

North Dakota Lottery
Bismarck, North Dakota
Audit Report

For the Years Ended
June 30, 2015 and 2014

ROBERT R. PETERSON
STATE AUDITOR



Office of the State Auditor
Division of State Audit

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STATE AUDITOR
ROBERT R. PETERSON



PHONE
(701) 328 - 2241
FAX
(701) 328 - 1406

STATE OF NORTH DAKOTA
OFFICE OF THE STATE AUDITOR
STATE CAPITOL
600 E. BOULEVARD AVENUE - DEPT. 117
BISMARCK, NORTH DAKOTA 58505

Independent Auditor's Report

Honorable Jack Dalrymple, Governor
Members of the Legislative Assembly
Honorable Wayne Stenehjem, Attorney General
Randy Miller, Director, North Dakota Lottery

Report on the Financial Statements

We have audited the accompanying financial statements of the business-type activities of the North Dakota Lottery, a division of the Office of the Attorney General of the state of North Dakota as of and for the fiscal years ended June 30, 2015 and 2014, and the related notes to the financial statements, which collectively comprise the North Dakota 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 audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit 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 the audit evidence we 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 respective financial position of the business-type activities of the North Dakota Lottery, as of June 30, 2015 and 2014, and the respective changes in its financial position and its cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

Reporting Entity

As discussed in Note 1 to the financial statements, the financial statements of the North Dakota Lottery are intended to present the financial position, the changes in financial position, and cash flows of only that portion of the business-type activities of the state of North Dakota that is attributable to the transactions of the North Dakota Lottery. They do not purport to, and do not present fairly the financial position of the state of North Dakota as of June 30, 2015 or 2014, or the changes in its financial position, or its cash flows for the years 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.

Adoption of New Accounting Standards

As described in Note 1 to the financial statements, the North Dakota Lottery adopted the provisions of GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, and GASB No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*. 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 the management's discussion and analysis on pages 4–8 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, who considers it to be an essential part of financial reporting for placing the 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 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 Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated February 2, 2016, on our considerations of the North Dakota 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 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 North Dakota Lottery's internal control over financial reporting and compliance.



Robert R. Peterson
State Auditor

Bismarck, North Dakota

February 2, 2016

Management's Discussion and Analysis

For the Fiscal Years Ended June 30, 2015 and 2014

The Management's Discussion and Analysis is an overview of the Lottery's financial activity for the fiscal year ended June 30, 2015. The analysis is to be considered in conjunction with the financial statements to provide an objective breakdown of the Lottery's financial activity based on facts, decisions, and conditions that presently face the director.

Understanding the Lottery's Financial Statements

The Lottery, a division of the Office of Attorney General, is accounted for as an enterprise fund that reports all income, expense, assets, and liabilities using the accrual basis of accounting, like a private business entity. In accordance with generally accepted accounting principles, this report consists of three financial statements and explanatory notes. The financial statements are: 1) Statement of Net Position; 2) Statement of Revenues, Expenses, and Changes in Net Position; and 3) Statement of Cash Flows. The financial statements are designed to highlight the Lottery's operating activity and provide a snapshot of its financial condition.

A vital factor of the Lottery's financial statements is a statutory requirement that the Lottery transfer all net proceeds, less the amount allocated to the compulsive gambling prevention and treatment fund, amount allocated to the multi-jurisdictional drug task force grant fund, Lottery's share of a game's prize reserve pool, and holdback of any reserve funds the director may need for continuing operations, to the State Treasurer on at least an annual basis for deposit in the state general fund.

Most of the assets included on the Statements of Net Position represent current amounts such as cash and accounts receivable from lottery retailers. Most liabilities represent current prizes, including prizes payable to players in North Dakota and prizes payable to the Multi-State Lottery Association (MUSL) to fund grand/jackpot prizes, and an amount due to the state general fund.

Financial Highlights

Since the Lottery began in March 2004, North Dakota players have won over \$89 million in prizes and Lottery retailers earned over \$13.6 million in sales and bonus commissions. In addition, the Lottery contributed \$68.9 million to the general fund, along with \$2.4 million to the Compulsive Gambling Prevention and Treatment Fund, and \$3.3 million to the Multi-Jurisdictional Drug Task Force Grant Fund.

The Lottery's ticket sales for the fiscal year ended June 30, 2015 were \$27,010,263 as compared to \$26,899,400 for the fiscal year ended June 30, 2014. This reflects an \$110,863 or 0.4% increase in ticket sales. Despite fewer high jackpots for Powerball, ticket sales increased slightly over the last fiscal year because of the addition of 50 lottery terminals.

Total prizes on winning tickets for the fiscal year ended June 30, 2015, were \$13,978,818, including prizes paid in North Dakota of \$8,147,582 and prizes paid to the MUSL to fund grand/jackpot prizes of \$6,215,658. In addition, North Dakota had expired prizes in the amount of \$384,422.

The Lottery's operating expenses are minimized because the Lottery blueprinted its organizational structure, functions, and gaming system features to optimize efficiency. Expenses such as salaries and fringe benefits, travel, telephone, and MUSL board dues are generally fixed. Other expenses have a direct incremental relationship to sales increases or decreases such as prizes, retailer commissions, game group dues, and vendor fees.

Total operating expenses for the fiscal year ended June 30, 2015 were \$20,359,788 as compared to \$19,228,494 for the fiscal year ended June 30, 2014. This reflects a \$1,131,294 or 5.9% increase in total operating expenses. The increase was mainly due to the increased prize expense due to more prizes won, increased operating expenses related to IT work, increased contractual services expense for the online Lottery system and services vendor, and the addition of the Players Club.

Net proceeds earned for the fiscal year ended June 30, 2015, were \$6,854,593. The total transfer of funds equated to \$6,722,500. Of that amount, \$200,000 was transferred to the Compulsive Gambling Prevention and Treatment Fund, and \$422,500 was transferred to the Multi-Jurisdictional Drug Task Force Grant Fund, leaving a balance of \$6,100,000, which was transferred to the state general fund.

- By law, effective July 1, 2005, \$50,000 must be transferred to the State Treasurer each quarter for deposit in the compulsive gambling prevention and treatment fund.
- By law, effective July 1, 2007, \$105,625 must be transferred to the State Treasurer each quarter for deposit in the multi-jurisdictional drug task force grant fund.

Financial Position

The Lottery's net position (assets and deferred outflows of resources less liabilities and deferred inflows of resources) is one measure of the financial health or financial position. Total net position for the fiscal year ended June 30, 2015 was \$1,523,594. This reflects a \$314,269 or 17.1% decrease in total net position compared to the fiscal year ended June 30, 2014. \$1,130,293 of the total net position is restricted for MUSL uses. Variations in the Lottery's net position over time are indicators of its financial stability. The decrease in net position is the result of the implementation of the new GASB statement number 68 and the increase in operating expenses.

