents at end of period		
Equity in State Treasurer's Common Cash Fund	\$ 89,892,897	\$ 95,783,806
Warrants outstanding	(54,882)	(487,922)
Net cash and cash equivalents at end of period	\$ 89,838,015	\$ 95,295,884
Schedule of noncash investing, capital, and financing activities		
Decrease in fair value of investments	\$ (4,668,689)	\$ (4,529,613)
Disbursements to other funds (accrual)	(75,405,436)	(100,598,850)
Total noncash investing, capital, and financing activities	\$ (80,074,125)	\$ (105,128,463)

Concluded
See Accompanying Notes to the Financial Statements

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, a multi-state lottery game, 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 12 states: California, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, Washington and MUSL. Net income from Mega Millions, Megaplier, Powerball and Power Play 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 online tickets. Operating expenses mainly consist of payments to instant and online prize winners and commissions to retailer agents and vendors. Excess revenue over expenses is designated for payment to the State School Aid Fund, except for the 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. All other revenues and expenses are reported as non-operating.

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, the Lottery no longer needs to elect whether to apply Financial Accounting Standards Board (FASB) statements and interpretations issued after November 30, 1989 to its financial statements. This GASB statement codifies all existing FASB, APB, and AICPA guidance currently in effect, which does not conflict with or contradict GASB pronouncements.

Revenue Recognition

Revenue is recognized for instant and pull tab games when tickets are activated by retailers. For online 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.

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, 2013 and 2012. 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 \$1,308,073 as of March 31, 2013 and \$1,269,402 as of March 31, 2012.

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 eight years, the estimated useful life of the improvements. 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 online 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 game tickets, are forfeited by the ticket holder. The Lottery estimates the amount of winning online, instant and pull tab tickets which will not be claimed within one year after the drawing date for online 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*. Net investment in capital assets consists of equipment and leasehold improvements and deferred inflows and outflows of resources attributable to the acquisition, construction, or improvement of those assets or related to debt. 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

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 pool functions as both a cash management pool and a demand deposit account. 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 State funds. 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.

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 precluded by State policy.

Bureau of State Lottery, State of Michigan

Notes to Financial Statements

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, 2013 and 2012, 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 & 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, 2013 and 2012, 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 \$252,923,245 at March 31, 2013 and \$272,688,163 at March 31, 2012 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 \$23,519,000 in the six-month period ended March 31, 2013 and \$27,944,000 in the six-month period ended March 31, 2012.

Investments at March 31 consist of the following:

	<u>2013</u>	<u>2012</u>
U.S. Treasury zero-coupon bonds	\$ 168,895,514	\$ 162,149,776
Michigan CAB bonds	<u>84,027,731</u>	<u>110,538,387</u>
Total investments	<u>\$ 252,923,245</u>	<u>\$ 272,688,163</u>

As reported on the Statement of Net Position:

	<u>2013</u>	<u>2012</u>
Current investments	\$ 37,739,733	\$ 44,467,083
Noncurrent investments	<u>215,183,512</u>	<u>228,221,080</u>
Total Investments	<u>\$ 252,923,245</u>	<u>\$ 272,688,163</u>

Policy Disclosures

Investment authority with regard to the State Lottery Fund is delegated to the State Treasurer per 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, 2013 and 2012 consist of the following:

March 31, 2013

Maturities In Years	Investments in United States Treasury Zero-Coupon Bonds	Interest Rate Low to High	Investments in Michigan CAB Bonds	Interest Rate Low to High
Less than 1	\$ 13,158,691	0.79% to 7.14%	\$ 24,581,041	4.33% to 4.90%
1-5	58,342,223	0.19% to 7.19%	37,577,893	4.97% to 7.01%
6-10	40,016,544	1.24% to 4.99%	13,985,588	7.15% to 8.20%
11-15	29,942,955	3.84% to 4.84%	3,962,627	8.25% to 8.38%
16-20	21,199,729	4.33% to 4.71%	3,920,582	8.39% to 8.39%
21-25	6,235,372	4.58% to 4.79%	-	-
Fair Market Value	<u>\$ 168,895,514</u>		<u>\$ 84,027,731</u>	

