

North Dakota Lottery
Bismarck, North Dakota
Audit Report

For the Years Ended
June 30, 2017 and 2016

JOSHUA C. GALLION
STATE AUDITOR

Office of the State Auditor
Division of State Audit

**LEGISLATIVE AUDIT AND FISCAL REVIEW
COMMITTEE MEMBERS**

Senator Jerry Klein – Chairman
Representative Chet Pollert – Vice Chairman

Representatives

Bert Anderson
Patrick Hatlestad
Mary Johnson
Keith Kempenich
Gary Kreidt
Andrew G. Maragos
Mike Nathe
Marvin E. Nelson
Wayne A. Trottier

Senators

Dwight Cook
Judy Lee
Richard Marcellais

AUDITOR AND AGENCY PERSONNEL

State Auditor Personnel

Cindi Pedersen, Audit Manager
Jacqueline Ressler, In-Charge
Michael Schmitcke
Kristi Morlock

Primary State Agency Contacts

Randy Miller, Director
Mathias Anderson, Acct/Bdgt Spec. III

Contents

<i>Independent Auditor’s Report</i>	<i>1</i>
<i>Management’s Discussion and Analysis</i>	<i>4</i>
<i>Financial Statements</i>	<i>9</i>
<i>Statement of Net Position</i>	<i>9</i>
<i>Statement of Revenues, Expenses, and Changes in Net Position</i>	<i>10</i>
<i>Statement of Cash Flows</i>	<i>11</i>
<i>Notes to the Financial Statements</i>	<i>13</i>
<i>Required Supplementary Information</i>	<i>29</i>
<i>Notes to the Required Supplementary Information</i>	<i>30</i>
<i>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</i>	<i>31</i>
<i>Special Comments Requested by the Legislative Audit and Fiscal Review Committee</i>	<i>33</i>
<i>Governance Communications</i>	<i>36</i>



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 Doug Burgum, 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, 2017 and 2016, and the related notes to the 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, 2017 and 2016, 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, 2017 or 2016, 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.

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 and the Schedule of Employer's Share of Net Pension Liability and the Schedule of Employer Contributions on page 29, be presented to supplement the basic financial statements. Such information, although not a part of the 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 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 March 22, 2018, 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.

Joshua C. Gallion
State Auditor

Bismarck, North Dakota

March 22, 2018

Management's Discussion and Analysis

For the Fiscal Years Ended June 30, 2017 and 2016

The Management's Discussion and Analysis is an overview of the Lottery's financial activity for the fiscal year ended June 30, 2017, and comparative data for 2016 and 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 division.

Understanding the Lottery's Financial Statements

The Lottery 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.

One of the Lottery's statutory requirements is to 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 reserve funds the division may need for continued 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 \$113 million in prizes and Lottery retailers earned over \$16.8 million in sales and bonus commissions. In addition, the Lottery contributed \$84.7 million to the general fund, along with \$3 million to the Compulsive Gambling Prevention and Treatment Fund, and \$4.2 million to the Multi-Jurisdictional Drug Task Force Grant Fund.

The Lottery's ticket sales for the fiscal year ended June 30, 2017 were \$27,620,258 as compared to \$35,624,903 for the fiscal year ended June 30, 2016. This reflects an \$8,004,645 or 22.4% decrease in ticket sales. The decrease was primarily due to the Powerball jackpot run that peaked at \$1.5 billion in January 2016.

The Wild Card 2 game ended by the mutual consent of all four participating state lotteries, due to the declining popularity of the game in some of the participating jurisdictions. The final draw for Wild Card 2 was on February 24, 2016.

The Lucky for Life game launched January 31, 2016. Lucky for Life sales for fiscal years ending June 30, 2016 and 2017, totaled more than \$2.6 million and \$3.7 million, respectively.

Total prizes on winning tickets for the fiscal year ended June 30, 2017, were \$14,323,800, including prizes paid in North Dakota of \$8,735,425 and prizes paid to the MUSL to fund grand/jackpot prizes of \$6,322,655. In addition, North Dakota had expired prizes in the amount of \$734,280.

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, and contractual services.

Total operating expenses for the fiscal year ended June 30, 2017 were \$20,637,600 as compared to \$26,038,233 for the fiscal year ended June 30, 2016. This reflects a \$5,400,634 or 20.7% decrease in total operating expenses. The decrease was primarily due to the high prize expenses incurred due to the historical Powerball jackpot run during fiscal year ended June 30, 2016, along with the incremental relationship in sales for retailer commissions and contractual services.