Overview of the Financial Statements

Statement of Net Position Summary:

| | <u>6/30/2015</u> | <u>6/30/2014</u> | <u>6/30/2013</u> |
|---------------------------------------|---------------------|----------------------|----------------------|
| Assets: | | | |
| Total Current Assets | \$ 8,327,552 | \$ 8,842,156 | \$ 8,920,911 |
| Total Noncurrent Assets | 1,144,711 | 1,242,643 | 1,300,856 |
| Total Assets | <u>\$ 9,472,263</u> | <u>\$ 10,084,799</u> | <u>\$ 10,221,767</u> |
| Deferred Outflows of Resources | <u>\$ 53,451</u> | <u>\$ -</u> | <u>\$ -</u> |

Statement of Net Position Summary (Continued):

| | <u>6/30/2015</u> | <u>6/30/2014</u> | <u>6/30/2013</u> |
|--------------------------------------|---------------------|---------------------|---------------------|
| Liabilities: | | | |
| Total Current Liabilities | \$ 7,440,451 | \$ 8,191,594 | \$ 8,308,595 |
| Total Noncurrent Liabilities | 480,139 | 55,342 | 48,531 |
| Total Liabilities | <u>\$ 7,920,590</u> | <u>\$ 8,246,936</u> | <u>\$ 8,357,126</u> |
| Deferred Inflows of Resources | <u>\$ 81,530</u> | <u>\$ -</u> | <u>\$ -</u> |
| Net Position: | | | |
| Invested in Capital Assets | \$ 14,418 | \$ 19,386 | \$ 14,100 |
| Restricted | 1,130,293 | 1,223,257 | 1,286,756 |
| Unrestricted | 378,883 | 595,220 | 563,785 |
| Total Net Position | <u>\$ 1,523,594</u> | <u>\$ 1,837,863</u> | <u>\$ 1,864,641</u> |

Statement of Revenues, Expenses, and Changes in Net Position Summary:

| | <u>6/30/2015</u> | <u>6/30/2014</u> | <u>6/30/2013</u> |
|--|---------------------|---------------------|---------------------|
| Total Operating Revenue | \$27,212,010 | \$27,021,221 | \$27,999,486 |
| Total Operating Expenses | 20,359,788 | 19,228,494 | 19,713,987 |
| Operating Income | <u>\$ 6,852,222</u> | <u>\$ 7,792,727</u> | <u>\$ 8,285,499</u> |
| Total Non-Operating Revenue | 2,371 | 2,995 | 2,938 |
| Income Before Transfers | <u>\$ 6,854,593</u> | <u>\$ 7,795,722</u> | <u>\$ 8,288,437</u> |
| Total Transfers to Other Funds | 6,722,500 | 7,822,500 | 7,922,500 |
| Change in Net Position | <u>\$ 132,093</u> | <u>\$ (26,778)</u> | <u>\$ 365,937</u> |
| Total Net Position, Beginning of Year, | | | |
| As Previously Reported | 1,837,863 | 1,864,641 | 1,498,704 |
| Prior Period Adjustment | (446,362) | - | - |
| Total Net Position, Beginning of Year, | | | |
| As Restated | 1,391,501 | 1,864,641 | 1,498,704 |
| Total Net Position, End of Year | <u>\$ 1,523,594</u> | <u>\$ 1,837,863</u> | <u>\$ 1,864,641</u> |
| Revenue: | | | |
| Powerball Ticket Sales | \$12,271,691 | \$12,702,032 | \$16,353,914 |
| Mega Millions Ticket Sales | 5,729,100 | 6,020,880 | 3,314,304 |
| Hot Lotto Ticket Sales | 3,179,642 | 2,683,501 | 2,912,792 |
| Wild Card 2 Ticket Sales | 1,623,461 | 1,636,771 | 1,786,280 |
| 2by2 Ticket Sales | 4,207,353 | 3,857,172 | 3,470,558 |
| Less Retailer Credit Adjustments | (984) | (956) | (532) |
| Total Ticket Sales | <u>\$27,010,263</u> | <u>\$26,899,400</u> | <u>\$27,837,316</u> |
| Other Operating Revenue | 201,747 | 121,821 | 162,170 |
| Total Revenue | <u>\$27,212,010</u> | <u>\$27,021,221</u> | <u>\$27,999,486</u> |
| Expenses: | | | |
| Prizes | \$13,978,818 | \$13,763,244 | \$14,216,632 |
| Retailer Commissions | 1,329,373 | 1,313,359 | 1,359,799 |
| Retailer Bonuses | 39,750 | 35,550 | 37,000 |
| Operating | 5,011,847 | 4,116,341 | 4,100,556 |
| Total Expenses | <u>\$20,359,788</u> | <u>\$19,228,494</u> | <u>\$19,713,987</u> |
| Net Proceeds: | | | |
| Income before Transfers | \$ 6,854,593 | \$ 7,795,722 | \$ 8,288,437 |
| Percent of Income before Transfers to Total Operating Revenue | 25.2% | 28.9% | 29.6% |

Potential Factors Affecting Future Sales

The challenge facing the Lottery is to sustain sales and net proceeds by actively promoting sales of tickets for present and new games in a very competitive retail environment.

The Lottery is unique compared to all other state lotteries because it may only conduct multi-state online games. The constitution restricts the Lottery to multi-state games. The law restricts the Lottery to online games. Therefore, the Lottery must partner with one or more other government-authorized lotteries to conduct a game. This restriction generally limits the Lottery to games administered by the MUSL. The MUSL may not have a broad range of games available to fulfill the Lottery's desired product mix or the MUSL's games may become stale. Should the MUSL dissolve, although it is not anticipated, the Lottery would not have a source of games to conduct.

Looking Ahead

The Lottery's goal is to provide a service to the citizens of North Dakota and, while considering the sensitive nature of the Lottery, promote games, and ensure the integrity, security, and fairness of its operation. To accomplish this, the Lottery must offer attractive games that add value to the Lottery's product mix, license retailers that are in convenient locations, create effective annual marketing plans, provide quality customer service to retailers and players, and control operating expenses.

To attract players, games must be interesting to play and have a broad range of player odds and starting jackpot prizes. The MUSL game groups periodically refresh their games by replacing them, or re-launching the games with new features or options. Total sales of a game are dramatically affected by the size of the game's jackpot and, to a lesser degree, on the odds of winning a prize. Larger jackpots generate higher sales. However, larger jackpots cannot be predicted or relied upon. Therefore, a variety of games with varying jackpots and odds of winning a prize is necessary to attract players.

For the fiscal year 2016, the Lottery plans to:

- Re-launch the Powerball game with better overall odds, more winners and bigger jackpots;
- Add the Lucky for Life game with a top prize of \$7,000/week for life and the second prize of \$25,000/year for life;
- Develop and conduct innovative promotional and public awareness campaigns that will attract new players as well as strengthen the current player/lottery relationship;
- Build membership in the Players Club that rewards players for their continued patronage;
- Increase awareness of the subscription service;
- Research the opportunity to introduce a mobile application.

Contacting the Lottery

If a person has a question on any information in this report or desires additional information, please write to:

North Dakota Lottery
Office of Attorney General
1050 E. Interstate Ave, Suite 200
Bismarck, ND 58503-5574

Financial Statements
Statement of Net Position
June 30, 2015 and 2014

| | June 30, 2015 | June 30, 2014 |
|---------------------------------------|----------------------|----------------------|
| Assets: | | |
| Current Assets: | | |
| Cash and Cash Equivalents | \$ 7,180,602 | \$ 8,458,910 |
| Cash at Fiscal Agent | 381,537 | |
| Accounts Receivable | 765,413 | 364,415 |
| Prepaid Expenses | | 18,831 |
| Total Current Assets | \$ 8,327,552 | \$ 8,842,156 |
| Noncurrent Assets: | | |
| Reserves on Deposit | \$ 1,130,293 | \$ 1,223,257 |
| Equipment and Software, Net | 14,418 | 19,386 |
| Total Noncurrent Assets | \$ 1,144,711 | \$ 1,242,643 |
| Total Assets | \$ 9,472,263 | \$ 10,084,799 |
| Deferred Outflows of Resources | \$ 53,451 | \$ 0 |
| Liabilities: | | |
| Current Liabilities: | | |
| Accounts Payable | \$ 352,374 | \$ 231,831 |
| Due to Other State Funds | 6,113,808 | 7,215,397 |
| Accrued Payroll | 68,306 | 65,247 |
| Prizes Payable | 369,261 | 310,970 |
| Deferred Revenue | 536,702 | 368,149 |
| Total Current Liabilities | \$ 7,440,451 | \$ 8,191,594 |
| Noncurrent Liabilities: | | |
| Net Pension Liability | \$ 417,667 | |
| Compensated Absences Payable | 62,472 | \$ 55,342 |
| Total Noncurrent Liabilities | \$ 480,139 | \$ 55,342 |
| Total Liabilities | \$ 7,920,590 | \$ 8,246,936 |
| Deferred Inflows of Resources | \$ 81,530 | \$ 0 |
| Net Position: | | |
| Net Investment in Capital Assets | \$ 14,418 | \$ 19,386 |
| Restricted | 1,130,293 | 1,223,257 |
| Unrestricted | 378,883 | 595,220 |
| Total Net Position | \$ 1,523,594 | \$ 1,837,863 |

The accompanying Notes to the Financial Statements are an integral part of this statement.