March 31, 2012

Maturities In Years	Investments in United States Treasury Zero-Coupon Bonds	Interest Rate Low to High	Investments in Michigan CAB Bonds	Interest Rate Low to High
Less than 1	\$ 13,156,867	0.51% to 7.11%	\$ 31,310,216	3.60% to 4.16%
1-5	57,878,429	0.79% to 7.19%	55,466,888	4.33% to 6.75%
6-10	32,521,705	2.51% to 4.99%	16,283,342	7.01% to 8.05%
11-15	28,986,433	3.69% to 4.94%	3,590,738	8.20% to 8.33%
16-20	20,582,838	4.26% to 4.71%	3,887,203	8.38% to 8.39%
21-25	9,023,504	4.35% to 4.79%	-	-
Fair Market Value	<u>\$ 162,149,776</u>		<u>\$ 110,538,387</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, 2013 and March 31, 2012, the Lottery's investments in Michigan CAB bonds were rated AA- by Standard & Poor's 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, 2013, investments in Michigan CAB bonds account for 33.2% of the total investments as compared to 40.5% as of March 31, 2012. This decrease of 7.3% is due to the maturities of Michigan CAB bonds during this six-month period.

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, 2013 and 2012, 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, 2013 and 2012 was as follows:

<u>Period Ending</u>	<u>Beginning Balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending Balance</u>
<u>March 31, 2013</u>				
Capital assets being depreciated:				
Leasehold improvements	\$ 1,955,989	\$ -	\$ -	\$ 1,955,989
Equipment	2,442,540	626,497	-	3,069,037
Total capital assets being depreciated	<u>4,398,529</u>	<u>626,497</u>	<u>-</u>	<u>5,025,026</u>
Less: accumulated depreciation				
Leasehold improvements	1,936,126	1,602	-	1,937,728
Equipment	2,204,142	101,048	-	2,305,190
Total accumulated depreciation	<u>4,140,268</u>	<u>102,650</u>	<u>-</u>	<u>4,242,918</u>
Total capital assets being depreciated, net	<u>\$ 258,261</u>	<u>\$ 523,847</u>	<u>\$ -</u>	<u>\$ 782,108</u>

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

Period Ending	Beginning Balance	Additions	Deletions	Ending Balance
<u>March 31, 2012</u>				
Capital assets being depreciated:				
Leasehold improvements	\$ 1,955,989	\$ -	\$ -	\$ 1,955,989
Equipment	2,442,540	-	-	2,442,540
Total capital assets being depreciated	<u>4,398,529</u>	<u>-</u>	<u>-</u>	<u>4,398,529</u>
Less: accumulated depreciation				
Leasehold improvements	1,932,922	1,602	-	1,934,524
Equipment	2,018,488	93,261	-	2,111,749
Total accumulated depreciation	<u>3,951,410</u>	<u>94,863</u>	<u>-</u>	<u>4,046,273</u>
Total capital assets being depreciated, net	<u>\$ 447,119</u>	<u>\$ (94,863)</u>	<u>\$ -</u>	<u>\$ 352,256</u>

NOTE 5 - DISAGGREGATION OF PAYABLE BALANCE

Accounts payable and other liabilities at March 31, 2013 and 2012 were as follows:

	<u>2013</u>	<u>2012</u>
Accounts payable vendors	\$ 11,654,081	\$ 11,005,591
Retailer security deposits/accounts payable	2,464,571	2,220,275
Accrued intragovernmental expenses	1,951,814	1,575,290
Accrued salaries	748,154	766,011
Compensated absences	602,275	670,930
Supplemental retirement	102,559	51,280
Total	<u>\$ 17,523,454</u>	<u>\$ 16,289,377</u>

NOTE 6 - PRIZE AWARDS

Installment prize awards are recorded at their present value using discount rates ranging from 3.5% to 8.5%. 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>2013</u>	<u>2012</u>
Current - at face amount	\$ 102,635,487	\$ 122,720,050
Less - unamortized discount	<u>(1,052,372)</u>	<u>(1,207,824)</u>
Current - at present value	<u>101,583,115</u>	<u>121,512,226</u>
Long-term - at face amount	304,355,500	328,710,333
Less - unamortized discount	<u>(104,194,784)</u>	<u>(110,245,491)</u>
Long-term - at present value	<u>200,160,716</u>	<u>218,464,842</u>
Total	<u>\$ 301,743,831</u>	<u>\$ 339,977,068</u>