Income before transfers earned for the fiscal year ended June 30, 2017, was \$7,109,886. The total transfer of funds equated to \$6,942,500. Of that amount, \$320,000 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 \$6,200,000, which was transferred to the state general fund.

- By law, effective July 1, 2015, \$80,000 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, 2017 was \$1,069,499. This reflects a \$167,387 or a 18.5% increase in total net position compared to the fiscal year ended June 30, 2016. \$1,116,172 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. Each year in mid to late July, the transfer to the state general fund is estimated. Therefore, the Lottery's net assets will increase or decrease depending on the amount transferred compared to the Lottery's net proceeds. This year the general fund transfer calculation resulted in an increase of the final balance of the unrestricted net position.

Overview of the Financial Statements

Statement of Net Position Summary:

	<u>6/30/2017</u>	<u>6/30/2016</u>	<u>6/30/2015</u>
Assets:			
Total Current Assets	\$ 7,674,116	\$ 11,496,579	\$ 8,327,552
Total Noncurrent Assets	1,122,669	1,036,347	1,144,711
Total Assets:	<u>\$ 8,796,785</u>	<u>\$ 12,532,926</u>	<u>\$ 9,472,263</u>
Deferred Outflows of Resources			
Deferred Outflows - Pension	\$ 200,017	\$ 54,672	\$ 53,451
Liabilities:			
Total Current Assets	\$ 7,263,700	\$ 11,145,067	\$ 7,442,451
Total Noncurrent Assets	627,492	490,097	480,139
Total Liabilities:	<u>\$ 7,891,192</u>	<u>\$ 11,635,164</u>	<u>\$ 7,922,590</u>
Deferred Inflows of Resources			
Deferred Inflows - Pension	\$ 36,111	\$ 50,322	\$ 81,530
Net Position:			
Net Investment in Capital Assets	\$ 6,497	\$ 9,450	\$ 14,418
Restricted	1,116,172	1,026,897	1,130,293
Unrestricted	(53,170)	(134,235)	378,883
Total Net Position	<u>\$ 1,069,499</u>	<u>\$ 902,112</u>	<u>\$ 1,523,594</u>

Statement of Changes in Net Position Summary:

	<u>6/30/2017</u>	<u>6/30/2016</u>	<u>6/30/2015</u>
Revenues:			
Ticket Sales	\$ 27,620,258	\$ 35,624,903	\$ 27,010,263
Other Operating Revenue	124,318	111,557	201,747
Total Revenues:	<u>\$ 27,744,576</u>	<u>\$ 35,736,460</u>	<u>\$ 27,212,010</u>
Expenses:			
Prizes	\$ 14,323,800	\$ 18,323,305	\$ 13,978,818
Retailer Commission	1,338,697	1,748,440	1,329,373
Retailer Bonuses	44,900	70,900	39,750
Other Operating Expenses	4,930,202	5,895,588	5,011,847
Total Expenses:	<u>\$ 20,637,599</u>	<u>\$ 26,038,233</u>	<u>\$ 20,359,788</u>
Nonoperating Revenues	\$ 2,910	\$ 2,791	\$ 2,371
Income Before Transfers	\$ 7,109,887	\$ 9,701,018	\$ 6,854,593
Transfers to Other Funds	(6,942,500)	(10,322,500)	(6,722,500)
Increase (Decrease) in Net Position	<u>\$ 167,387</u>	<u>\$ (621,482)</u>	<u>\$ 132,093</u>
Net Position - Beginning of Year, as Previously Reported	\$ 902,112	\$ 1,523,594	\$ 1,837,863
GASB 68 Adjustment			(443,362)
Net Position - Beginning of Year, as Restated	<u>\$ 902,112</u>	<u>\$ 1,523,594</u>	<u>\$ 1,394,501</u>
Net Position - Ending	<u>\$ 1,069,499</u>	<u>\$ 902,112</u>	<u>\$ 1,526,594</u>

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 most other state lotteries since the constitution restricts the Lottery to multi-state online games. 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 MUSL. 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 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 2018, the Lottery plans to:

- End the Hot Lotto game;
- Launch the Lotto America game to replace Hot Lotto;
- Re-launch the Mega Millions game with new features;
- Launch the mobile application;
- Rebrand the campaign for subscription service (new name and logo);
- Increase subscription sales;
- Build membership in the Players Club that rewards players for their continued patronage;
- Continue to develop and conduct innovative marketing promotions and public awareness campaigns; and
- Continue to review and enhance security features to ensure the integrity and fairness of its operation.