Statement of Revenues, Expenses, and Changes in Net Position
For the Fiscal Years Ended June 30, 2015 and 2014

| | <u>June 30, 2015</u> | <u>June 30, 2014</u> |
|---|----------------------|----------------------|
| Operating Revenues: | | |
| Ticket Sales | \$ 27,010,263 | \$ 26,899,400 |
| Other Operating Revenue | 201,747 | 121,821 |
| Total Operating Revenues | <u>\$ 27,212,010</u> | <u>\$ 27,021,221</u> |
| Operating Expenses: | | |
| Prizes | \$ 13,978,818 | \$ 13,763,244 |
| Retailer Commissions and Bonuses | 1,369,123 | 1,348,909 |
| Contractual Services | 2,812,101 | 2,399,768 |
| Marketing | 633,695 | 601,093 |
| Salaries and Benefits | 799,896 | 796,747 |
| Operating | 766,155 | 318,733 |
| Total Operating Expenses | <u>\$ 20,359,788</u> | <u>\$ 19,228,494</u> |
| Operating Income | <u>\$ 6,852,222</u> | <u>\$ 7,792,727</u> |
| Nonoperating Revenues: | | |
| Interest Income | \$ 2,371 | \$ 2,995 |
| Total Nonoperating Revenues | <u>\$ 2,371</u> | <u>\$ 2,995</u> |
| Income Before Transfers | <u>\$ 6,854,593</u> | <u>\$ 7,795,722</u> |
| Transfers to Other Funds: | | |
| Compulsive Gambling Fund | \$ 200,000 | \$ 200,000 |
| Multi-Jurisdictional Drug Task Force | 422,500 | 422,500 |
| State General Fund | 6,100,000 | 7,200,000 |
| Total Transfers to Other Funds | <u>\$ 6,722,500</u> | <u>\$ 7,822,500</u> |
| Change in Net Position | \$ 132,093 | \$ (26,778) |
| Total Net Position- Beginning of Year, As Previously Reported | \$ 1,837,863 | \$ 1,864,641 |
| Prior Period Adjustment | (446,362) | |
| Total Net Position- Beginning of Year, As Restated | <u>\$ 1,391,501</u> | <u>\$ 1,864,641</u> |
| Total Net Position- End of Year | <u>\$ 1,523,594</u> | <u>\$ 1,837,863</u> |

The accompanying Notes to the Financial Statements are an integral part of this statement.

Statement of Cash Flows
For the Fiscal Years Ended June 30, 2015 and 2014

| | <u>June 30, 2015</u> | <u>June 30, 2014</u> |
|--|-----------------------|-----------------------|
| Cash Flows from Operating Activities: | | |
| Ticket Sales | \$ 20,044,056 | \$ 20,713,659 |
| Other Revenues | 103,610 | 117,112 |
| Paid to Prize Winners | (2,666,528) | (2,942,444) |
| Paid to Vendors | (10,224,464) | (9,353,485) |
| Paid to Employees | (790,622) | (786,809) |
| Payments to MUSL Prize Reserve | (11,472) | (28,535) |
| Funds Received from MUSL Prize Reserve | 87,510 | 92,551 |
| Net Cash Provided by Operating Activities | <u>\$ 6,542,090</u> | <u>\$ 7,812,049</u> |
| Cash Flows from Noncapital Financing Activities: | | |
| Transferred to Compulsive Gambling Treatment Fund | \$ (200,000) | \$ (200,000) |
| Transferred to Multi-Jurisdictional Drug Task Force Fund | (422,500) | (422,500) |
| Transferred to State General Fund | (7,200,000) | (7,300,000) |
| Net Cash Used in Noncapital Financing Activities | <u>\$ (7,822,500)</u> | <u>\$ (7,922,500)</u> |
| Cash Flows from Capital and Related Financing Activities: | | |
| Purchase of Property and Equipment | \$ | \$ (9,393) |
| Net Cash Used in Capital and Related Financing Activities | <u>\$ 0</u> | <u>\$ (9,393)</u> |
| Cash Flows from Investing Activities: | | |
| Interest Income | \$ 2,102 | \$ 2,484 |
| Net Cash Provided by Investing Activities | <u>\$ 2,102</u> | <u>\$ 2,484</u> |
| Cash and Cash Equivalents at Beginning of Year | <u>\$ 8,458,910</u> | <u>\$ 8,576,270</u> |
| Cash and Cash Equivalents at End of Year | <u>\$ 7,180,602</u> | <u>\$ 8,458,910</u> |

(Continued)

Statement of Cash Flows – Continued

| | <u>June 30, 2015</u> | <u>June 30, 2014</u> |
|---|----------------------|----------------------|
| Reconciliation of Operating Income to Net Cash Provided by Operating Activities: | | |
| Operating Income | \$ 6,852,222 | \$ 7,792,727 |
| Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities: | | |
| Depreciation | 4,968 | 4,107 |
| Changes in Assets and Liabilities: | | |
| (Increase) Decrease in Cash at Fiscal Agent | (381,537) | |
| (Increase) Decrease in Accounts Receivable | (401,046) | (36,931) |
| (Increase) Decrease in Prepaid Expenses | 18,831 | (1,630) |
| (Increase) Decrease in Reserves on Deposit | 93,280 | 63,966 |
| (Increase) Decrease in Deferred Outflows | (53,451) | |
| Increase (Decrease) in Deferred Inflows | 81,530 | |
| Increase (Decrease) in Accounts Payable | 120,544 | 68,190 |
| Increase (Decrease) in Due to Other State Funds | (1,589) | (8,640) |
| Increase (Decrease) in Accrued Payroll | 3,059 | 2,827 |
| Increase (Decrease) in Prizes Payable | 58,291 | (82,628) |
| Increase (Decrease) in Deferred Revenue | 168,553 | 3,250 |
| Increase (Decrease) in Net Pension Liability | (28,695) | |
| Increase (Decrease) in Compensated Absences Payable | 7,130 | 6,811 |
| Total Adjustments | <u>\$ (310,132)</u> | <u>\$ 19,322</u> |
| Net Cash Provided by Operating Activities | <u>\$ 6,542,090</u> | <u>\$ 7,812,049</u> |
| Noncash Transactions: | | |
| Interest Revenue on Prize Reserves | <u>\$ 317</u> | <u>\$ 517</u> |
| Total Noncash Transactions | <u>\$ 317</u> | <u>\$ 517</u> |

The accompanying Notes to the Financial Statements are an integral part of this statement.

Notes to the Financial Statements
For the Fiscal Years Ended June 30, 2015 and 2014

Note 1. Summary of Significant Accounting Policies

Reporting Entity

In accordance with Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, the Lottery should include all component units over which the Lottery exercises such aspects as: (1) appointing a voting majority of an organization's governing body and (2) has the ability to impose its will on that organization; or (3) the potential for the organization to provide specific financial benefits to, or impose specific burdens on the Lottery.

Based on the criteria of GASB Statement No. 14, no organization was determined to be part of the Lottery as a reporting entity. The Lottery is a division of the Office of Attorney General, which is part of the primary government of the state of North Dakota.

Basis of Accounting and Measurement Focus

The Lottery's activity is accounted for as a proprietary type enterprise fund for the state of North Dakota. A proprietary fund is accounted for using the accrual basis of accounting. Revenues are recognized when they are earned and expenses are recognized when they are incurred.