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

Installment prize awards payable as of March 31, 2013 are summarized as follows:

2014	\$ 37,868,433
2015	30,894,100
2016	26,593,000
2017	19,575,600
2018	16,329,600
2019-2023	70,660,000
2024-2028	54,805,000
2029-2033	49,118,400
2034-2038	27,103,800
2039-2043	3,388,000
2044-2048	2,612,000
2049-2053	2,028,000
2054-2058	<u>1,248,000</u>
Total	342,223,933
Less - unamortized discount	<u>(105,247,156)</u>
Total installment prize awards payable at present value	236,976,777
Noninstallment prize awards payable	<u>64,767,054</u>
Total prize awards payable	<u><u>\$ 301,743,831</u></u>

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

Ending March 31	Beginning Balance	Additions	Reductions	Ending Balance	One Year at Present Value
2013	\$ 251,693,697	\$ 10,918,513	\$ 25,635,433	\$ 236,976,777	\$ 36,816,061
2012	\$ 284,549,071	\$ 8,123,614	\$ 31,001,634	\$ 261,671,051	\$ 43,206,209

NOTE 7 - 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 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.

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

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, 2013.

Long-term liability activity of these benefits 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	Long-term Liability
2013	\$ 1,779,996	\$ 379,083	\$ 187,115	\$ 1,971,964	\$ 602,275	\$ 1,369,689
2012	\$ 1,599,784	\$ 511,259	\$ 271,484	\$ 1,839,559	\$ 670,930	\$ 1,168,629

NOTE 8 - PENSION AND POSTEMPLOYMENT BENEFITS

Public Act 264 of 2011 reformed the State Employees' Retirement Act and the Public Employee Retirement Health Care Funding Act as signed into law on December 15, 2011. Changes for both the Defined Benefit Plan (Plan 1) and Defined Contribution Plan (Plan 2) are included respectively 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. Recent 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.

Defined Contribution Plan (Plan 2)

The Lottery's employees hired after March 31, 1997 are enrolled in a defined contribution plan through the State Employees' 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 toward 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.

Bureau of State Lottery, State of Michigan

Notes to Financial Statements

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 10 or more years of service.

The cost of these pension and other postemployment benefits are allocated to the Lottery as a percentage of gross payroll. The payroll for the Lottery employees covered by Plan 1 and Plan 2 was \$5,846,466, 5,396,696, and \$5,283,036 for the six months ended March 31, 2013, 2012 and 2011, respectively. The Lottery's allocated contribution requirements and contributions actually made were \$3,407,698, \$2,222,078, and \$1,942,907 for the six months ended March 31, 2013, 2012, and 2011, respectively. Contributions represent approximately 58.3%, 41.2%, and 36.8 % of covered payroll during 2013, 2012, and 2011, 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.

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
2013	\$ 334,132		\$ 51,279	\$ 282,853	\$ 102,560	\$ 180,293
2012	\$ 436,691		\$ 51,279	\$ 385,412	\$ 102,559	\$ 282,853

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 Bureau 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.

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

NOTE 9 - LEASE AND RENTAL COMMITMENTS

The total operating lease payments on long-term lease commitments for the six months ended March 31, 2013 and 2012 were \$105,315 and \$94,715, respectively. These leases represent leases for buildings. There were no capital lease obligations.

A summary of remaining minimum building lease commitments follows:

<u>Year</u>	<u>Operating Leases</u>		
	<u>Six Months Ending March 31,</u>	<u>Six Months Ending September 30,</u>	<u>Year Ending September 30,</u>
2013	\$ 105,315	\$ 105,315	\$ 210,630
2014	105,315	105,315	210,630
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
2019-2022	95,400	74,200	169,600
	<u>\$ 613,180</u>	<u>\$ 553,525</u>	<u>\$ 1,166,705</u>

The total rent and lease expenses paid for all buildings for the six months ended March 31, 2013 and 2012 were \$538,051 and \$474,392, respectively.

NOTE 10 - 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.

NOTE 11 - COMMITMENTS AND CONTINGENCIES

The Lottery has contracted with a third party to provide for the operation of the gaming system through January 19, 2015. 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.