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, 2017 and 2016

	June 30, 2017	June 30, 2016
Assets:		
Current Assets:		
Cash and Cash Equivalents	\$ 7,097,335	\$ 10,829,814
Cash at Fiscal Agent	265,192	231,669
Accounts Receivable	290,266	406,204
Prepaid Expenses	21,323	28,892
Total Current Assets	\$ 7,674,116	\$ 11,496,579
Noncurrent Assets:		
Reserves on Deposit	\$ 1,116,172	\$ 1,026,897
Equipment and Software, Net	6,497	9,450
Total Noncurrent Assets	\$ 1,122,669	\$ 1,036,347
Total Assets	\$ 8,796,785	\$ 12,532,926
Deferred Outflows of Resources		
Deferred Outflows - Pension	\$ 200,017	\$ 54,672
Liabilities:		
Current Liabilities:		
Accounts Payable	\$ 90,891	\$ 158,524
Due to Other State Funds	6,220,060	9,710,212
Accrued Payroll	74,633	71,100
Prizes Payable	602,747	897,183
Unearned Revenue	275,369	308,048
Total Current Liabilities	\$ 7,263,700	\$ 11,145,067
Noncurrent Liabilities:		
Net Pension Liability	\$ 574,007	\$ 427,838
Compensated Absences Payable	53,485	62,259
Total Noncurrent Liabilities	\$ 627,492	\$ 490,097
Total Liabilities	\$ 7,891,192	\$ 11,635,164
Deferred Inflows of Resources		
Deferred Inflows - Pension	\$ 36,111	\$ 50,322
Net Position:		
Net Investment in Capital Assets	\$ 6,497	\$ 9,450
Restricted	1,116,172	1,026,897
Unrestricted	(53,170)	(134,235)
Total Net Position	\$ 1,069,499	\$ 902,112

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, 2017 and 2016

	<u>June 30, 2017</u>	<u>June 30, 2016</u>
Operating Revenues:		
Ticket Sales	\$ 27,620,258	\$ 35,624,903
Other Operating Revenue	124,318	111,557
Total Operating Revenues	<u>\$ 27,744,576</u>	<u>\$ 35,736,460</u>
Operating Expenses:		
Prizes	\$ 14,323,800	\$ 18,323,305
Retailer Commissions and Bonuses	1,383,597	1,819,340
Contractual Services	2,882,289	3,730,664
Players Club	325,000	325,000
Marketing	581,313	652,065
Salaries and Benefits	865,406	830,172
Operating	276,194	357,687
Total Operating Expenses	<u>\$ 20,637,599</u>	<u>\$ 26,038,233</u>
Operating Income	<u>\$ 7,106,977</u>	<u>\$ 9,698,227</u>
Nonoperating Revenues:		
Interest Income	\$ 2,910	\$ 2,992
Interest Expense		(201)
Total Nonoperating Revenues	<u>\$ 2,910</u>	<u>\$ 2,791</u>
Income Before Transfers	<u>\$ 7,109,887</u>	<u>\$ 9,701,018</u>
Transfers to Other Funds:		
Compulsive Gambling Fund	\$ 320,000	\$ 320,000
Multi-Jurisdictional Drug Task Force	422,500	422,500
State General Fund	6,200,000	9,580,000
Total Transfers to Other Funds	<u>\$ 6,942,500</u>	<u>\$ 10,322,500</u>
Change in Net Position	<u>\$ 167,387</u>	<u>\$ (621,482)</u>
Total Net Position- Beginning of Year	<u>\$ 902,112</u>	<u>\$ 1,523,594</u>
Total Net Position- End of Year	<u>\$ 1,069,499</u>	<u>\$ 902,112</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, 2017 and 2016

	<u>June 30, 2017</u>	<u>June 20, 2016</u>
Cash Flows from Operating Activities:		
Ticket Sales	\$ 20,332,851	\$ 27,132,163
Other Revenues	97,059	96,543
Paid to Prize Winners	(2,516,086)	(8,074,766)
Paid to Vendors	(10,352,712)	(7,918,133)
Paid to Employees	(884,035)	(849,849)
Payments to MUSL Prize Reserve	(147,625)	(44,735)
Funds Received from MUSL Prize Reserve	58,350	148,131
Net Cash Provided by Operating Activities	<u>\$ 6,587,802</u>	<u>\$ 10,489,354</u>
Cash Flows from Noncapital Financing Activities:		
Proceeds from Noncapital Debt		\$ 600,000
Principal paid on Noncapital Debt		(600,000)
Interest paid on Noncapital Debt		(201)
Transferred to Compulsive Gambling Treatment Fund	\$ (320,000)	(320,000)
Transferred to Multi-Jurisdictional Drug Task Force Fund	(422,500)	(422,500)
Transferred to State General Fund	(9,580,000)	(6,100,000)
Net Cash Used in Noncapital Financing Activities	<u>\$ (10,322,500)</u>	<u>\$ (6,842,701)</u>
Cash Flows from Capital and Related Financing Activities:	<u>\$ 0</u>	<u>\$ 0</u>
Cash Flows from Investing Activities:		
Interest Income	\$ 2,219	\$ 2,559
Net Cash Provided by Investing Activities	<u>\$ 2,219</u>	<u>\$ 2,559</u>
Cash and Cash Equivalents at Beginning of Year	<u>\$ 10,829,814</u>	<u>\$ 7,180,602</u>
Cash and Cash Equivalents at End of Year	<u><u>\$ 7,097,335</u></u>	<u><u>\$ 10,829,814</u></u>