An enterprise fund is used to account for an activity that is financed and operated in a manner similar to a private business enterprise where the costs of providing goods or services to the public on a continuing basis are financed through the sale of those goods or services. The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. An enterprise fund is accounted for by using the economic resources measurement focus in which all assets and liabilities associated with the operation of the funds are included on the statement of net position. Net position is segregated into investments in capital assets and restricted and unrestricted components. The statement of revenues, expenses, and changes in net position presents increases and decreases in total net position. The statement of cash flows presents the cash flows for operating, investing, capital, and non-capital financing activities.

According to North Dakota Century Code chapter 53-12.1, the Lottery must be self-funded and self-sustaining. As a result, general fund monies of the state may not be used or obligated to pay expenses or prizes of the Lottery.

Accounting Standards

The Lottery follows the pronouncements of the GASB, which is the nationally accepted standard-setting body for establishing generally accepted accounting principles for governmental entities.

Operating and Nonoperating Revenues

An enterprise fund distinguishes operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with the proprietary fund's principal ongoing operation. The principal operating revenue of the Lottery is sales of tickets. The principal operating expenses of the Lottery are prizes, retailer commissions, contractual services, marketing, MUSL game group dues, and salaries and fringe benefits. All revenue and expenses not meeting the criteria are reported as nonoperating income and expenses.

Cash and Cash Equivalents

Cash and cash equivalents are defined as deposits with the Bank of North Dakota and the State Treasurer. The Lottery does not invest in marketable securities.

Cash at Fiscal Agent

Cash at fiscal agent is the balance in the bank account held by Scientific Games, Inc. to service subscriptions on the internet. This account balance consists of uncommitted amounts held in players online wallets, ticket sales, and uncollected winnings. As of June 30, 2015 the balance was \$381,537.

Accounts Receivable

Accounts receivable primarily represents prizes due from MUSL and lottery funds due from retailers for ticket sales, less commissions and prizes on winning tickets paid by retailers. Lottery funds are collected weekly through electronic funds transfer by the Lottery from retailers' bank accounts. The Lottery has not incurred and does not project any bad debts.

Reserves on Deposit

As of June 30, 2015 the Lottery has \$1,130,293 on deposit with the MUSL related to the Prize Reserve Pools and Unreserved Account as compared to \$1,223,257 at June 30, 2014. When both restricted and unrestricted resources are available, which is only applicable for certain MUSL related expenses, it is the Lottery's policy to generally use restricted resources first. See Note 7.

Prepaid Expenses

The prepaid expenses are primarily rent and retailer commissions on future sales. There were no prepaid expenses at June 30, 2015 as compared to \$18,831 at June 30, 2014.

Equipment and Software

Equipment and software are stated at cost, net of accumulated depreciation. Equipment and software with a cost of \$5,000 or more per unit are capitalized and reported in the accompanying financial statements. Depreciation is computed using the straight-line method over the estimated useful lives of the assets which range from three to ten years.

Prizes

Prize expense is recorded based on actual drawing results.

Prizes payable represents the difference between the amount of prize expense recognized and actual prizes paid.

Players may redeem winning tickets for up to 180 days after the draw for the game. As of June 30, 2015, unclaimed prizes were \$369,261 compared to \$310,970 on June 30, 2014. Prizes that expired in fiscal years ended June 30, 2015 and 2014 were \$384,422 and \$464,403, respectively.

Unearned Revenue

A liability has been recorded for lottery tickets, multi-draw tickets, and for subscriptions sold on or before June 30, 2015 and 2014 that contain plays for future draws that will occur after June 30, 2015 and 2014, respectively. The amount related to future ticket sales on multi-draw tickets as of June 30, 2015 and 2014 were \$136,066 and \$132,257, respectively. The amount for future sales on subscriptions as of June 30, 2015 and 2014 were \$3,862 and \$230,359, respectively. The significant change in fiscal year 2015 was due to a change in the Lottery's subscription service moving to internet only participation. A new bank account held by Scientific Games, Inc. consists of uncommitted amounts held in players' online wallets, ticket sales, and uncollected winnings. As of June 30, 2015 the balance was \$381,537, with an offsetting asset for the same amount under the caption, cash at fiscal agent.

Sales of uncashed gift certificates for fiscal years ended June 30, 2015 and 2014 were \$5,740 and \$5,533, respectively and are also classified as unearned revenue. Sales of uncashed play central terminal (PCT) vouchers for fiscal year ended June 30, 2015 were \$9,497 and are also classified as unearned revenue.

Interfund Balances and Transfers

At June 30, 2015, the Lottery had nominal accounts payable and receivable involving normal business expenses with several state agencies, and had net proceeds due to be transferred to one state fund.

By law, the net proceeds of the Lottery, less the amount allocated to the Compulsive Gambling Prevention and Treatment Fund, amount allocated to the Multi-Jurisdictional Drug Task Force Grant Fund, Lottery's share of a game's prize reserve pool, and holdback of any reserve funds the director may need for continuing operations, must be transferred to the State Treasurer on at least an annual basis for deposit in the state general fund. By law, \$50,000 must be transferred to the State Treasurer each quarter for deposit in the Compulsive Gambling Prevention and Treatment Fund and \$105,625 must be transferred to the State Treasurer each quarter for deposit in the Multi-Jurisdictional Drug Task Force Grant Fund. The reserve funds held by the director are funds that are required to be transferred to the MUSL for prize reserve pools. The balance of the net proceeds is transferred to the state general fund.

Retailer Commissions

Lottery retailers receive a 5% commission on each ticket sold or otherwise provided to players, and for subscriptions that players may choose to designate to a recipient retailer. Effective January 1, 2006, the Lottery provides retailers a bonus commission, as a sales incentive, for selling jackpot/grand prize and certain high tier prize winning tickets. The Lottery does not provide retailers a commission for redeeming winning tickets. Total retailer commissions for June 30, 2015 and 2014 were \$1,369,123 and \$1,348,909, including bonus commissions of \$39,750 and \$35,500, respectively.

Marketing and Advertising

Costs incurred for developing creative, including point-of-sale items, research, and media advertising are expensed when incurred which generally is when point-of-sale items are first distributed to retailers or advertising first takes place.

Pensions

For purposes of measuring the net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the fiduciary net position of the North Dakota Public Employees Retirement System (NDPERS) and additions to/deductions from NDPERS' fiduciary net position have been determined on the same basis as they are reported by NDPERS. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with the benefit terms. Investments are reported at fair value.

Accumulated Unpaid Vacation, Sick Pay, and Compensatory Pay

Annual leave and sick leave are part of a permanent employees' compensation as set forth in Section 54-06-14 of the North Dakota Century Code. Annual leave is earned based on tenure of employment, within a range of a minimum of one working day per month of employment, to a maximum of two working days per month of employment, to be fixed by rules and regulations adopted by the employing unit. In general, accrued annual leave cannot exceed 30 days at April 30 each year, as set by the Office of Attorney General. Employees are paid for unused annual leave upon termination or retirement.

Sick leave is earned at the rate of one working day per month of employment. There are no limitations on the amount of sick leave that an employee can accumulate. Employees who have ten continuous years of service are paid one-tenth of their accumulated sick leave upon termination or retirement under chapter 54-52 of the North Dakota Century Code. A liability is recognized for that portion of accumulated sick leave benefits that is estimated will be taken as required by the GASB Statement No. 16, *Accounting for Compensated Absences*.

Compensatory leave is earned by employees who work overtime each week in accordance with the Office of Attorney General's policy. Generally, upon termination or retirement, employees are not eligible to receive compensation for their compensatory leave balances.