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
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 Charitable Gaming millionaire party activities were transferred to the Gaming Control Board by Executive Order in April 2012. The following is a summarization of these charges for the six months ended March 31, 2013 and 2012:

March 31, 2013

Department of Technology, Management and Budget:

Information Technology		
Direct costs	\$ 2,204,897	
Lansing Metropolitan Area Network (LMAN)	7,942	
Michigan.gov portal web charges	107,914	
Overhead	<u>223,627</u>	
Total Information Technology Charges	\$ 2,544,380	
Support services (including internal audit)	134,550	
Space rental - Lottery Central, Detroit, Saginaw offices	429,659	
Vehicle and travel services	406,144	
Other - Telephone, mailing and other offices services	<u>139,982</u>	
Total Department of Technology, Management and Budget		\$ 3,654,715
Gaming Control Board		1,026,485
Civil Service Commission		166,440
Department of Treasury		245,380
Attorney General		130,681
Other Agencies		<u>6,814</u>
Total all State agencies		<u><u>\$ 5,230,515</u></u>

March 31, 2012

Department of Technology, Management and Budget:

Information Technology:		
Direct costs	\$ 2,212,989	
Lansing Metropolitan Area Network (LMAN)	8,328	
Michigan.gov portal web charges	209,741	
Overhead	<u>87,896</u>	
Total Information Technology Charges	\$ 2,518,954	
Support services (including internal audit)	151,250	
Space rental - Lottery Central, Detroit, Saginaw offices	376,730	
Vehicle and travel services	390,825	
Other - Telephone, mailing and other offices services	<u>146,704</u>	
Total Department of Technology, Management and Budget		\$ 3,584,463
Civil Service Commission		149,628
Department of Treasury		221,945
Attorney General		125,000
Other Agencies		<u>5,436</u>
Total all State agencies		<u><u>\$ 4,086,472</u></u>

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

NOTE 13 - UPCOMING ACCOUNTING PRONOUNCEMENTS

In March 2012, the GASB issued GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities*, which is required to be implemented for financial statements for periods beginning after December 15, 2012. Statement No. 65 establishes accounting and financial reporting standards that reclassify, as deferred outflows and inflows of resources, certain items that were previously reported as assets and liabilities. This statement also provides other financial reporting guidance related to the impact of the financial statement elements deferred outflows of resources and deferred inflows of resources. Statement No. 65 will be implemented for the Lottery as of the 2013-2014 fiscal year.

In June 2012, the GASB issued GASB Statement 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. This net pension liability that will be recorded on the government-wide, proprietary, and discretely presented component units statements will be computed differently than the current unfunded actuarial accrued liability, using specific parameters set forth by the GASB. The statement also enhances accountability and transparency through revised note disclosures and required supplemental information (RSI). The Lottery is currently evaluating the impact this standard will have on the financial statements when adopted. The provisions of this statement are effective for financial statements for the year ending March 31, 2015.

Bureau of State Lottery, State of Michigan
Supplementary Schedule of Revenues and Expenses
For the Six Months Ended March 31, 2013 and 2012