Deferred Outflows/Inflows of Resources

In addition to assets, the statement of net position reports a separate section for deferred outflows of resources. This separate financial statement element, *deferred outflows of resources*, represents a consumption of net position that applies to a future period(s) and so will *not* be recognized as an outflow of resources (expense/expenditure) until then.

In addition to liabilities, the statement of net position reports a separate section for deferred inflows of resources. This separate financial statement element, *deferred inflows of resources*, represents an acquisition of net position that applies to a future period(s) and so will *not* be recognized as an inflow of resources (revenue) until that time.

New Accounting Pronouncements

As of July 1, 2014, the Lottery adopted GASB Statement No. 68, *Accounting and Financial Reporting for Pensions* and GASB Statement No. 71 *Pension Transition for Contributions Made Subsequent to the Measurement Date*. The implementation of these standards requires that governments calculate and report the costs and obligations associated with pensions in their basic financial statements. Employers are required to recognize pension amounts for all benefits provided through the plan which include the net pension liability, deferred outflows of resources, deferred inflows of resources, and pension expense. See additional information in Note 6.

Note 2. Prior Period Adjustment

The Lottery adopted GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, and GASB No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*, which required a prior period adjustment to record net pension liability and deferred outflows as of July 1, 2014; the cumulative effect of implementing these GASB statements was an increase in net pension liability of \$483,070 and an increase in deferred outflows of \$36,708 on the Statement of Net Position. The adjustments resulted in a net decrease of \$446,362 on the Statement of Net Position for the fiscal year ended June 30, 2015.

Note 3. Deposits

Custodial Credit Risk

State law generally requires all state funds be deposited in the state owned Bank of North Dakota. North Dakota Century Code (NDCC) Section 21-04-01 provides that public funds belonging to or in the custody of the state shall be deposited in the Bank of North Dakota. Also, NDCC Section 6-09-07 states, “[a]ll state funds ... must be deposited in the Bank of North Dakota” or must be deposited in accordance with constitutional and statutory provisions.

The Lottery deposits at the Bank of North Dakota at June 30, 2015 and 2014 include \$7,180,602 and \$8,458,910, respectively.

These deposits are exposed to custodial credit risk as uninsured and uncollateralized. However, these deposits at the Bank of North Dakota are guaranteed by the state of North Dakota through NDCC Section 6-09-10.

Note 4. Compensated Absences

A summary of compensated absences follows for 2015 and 2014:

| | |
|---------------------------------|------------------|
| Beginning balance, July 1, 2014 | \$ 55,342 |
| Addition | 7,130 |
| Reduction | |
| Ending balance, June 30, 2015 | <u>\$ 62,472</u> |
| Amount payable within one year | <u>\$ 0</u> |
| | |
| Beginning balance, July 1, 2013 | \$ 48,531 |
| Addition | 6,811 |
| Reduction | |
| Ending balance, June 30, 2014 | <u>\$ 55,342</u> |
| Amount payable within one year | <u>\$ 0</u> |

Note 5. Due to / Due from Other State Funds

At June 30, 2015 and 2014, accounts payable due to several state agencies and transfers of net proceeds due to the state general fund are:

| | 2015 | 2014 |
|--|--------------------|--------------------|
| Due to the Department of Transportation | \$ 1,958 | \$ 1,344 |
| Due to the Information Technology Department | 2,431 | 2,819 |
| Due to the Office of Management and Budget | 850 | 1,287 |
| Due to the Office of State Tax Commissioner | 8,569 | 9,947 |
| Due to the state General Fund | 6,100,000 | 7,200,000 |
| Total | <u>\$6,113,808</u> | <u>\$7,215,397</u> |

Note 6. Equipment and Software

A summary of changes in equipment, software, and accumulated depreciation is as follows for 2015 and 2014:

| | <u>Equipment</u> | <u>Software</u> | <u>Accumulated Depreciation</u> | <u>Net</u> |
|-----------------------|------------------|------------------|-------------------------------------|------------------|
| Balance, June 30,2014 | \$ 53,113 | \$ 32,000 | \$ 65,727 | \$ 19,386 |
| Additions | - | - | 4,968 | (4,968) |
| Disposals | - | - | - | - |
| Balance, June 30,2015 | <u>\$ 53,113</u> | <u>\$ 32,000</u> | <u>\$ 70,695</u> | <u>\$ 14,418</u> |

| | <u>Equipment</u> | <u>Software</u> | <u>Accumulated Depreciation</u> | <u>Net</u> |
|-----------------------|------------------|------------------|-------------------------------------|------------------|
| Balance, June 30,2013 | \$ 43,720 | \$ 32,000 | \$ 61,620 | \$ 14,100 |
| Additions | 9,393 | - | 4,107 | 5,286 |
| Disposals | - | - | - | - |
| Balance, June 30,2014 | <u>\$ 53,113</u> | <u>\$ 32,000</u> | <u>\$ 65,727</u> | <u>\$ 19,386</u> |

Note 7. Employee Pension Plan

General Information about the Pension Plan

North Dakota Public Employees Retirement System (Main System)

The following brief description of NDPERS is provided for general information purposes only. Participants should refer to NDCC Chapter 54-52 for more complete information.

NDPERS is a cost-sharing multiple-employer defined benefit pension plan that covers substantially all employees of the state of North Dakota, its agencies and various participating political subdivisions. NDPERS provides for pension, death, and disability benefits. The cost to administer the plan is financed through the contributions and investment earnings of the plan.

Responsibility for administration of the NDPERS defined benefit pension plan is assigned to a Board comprised of seven members. The Board consists of a Chairman, who is appointed by the Governor; one member appointed by the Attorney General; one member appointed by the State Health Officer; three members elected by the active membership of the NDPERS system; and one member elected by the retired public employees.

Pension Benefits

Benefits are set by statute. NDPERS has no provision or policies with respect to automatic and ad hoc post-retirement benefit increases. Members of the Main System are entitled to unreduced monthly pension benefits beginning when the sum of age and years of credited service equal or exceed 85 (Rule of 85), or at normal retirement age (65). The annual pension

benefit is equal to 2.00% of their average monthly salary, using the highest 36 months out of the last 180 months of service, for each year of service. The plan permits early retirement at ages 55-64 with three or more years of service.

Members may elect to receive the pension benefits in the form of a single life, joint and survivor, term-certain annuity, or partial lump sum with ongoing annuity. Members may elect to receive the value of their accumulated contributions, plus interest, as a lump sum distribution upon retirement or termination, or they may elect to receive their benefits in the form of an annuity. For each member electing an annuity, total payment will not be less than the members' accumulated contributions plus interest.

Death and Disability Benefits

Death and disability benefits are set by statute. If an active member dies with less than three years of service for the Main System, a death benefit equal to the value of the member's accumulated contributions, plus interest, is paid to the member's beneficiary. If the member has earned more than three years of credited service for the Main System, the surviving spouse will be entitled to a single payment refund, life-time monthly payments in an amount equal to 50% of the member's accrued normal retirement benefit, or monthly payments in an amount equal to the member's accrued 100% Joint and Survivor retirement benefit if the member had reached normal retirement age prior to date of death. If the surviving spouse dies before the member's accumulated pension benefits are paid, the balance will be payable to the surviving spouse's designated beneficiary.

Eligible members, who become totally disabled after a minimum of 180 days of service, receive monthly disability benefits equal to 25% of their final average salary with a minimum benefit of \$100. To qualify under this section, the member has to become disabled during the period of eligible employment and apply for benefits within one year of termination. The definition of disabled is set by the NDPERS in the North Dakota Administrative Code.

Refunds of Member Account Balance

Upon termination, if a member of the Main System is not vested (is not 65 or does not have three years of service), they will receive the accumulated member contributions and vested employer contributions, plus interest, or may elect to receive this amount at a later date. If the member has vested, they have the option of applying for a refund or can remain as a terminated vested participant. If a member terminated and withdrew their accumulated member contribution and is subsequently reemployed, they have the option of repurchasing their previous service.

The member's account balance includes the vested employer contributions equal to the member's contributions to an eligible deferred compensation plan. The minimum member contribution is \$25 and the maximum may not exceed the following:

- 1 to 12 months of service – Greater of 1% of monthly salary or \$25
- 13 to 25 months of service – Greater of 2% of monthly salary or \$25
- 25 to 36 months of service – Greater of 3% of monthly salary or \$25
- Longer than 36 months of service – Greater of 4% of monthly salary or \$25

Member and Employer Contributions

Member and employer contributions paid to NDPERS are set by statute and are established as a percent of covered compensation. Member contribution rates are 7% and employer contribution rates are 7.12% of covered compensation.

Pension Liabilities, Pension Expense, and Deferred Outflows of Resources and Deferred Inflows of Resources Related to Pensions

At fiscal year ending June 30, 2015, the North Dakota Lottery reported a liability of \$417,667 for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2014, and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of that date. The employer's proportion of the net pension liability was based on the employer's share of covered payroll in the Main System pension plan relative to the covered payroll of all participating Main System employers. At June 30, 2014 the North Dakota Lottery's proportion was 0.065803%.

For the year ended June 30, 2015, the North Dakota Lottery recognized pension expense of \$616. At June 30, 2015, the North Dakota Lottery reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

| | Deferred Outflow of Resources | Deferred Inflow of Resources |
|--|-------------------------------------|------------------------------------|
| Difference between expected and actual experience | \$ 13,541 | \$ (81,530) |
| Changes of Assumptions | | |
| Net difference between projected and actual earnings on pension plan investments | | |
| Changes in proportion and differences between employer contributions and proportionate shares of contributions | | |
| Employer contributions subsequent to the measurement date (see below) | 39,910 | |
| Total | <u>\$ 53,451</u> | <u>\$ (81,530)</u> |

\$39,910 reported as deferred outflows of resources related to pensions resulting from Employer contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ended June 30, 2016.

Other amounts reported as deferred outflows of resources and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

| Year ended June 30: | |
|----------------------------|------------|
| 2016 | \$(17,501) |
| 2017 | (17,501) |
| 2018 | (17,501) |
| 2019 | (17,501) |
| 2020 | 2,015 |
| Thereafter | 0 |

Actuarial assumptions

The total pension liability in the July 1, 2014 actuarial valuation was determined using the following actuarial assumptions, applied to all periods included in the measurement:

| | |
|----------------------------|---|
| Inflation | 3.50% |
| Salary increases | 3.85% per annum for four years, then 4.50% per annum |
| Investment rate of return | 8.00%, net of investment expenses |
| Cost-of-living adjustments | None |

For active members, inactive members, and healthy retirees, mortality rates were based on the RP-2000 Combined Healthy Mortality Table with ages set back three years. For disabled retirees, mortality rates were based on the RP-2000 Disabled Retiree Mortality Table with ages set back one year for males (not set back for females).

The actuarial assumptions used were based on the results of an actuarial experience study completed in 2010. They are the same as the assumptions used in the July 1, 2014, funding actuarial valuation for NDPERS.

The long-term expected rate of return on pension plan investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of arithmetic real rates of return for each major asset class included in the Fund's target asset allocation are summarized in the following table:

| Asset Class | Target Allocation | Long-Term Expected Real Rate of Return |
|----------------------------|-------------------|--|
| Domestic Equity | 31% | 6.90% |
| International Equity | 21% | 7.55% |
| Private Equity | 5% | 11.30% |
| Domestic Fixed Income | 17% | 1.55% |
| International Fixed Income | 5% | 0.90% |
| Global Real Assets | 20% | 5.38% |
| Cash Equivalents | 1% | 0.00% |

Discount rate

The discount rate used to measure the total pension liability was 8% as of June 30, 2014. The projection of cash flows used to determine the discount rate assumes that member and employer contributions will be made at rates equal to those based on the July 1, 2014, Actuarial Valuation Report. For this purpose, only employer contributions that are intended to fund benefits of current plan members and their beneficiaries are included. Projected employer contributions that are intended to fund the service costs of future plan members and their beneficiaries, as well as projected contributions from future plan members, are not included. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments for current plan members as of June 30, 2014. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability as of June 30, 2014.

Sensitivity of the Employer's proportionate share of the net pension liability to changes in the discount rate

The following presents the employer's proportionate share of the net pension liability calculated using the discount rate of 8%, as well as what the employer's proportionate share of the net pension liability would be if it were calculated using a discount rate that is 1-percentage-point lower (7%) or 1-percentage-point higher (9%) than the current rate:

| | 1% Decrease (7.00%) | Current Discount Rate (8.00%) | 1% Increase (9.00%) |
|--|------------------------|-------------------------------------|------------------------|
| Employer's proportionate share of the net pension liability | \$644,164 | \$417,667 | \$228,282 |

Pension plan fiduciary net position

Detailed information about the pension plan's fiduciary net position is available in the separately issued NDPERS financial report.

Member and Employer Contributions (GASB 27 disclosure for years prior to Fiscal Year Ending June 30, 2015)

Benefit and contribution provisions are administered in accordance with chapter 54-52 of the North Dakota Century Code. This state statute requires employee contributions of 4% (effective through December 31, 2011), 5% (effective January 1, 2012), 6 % (effective January 1, 2013), and 7% (effective January 1, 2014) of the participant's regular compensation. During the 1983-1985 biennium, the state implemented the employer pickup provision of the IRS code whereby a portion or all of the required employee contributions are made by the employer. The state is paying 4% of the full employee contribution. Employer contributions of 4.12% (effective through December 31, 2011), 5.12% (effective January 1, 2012), 6.12% (effective January 1, 2013), and 7.12% (effective January 1, 2014) of covered compensation are set by statute. The

required contributions are determined using an entry age normal actuarial funding method. The North Dakota Retirement Board was created by the State Legislature and is the governing authority of NDPERS. The Lottery's required actual contribution to NDPERS for the fiscal years ended June 30, 2014, 2013, and 2012 was \$58,881, \$50,745, and \$41,696, respectively.

Note 8. Multi-State Lottery Association

The Lottery is a member of the MUSL, which administers games on behalf of member lotteries. MUSL administers the Powerball, Mega Millions, Hot Lotto, Wild Card 2, and 2by2 games for the Lottery. Each member lottery sells game tickets through its retailers and makes weekly wire transfers to MUSL in an amount equal to the member lottery's share of the jackpot prize liability. If this results in a negative amount, the MUSL transfers funds to the Lottery. Lesser prizes are paid directly to the winners by each member lottery. The prize pools for Powerball, Powerplay, Hot Lotto, and Triple Sizzler are 50% of each drawing period's sales, after the prize reserve accounts are funded to the amounts set by the game groups. The prize pool for Wild Card 2 is 57%. The prize pool for Mega Millions is up to 51.5% of the Mega Millions and Megaplier sales. The prize pool for 2by2 is 39.5% with the prize expense being 66% after the free tickets. Up to 5% of sales for Powerball and 2% of sales for Wild Card 2 are deducted from the prize pool and placed in prize reserve pools. Up to 5% of sales for Mega Millions are deducted from the prize pool and placed in prize reserve pools. For Hot Lotto, up to 1% of sales is deducted from the prize pool and placed in a prize reserve pool when the jackpot prize exceeds \$2 million. An additional 2% of sales is placed in the prize reserve fund after the annuitized jackpot prize exceeds \$5 million. When the prize reserve funds exceed the designated caps, the excess amount becomes part of the jackpot prize pool.