		2013		2012	
		Amount	Percent of Sales	Amount	Percent of Sales
Lottery ticket sales:	Daily 3	\$ 157,975,732	13.0%	\$ 162,141,403	13.0%
	Daily 4	173,539,739	14.2%	183,104,396	14.7%
	Classic Lotto 47	21,677,242	1.8%	25,704,420	2.1%
	Mega Millions	43,543,273	3.6%	105,276,863	8.4%
	Megaplier	2,343,840	0.2%	4,012,926	0.3%
	Powerball	87,317,620	7.2%	52,718,639	4.2%
	Power Play	3,085,234	0.3%	3,816,137	0.3%
	Keno	5,800,630	0.5%	6,296,270	0.5%
	Fantasy Five	27,077,283	2.2%	26,062,819	2.1%
	Raffle	3,795,950	0.3%	6,787,690	0.5%
	Club Keno	199,048,640	16.3%	196,080,397	15.7%
	Club Keno Kicker	68,677,567	5.6%	63,164,692	5.1%
	The Jack	5,793,965	0.5%	7,061,101	0.6%
	Lucky Lines	-	0.0%	1,625,039	0.1%
	Pull-Tab tickets	15,776,393	1.3%	13,967,863	1.1%
	Instant tickets	402,410,020	33.0%	390,839,222	31.3%
Total lottery ticket sales		<u>1,217,863,128</u>	<u>100.0%</u>	<u>1,248,659,877</u>	<u>100.0%</u>
Prize awards:	Daily 3	81,800,038	6.7%	79,031,581	6.3%
	Daily 4	80,564,534	6.6%	81,159,377	6.5%
	Classic Lotto 47	11,805,979	1.0%	14,146,321	1.1%
	Mega Millions/Megaplier	22,464,365	1.8%	55,036,270	4.4%
	Powerball/Power Play	46,638,709	3.8%	27,060,551	2.2%
	Keno	2,936,762	0.2%	3,075,363	0.2%
	Fantasy Five	14,384,553	1.2%	13,438,373	1.1%
	Raffle	2,505,340	0.2%	5,981,796	0.5%
	Club Keno/Kicker/Jack	177,317,742	14.6%	172,941,798	13.9%
	Players Club all games	985,492	0.1%	-	0.0%
	Lucky Lines	-	0.0%	926,897	0.1%
	Merchandise	(251)	0.0%	70,765	0.0%
	Pull-Tab tickets	11,710,375	1.0%	10,467,491	0.8%
	Instant tickets	271,805,428	22.3%	259,208,937	20.8%
Total prize awards		<u>724,919,066</u>	<u>59.5%</u>	<u>722,545,520</u>	<u>57.9%</u>
Less: unclaimed prizes		<u>(15,949,863)</u>	<u>-1.3%</u>	<u>(12,985,863)</u>	<u>-1.0%</u>
Net prize awards		<u>708,969,203</u>	<u>58.2%</u>	<u>709,559,657</u>	<u>56.9%</u>
Gross margin		508,893,925	41.8%	539,100,220	43.1%
Retailer and vendor commission expense		(105,246,148)	-8.6%	(105,751,977)	-8.5%
Game related expense		(9,856,403)	-0.8%	(10,812,139)	-0.9%
Net ticket revenue		<u>393,791,374</u>	<u>32.4%</u>	<u>422,536,104</u>	<u>33.7%</u>
Other operating expense		(20,514,426)	-1.7%	(21,452,352)	-1.7%
Other miscellaneous revenue		632,426	0.1%	1,860,245	0.1%
Net lottery operating income		<u>373,909,374</u>	<u>30.8%</u>	<u>402,943,997</u>	<u>32.1%</u>
Charitable gaming					
Charitable gaming revenue		6,885,151	0.6%	7,539,363	0.6%
Charitable gaming expense		(4,523,141)	-0.4%	(3,659,654)	-0.3%
Net charitable gaming income		<u>2,362,010</u>	<u>0.2%</u>	<u>3,879,709</u>	<u>0.3%</u>

Continued

Bureau of State Lottery, State of Michigan
Supplementary Schedule of Revenues and Expenses
For the Six Months Ended March 31, 2013 and 2012

	2013		2012	
	Amount	Percent of Sales	Amount	Percent of Sales
Non-operating revenues (expenses)				
Amortization expense - prize discount	\$ (5,981,448)	-0.5%	\$ (6,903,840)	-0.6%
Amortization revenue - investment discount	5,059,590	0.4%	5,634,806	0.5%
Unrealized loss on investments	(4,668,689)	-0.4%	(4,529,613)	-0.4%
Interest revenue - common cash fund	58,073	0.0%	46,688	0.0%
Bank fees	(2,163)	0.0%	(2,510)	0.0%
Disbursement to School Aid Fund	(372,548,426)	-30.6%	(401,224,141)	-32.1%
Disbursement to General Fund	(2,362,010)	-0.2%	(3,879,709)	-0.3%
Disbursement to Community Health	(495,000)	0.0%	(495,000)	0.0%
Net non-operating revenues (expenses)	<u>(380,940,073)</u>	<u>-31.3%</u>	<u>(411,353,319)</u>	<u>-32.9%</u>
Change in net position	<u>\$ (4,668,689)</u>	<u>-0.3%</u>	<u>\$ (4,529,613)</u>	<u>-0.5%</u>