The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities and the money in this reserve fund is used at the discretion of the MUSL board of directors. The prize reserve fund monies are refundable to MUSL member lotteries if MUSL dissolves or if a member lottery leaves MUSL. A member lottery leaving MUSL must wait one year before receiving their remaining share, if any, of the prize reserve funds. Any amount remaining in the prize pools at the end of the games is carried forward to a replacement game or expended in a manner as directed by the game group. The MUSL prize reserve pool account balance and the Lottery's share of that balance are as follows:

| | 6/30/2015 | 6/30/2014 |
|---|---------------|---------------|
| MUSL prize reserve pool account | \$155,643,044 | \$155,648,011 |
| Lottery's share of the MUSL prize reserve pool account (on deposit) | \$1,033,486 | \$1,121,639 |

The Lottery also has an unreserved account with MUSL. Interest earned on MUSL funds, and any unclaimed jackpot prizes may be deposited into this account and the Lottery board and game group dues and other MUSL related expenses may be paid from this fund.

| | 6/30/2015 | 6/30/2014 |
|--|--------------|--------------|
| MUSL unreserved account | \$15,446,835 | \$16,082,650 |
| Lottery's share of the MUSL unreserved account | \$96,807 | \$101,618 |

A winner of a Powerball, Mega Millions, or Hot Lotto jackpot prize may select that the prize be paid at the cash value of the prize or as an annuity. A Powerball jackpot prize is paid out in 30 installments, a Mega Millions jackpot is paid out in 26 installments, and a Hot Lotto jackpot prize in 25 installments. Powerball annuitized prizes are paid annually in thirty graduated payments (increasing each year) by a rate determined by the Powerball game group. If a jackpot winner selects annual installments for Powerball, Mega Millions, or Hot Lotto, the MUSL purchases United States government securities to fund awarded prizes. The securities are held in Winner Trust accounts with the member lottery named as the trust beneficiary. MUSL transfers cash to the member lotteries to facilitate the payment of the annual jackpot prize amount. The source of this money is a game group's grand prize pool. The assets and related liabilities are reflected in the MUSL's financial statements and therefore, are not reflected in the Lottery's financial statements. MUSL is responsible for transferring the cash or the annuity installment amounts to the member lottery before the payment to the jackpot prize winner. The Lottery currently is not paying any prize winner any annuity prize payments. The Wild Card 2 jackpot prize and 2by2 grand prize are paid in a single cash payment. The Powerball, Mega Millions, Hot Lotto, and Wild Card 2 jackpot prizes are divided equally among multiple winning tickets among the participating state lotteries.

As a member of the MUSL board and Powerball, Mega Millions, Hot Lotto, Wild Card 2, and 2by2 game groups, the Lottery is responsible for its pro-rated share of the MUSL board dues. MUSL Board dues for fiscal years ended June 30, 2015, and 2014, were \$20,000, and \$20,000, respectively. MUSL board dues and game group dues are decreased by MUSL's non-game earnings including, interest, web advertising, and trademark license fees.

Note 9. Commitments and Contingencies

The Lottery entered into contracts with:

1. Scientific Games International, Inc. of Alpharetta, GA on February 3, 2004. The vendor provides an online lottery gaming system and related services through June 30, 2022. Payments for the fiscal years ended June 30, 2015 and 2014 totaled \$2,812,101 and \$2,399,768 based on 10.473% and 8.8761% of ticket sales, respectively. The Lottery's future obligation through June 30, 2022 is based on 10.473% of ticket sales; there is an annual minimum fee of \$325,000 to fund the Player's Club Points for Prizes Program.
2. KKBold of Bismarck, ND on July 1, 2012. KKBold provides marketing and related services, and their contract runs through June 30, 2016. Payments for the fiscal years ended June 30, 2015, and 2014 totaled \$475,387 and \$399,764, respectively. The Lottery's future obligation is for actual services requested; there is no minimum fee or retainer fee. The contract can be extended by the state by written notice no later than 30 days prior to the expiration of the original contract. As of June 30, 2015 this contract expired and was renewed through June 30, 2016.

The Lottery has a contingent gain estimated at \$296,301 at June 30, 2015 from prizes that may be forfeited due to winning players not claiming them within the required time frame. This contingent gain has not been accrued in these financial statements but will be recognized when realized.

Note 10. Line of Credit

In accordance with subsection 2 of section 53-12.1-02 of the North Dakota Century Code, the Lottery has secured a short-term line of credit with the Bank of North Dakota. The law provides that the line of credit be limited to the amount of each cash prize of \$100,000 or more that relates to prize funds known to be due and forthcoming to the Lottery from other government-authorized lotteries through the MUSL. The line of credit may not exceed \$1 million in the aggregate. To date, no credit advances have been requested.

Note 11. Risk Management

The Lottery is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Lottery, as a division of the Office of Attorney General, participates in the same funds/pools established by the state for risk management issues.

The 1995 Legislative Assembly established the Risk Management Fund (RMF), an internal service fund, to provide a self-insurance vehicle for funding the liability exposures of state agencies resulting from the elimination of the state's sovereign immunity. The RMF manages the tort liability of the state, its agencies' employees, and the University System. All state agencies participating in the RMF and their fund contributions were determined using a projected cost allocation approach. The statutory liability of the state is limited to a total of \$250,000 per person and \$1 million per occurrence.

The Office of Attorney General also participates in the North Dakota Fire and Tornado Fund. The office pays an annual premium to the Fire and Tornado Fund to cover property damage to building and personal property. Replacement cost coverage is provided by estimating replacement cost in consultation with the Fire and Tornado Fund.

The Office of Attorney General also participates in the State Bonding Fund in which the office has blanket employee fidelity bond coverage in the amount of \$2 million. The State Bonding Fund did not charge any premium for this coverage.

Note 12. Postretirement Benefits

Former employees receiving retirement benefits under the Retirement Plan for Employees of the Lottery are eligible to participate in the Retiree Health Benefits Fund, a cost-sharing multiple employer plan, as administered by the Public Employees Retirement Board. During each month of employment, the Lottery contributes 1.14% of each employee's salary into the Retiree Health Benefits Fund. Total contributions for the fiscal years ending June 30, 2015, 2014, and 2013 were \$6,390, \$6,319, and \$6,009, respectively.

Note 13. Lease Commitments

The North Dakota Lottery entered into an operating lease for its office space at 1050 E. Interstate Avenue – Suite 200, Bismarck, ND 58503-5574. Lease expenditures for the fiscal year ended June 30, 2015 and 2014 totaled \$48,505 and \$48,505, respectively. The lease expires on June 30, 2017. The future annual rental commitments are as follows:

Lease commitments for fiscal year ended
June 30, 2015:

| <u>Years Ending</u> | |
|---------------------|------------------|
| 2016 | \$50,464 |
| 2017 | <u>50,464</u> |
| Total | <u>\$100,928</u> |

Lease commitments for fiscal year ended
June 30, 2014:

| <u>Years Ending</u> | |
|---------------------|------------------|
| 2015 | \$48,505 |
| 2016 | 50,464 |
| 2017 | <u>50,464</u> |
| Total | <u>\$149,433</u> |

Required Supplementary Information

Schedule of Employer's Share of Net Pension Liability ND Public Employees Retirement System Last 10 Fiscal Years *

| | 2015 |
|---|------------|
| Employers proportion of the net pension liability (asset) | .065803% |
| Employer's proportionate share of the net pension liability (asset) | \$ 417,667 |
| Employer's covered- employee payroll | \$554,314 |
| Employer's proportionate share of the net pension liability (asset) as a percentage of its covered-employee payroll | 75.35% |
| Plan fiduciary net position as a percentage of the total pension liability | 77.70% |

*Complete data for this schedule is not available prior to 2015.

The amounts presented for each fiscal year have a measurement date of the previous fiscal year end.

Schedule of Employer Contributions ND Public Employees Retirement System Last 10 Fiscal Years*

| | 2015 | 2014 |
|--|-------------|----------------------------|
| Statutorily required contribution | \$ 62,331 | \$ 58,881 |
| Contributions in relation to the statutorily required contribution | \$ (62,331) | \$ (58,881) |
| Contribution deficiency (excess) | - | - |
| Employer's covered-employee payroll | \$ 560,531 | \$ 554,314 |
| Contributions as a percentage of covered-employee payroll | 11.12% | 10.12% ½ yr 11.12% ½ yr |

*Complete data for this schedule is not available prior to 2014.

STATE AUDITOR
ROBERT R. PETERSON



PHONE
(701) 328 - 2241
FAX
(701) 328 - 1406

STATE OF NORTH DAKOTA
OFFICE OF THE STATE AUDITOR
STATE CAPITOL
600 E. BOULEVARD AVENUE - DEPT. 117
BISMARCK, NORTH DAKOTA 58505

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

Honorable Jack Dalrymple, Governor

Members of the Legislative Assembly

Honorable Wayne Stenehjem, Attorney General

Randy Miller, Director North Dakota Lottery

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 business-type activities of the North Dakota Lottery, a division of the Office of the Attorney General of the state of North Dakota as of and for the year ended June 30, 2015, and the related notes to the financial statements, which collectively comprise the North Dakota Lottery's basic financial statements, and have issued our report thereon dated February 2, 2016.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the North Dakota Lottery'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 North Dakota Lottery's internal control. Accordingly, we do not express an opinion on the effectiveness of the North Dakota 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 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.

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.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the North Dakota Lottery'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 result 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.



Robert R. Peterson
State Auditor

Bismarck, North Dakota

February 2, 2016

Special Comments Requested by the Legislative Audit and Fiscal Review Committee

The Legislative Audit and Fiscal Review Committee requires that certain items be addressed by auditors performing audits of state agencies. These items and our responses are as follows:

Responses to LAFRC Audit Questions

1. What type of opinion was issued on the financial statements?

Unmodified.

2. Was there compliance with statutes, laws, rules, and regulations under which the agency was created and is functioning?

Yes.

3. Was internal control adequate and functioning effectively?

Yes.

4. Were there any indications of lack of efficiency in financial operations and management of the agency?

No.

5. Has action been taken on findings and recommendations included in prior audit reports?

There were no formal recommendations included in the prior audit report.

6. Was a management letter issued? If so, provide a summary below, including any recommendations and the management responses.

Yes, a management letter was issued and is included on page 34 of this report, along with management's response.

LAFRC Audit Communications

1. Identify any significant changes in accounting policies, any management conflicts of interest, any contingent liabilities, or any significant unusual transactions.

The North Dakota Lottery adopted the provisions of the Statement of Governmental Accounting Standards (GASB Statement) No. 65, *Items Previously Reported as Assets and Liabilities* in 2014.

No management conflicts of interest were noted.

No contingent liabilities were identified.

There were no significant or unusual transactions.

2. Identify any significant accounting estimates, the process used by management to formulate the accounting estimates, and the basis for the auditor's conclusions regarding the reasonableness of those estimates.

The North Dakota Lottery's financial statements do not include any significant accounting estimates.

3. Identify any significant audit adjustments.

Significant audit adjustments were not necessary.

4. Identify any disagreements with management, whether or not resolved to the auditor's satisfaction relating to a financial accounting, reporting, or auditing matter that could be significant to the financial statements.

None.

5. Identify any serious difficulties encountered in performing the audit.

None.

6. Identify any major issues discussed with management prior to retention.

This is not applicable for audits conducted by the Office of the State Auditor.

7. Identify any management consultations with other accountants about auditing and accounting matters.

None.

8. Identify any high-risk information technology systems critical to operations based on the auditor's overall assessment of the importance of the system to the agency and its mission, or whether any exceptions identified in the six audit report questions to be addressed by the auditors are directly related to the operations of an information technology system.

ConnectND Finance, Human Resource Management System (HRMS), Games Management System (GMS), and Internal Control System (ICS) are high risk systems critical to the ND Lottery.



STATE OF NORTH DAKOTA
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STATE CAPITOL
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Governance Communications

February 2, 2016

Honorable Wayne Stenehjem, Attorney General
The Legislative Audit and Fiscal Review Committee

We have audited the financial statements of the North Dakota Lottery for the year ended June 30, 2015, and have issued our report thereon dated February 2, 2016. Professional standards require that we provide you with the following information related to our audit.

Significant Audit Findings

Qualitative Aspects of Accounting Practices

Management is responsible for the selection and use of appropriate accounting policies. The significant accounting policies used by North Dakota Lottery are described in Note 1 to the financial statements. As described in Note 1 to the financial statements, the North Dakota Lottery adopted the provisions of the Statement of Governmental Accounting Standards (GASB Statement) No. 68, *Accounting and Financial Reporting for Pensions*, and No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date*, in 2015.

We noted no transactions entered into by the governmental unit during the year for which there is a lack of authoritative guidance or consensus. There are no significant transactions that have been recognized in the financial statements in a different period than when the transaction occurred.

Difficulties Encountered in Performing the Audit

We encountered no significant difficulties in dealing with management in performing and completing our audit.

Corrected and Uncorrected Misstatements

Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. No such misstatements were noted.

Disagreements with Management

For purposes of this letter, professional standards define a disagreement with management as a financial accounting, reporting, or auditing matter, whether or not resolved to our satisfaction, that could be significant to the financial statements or the auditor's report. We are pleased to report that no such disagreements arose during the course of our audit.

Management Representations

We have requested certain representations from management that are included in the management representation letter dated February 2, 2016.

Management Consultations with Other Independent Accountants

In some cases, management may decide to consult with other accountants about auditing and accounting matters, similar to obtaining a "second opinion" on certain situations. If a consultation involves application of an accounting principle to the governmental unit's financial statements or a determination of the type of auditor's opinion that may be expressed on those statements, our professional standards require the consulting accountant to check with us to determine that the consultant has all the relevant facts. To our knowledge, there were no such consultations with other accountants.

Other Audit Findings or Issues

We generally discuss a variety of matters, including the application of accounting principles and auditing standards, with management each year prior to retention as the governmental unit's auditors. However, these discussions occurred in the normal course of our professional relationship and our responses were not a condition to our retention. It should be noted that the retention of the State Auditor is a matter of state law and is not under control of the North Dakota Lottery.

The following present our informal recommendations.

Revenue

Informal Recommendation 15-1: We recommend the North Dakota Lottery perform the reconciliation of subscription revenue to Game Management System (GMS) in accordance with the Online Lottery System and Services Contract.

Financial Statements

Informal Recommendation 15-2: We recommend the North Dakota Lottery complete their financial statements by the Comprehensive Annual Financial Report (CAFR) deadline given by the Office of Management and Budget.

Accounts Receivable

Informal Recommendation 15-3: We recommend the North Dakota Lottery implement controls to ensure reimbursements from Multi-State Lottery Association (MUSL) are received on a timely basis.

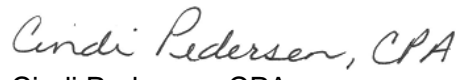
Management of the North Dakota Lottery agreed with these recommendations.

Other Matters

With respect to the supplementary information accompanying the financial statements, we made certain inquiries of management and evaluated the form, content, and methods of preparing the information to determine that the information complies with accounting principles generally accepted in the United States of America, and the method of preparing it has not changed from the prior period, and the information is appropriate and complete in relation to our audit of the financial statements. We compared and reconciled the supplementary information to the underlying accounting records used to prepare the financial statements or to the financial statements themselves.

This information is intended solely for the use of Attorney General Wayne Stenehjem, the Legislative Audit and Fiscal Review Committee, and management of the North Dakota Lottery and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,


Cindi Pedersen, CPA
Audit Manager

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or by contacting the
Division of State Audit

Office of the State Auditor
600 East Boulevard Avenue – Department 117
Bismarck, ND 58505-0060

(701) 328-2241