Bureau of State Lottery, State of Michigan
Supplementary Schedule of Other Operating Expenses
For the Six Months Ended March 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Salaries and wages	\$ 6,027,466	\$ 5,424,002
Employee benefits and taxes	4,955,586	4,420,443
Promotion and advertising	7,453,800	9,513,552
Talent	-	152,055
Printing and supplies, including purchase of charitable gaming tickets	783,477	885,402
Other contractual services	4,307,950	3,369,413
Building rent and leases	538,051	474,392
Travel	438,222	433,117
Utilities	138,157	133,513
Postage	122,673	138,520
Equipment maintenance and rental	92,006	50,624
Bad debt expense	76,640	21,464
Interest paid on security deposits	889	646
Total	<u>\$ 24,934,917</u>	<u>\$ 25,017,143</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

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Thomas H. McTavish, CPA
Auditor General State of Michigan

We have audited, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Bureau of State Lottery, State of Michigan (the "Lottery"), a proprietary fund of the State of Michigan, as of and for the six-month periods ended March 31, 2013 and 2012, and related notes to the financial statements, which collectively comprise the Lottery's basic financial statements, and have issued our report thereon dated June 27, 2013.

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 entity's internal control. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control.

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

Mr. M. Scott Bowen, Commissioner
Bureau of State Lottery, State of Michigan
and
Mr. Thomas H. McTavish, CPA
Auditor General State of Michigan

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 and therefore, material weaknesses or significant deficiencies may exist that were not identified. 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. We did identify a certain deficiency in internal control, described in the accompanying schedule of findings and questioned costs, as Finding 2013-001, that we consider to be a significant deficiency.

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*.

Michigan Bureau of State Lottery's Response to Finding

The Bureau of State Lottery, State of Michigan's response to the finding identified in our audit is described in the accompanying schedule of findings and questioned costs. Michigan Bureau of State Lottery's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

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 entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Plante & Moran, PLLC

East Lansing, Michigan
June 27, 2013

Michigan Bureau of State Lottery

Schedule of Findings and Questioned Costs

Financial Statement Audit Findings

Reference Number	Finding
2013-001	<p>Finding Type - Significant deficiency</p> <p>Criteria - In accordance with generally accepted accounting principles, prize obligations for life should be based on the life expectancy of the winner and adjusted annually based on the current age of the winner. For games with lifetime prizes, the Lottery records a liability based on the remaining life expectancy of the winner at the time of the win and readjusts once the winner outlives their expectancy.</p> <p>Condition - For instant games in which the winner receives lifetime payments, the Lottery calculates and records prize payout obligations based on the winner's remaining life expectancy at the time of the win and does not reevaluate the recorded liability for changes in life expectancy.</p> <p>Context - The recorded liability for instant games with lifetime winners has not been updated for changes in life expectancies of the winners for those who have not outlived their expectancy. As a result, prize expense and the related liability for instant game prizes was understated by \$7,343,092 at March 31, 2013.</p> <p>Cause - During the current period, additional liabilities were recorded for winners of two instant games with lifetime prizes who had outlived their life expectancy as determined at the time of their win. These liabilities should be recalculated regularly based on updated life expectancy inputs.</p> <p>Effect - Prize expense and the related liability for instant games are understated by \$7,343,092 at March 31, 2013.</p> <p>Recommendation - We recommend that the Lottery reevaluate the assumptions used in the calculation of the prize liability for all instant games in which the winner receives lifetime payments on an annual basis and record an additional liability as necessary based on updated life expectancies.</p> <p>Views of Responsible Officials and Planned Corrective Actions - Historically, the Lottery recorded long-term prize liability for games with lifetime prizes at the date the prize was awarded. The number of annual installments was determined using the prize winner's life expectancy at that time, based on their current age and the most current actuarial table. When all annual installment payments for a lifetime prize winner were completed, the life expectancy was reevaluated and a new liability established with the corresponding number of annual installments. Prior audits performed had not questioned this methodology.</p>

Michigan Bureau of State Lottery

Schedule of Findings and Questioned Costs (Continued)

Financial Statement Audit Findings (Continued)

Reference Number	Finding
2013-001 (Con't)	Going forward as a result of this finding, the Lottery has revised its methodology. Annually, each lifetime prize will be recalculated based on the prize winner's current age and the most current actuarial table. If needed, an adjustment will be made to prize liability and related accounts as of September 30 each year.