(continued)

Statement of Cash Flows – Continued

	<u>June 30, 2017</u>	<u>June 30, 2016</u>
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating Income	\$ 7,106,977	\$ 9,698,227
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation	2,953	4,968
Changes in Assets and Liabilities:		
(Increase) Decrease in Cash at Fiscal Agent	(33,523)	149,868
(Increase) Decrease in Accounts Receivable	115,864	359,272
(Increase) Decrease in Prepaid Expenses	7,569	(28,892)
(Increase) Decrease in Reserves on Deposit	(88,510)	103,766
(Increase) Decrease in Deferred Outflows	(145,345)	(1,221)
Increase (Decrease) in Accounts Payable	(67,633)	(193,850)
Increase (Decrease) in Due to Other State Funds	(110,152)	116,404
Increase (Decrease) in Accrued Payroll	3,533	2,794
Increase (Decrease) in Prizes Payable	(294,436)	527,922
Increase (Decrease) in Deferred Revenue	(32,679)	(228,654)
Increase (Decrease) in Net Pension Liability	146,169	10,171
Increase (Decrease) in Compensated Absences Payable	(8,774)	(213)
Increase (Decrease) in Deferred Inflows – Pension	(14,211)	(31,208)
Total Adjustments	<u>\$ (519,175)</u>	<u>\$ 791,127</u>
Net Cash Provided by Operating Activities	<u>\$ 6,587,802</u>	<u>\$ 10,489,354</u>
Noncash Transactions:		
Interest Revenue on Prize Reserves	\$ 765	\$ 370
Total Noncash Transactions	<u>\$ 765</u>	<u>\$ 370</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, 2017 and 2016

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 revenues 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 ticket sales netted with prize expense, player account withdrawals, discounts and bank fees. As of June 30, 2017 and 2016, the balance was \$265,192 and \$231,669, respectively.

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, 2017, the Lottery has \$1,116,172 on deposit with MUSL related to the Prize Reserve Pools and Unreserved Account as compared to \$1,026,897 at June 30, 2016. 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 was \$21,323 of prepaid expenses at June 30, 2017, as compared to \$28,892 at June 30, 2016.

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. Prize expense also includes the net prize expense paid to MUSL according to the prize pool rates and game terms disclosed in the Multi-State Lottery Association note to the financial statements.

Prizes payable is the difference between the amounts of prize expense recognized (won) and actual prizes paid (claimed). The Lottery began to include the portion of prize expense payable to MUSL in prizes payable as of July 1, 2016. This change on the statement of net position prizes payable category will more directly reflect the activity in prize expense. Prior to July 1, 2016 prize expense payable to MUSL was reported as accounts payable.

Players may redeem winning tickets for up to 180 days after the draw. As of June 30, 2017 and 2016, unclaimed prizes were \$602,747 and \$897,183, respectively. Prizes that expired during fiscal years ended June 30, 2017 and 2016 were \$734,280 and \$449,431, respectively.

Unearned Revenue

A liability has been recorded for lottery tickets, multi-draw tickets and for subscription sales for draws that will occur after June 30, 2017 and 2016, respectively. The amount related to future ticket sales on multi-draw tickets as of June 30, 2017 and 2016 were \$142,789 and \$188,887, respectively. The amount for future sales on subscriptions as of June 30, 2017 and 2016 were \$98,777 and \$92,407, respectively.

Sales of uncashed gift certificates for fiscal years ended June 30, 2017 and 2016 were \$6,113 and \$5,932, respectively, and are also classified as unearned revenue. Sales of uncashed play central terminal (PCT) vouchers for fiscal years ended June 30, 2017 and 2016 were \$27,690 and \$20,822, respectively and are also classified as unearned revenue.

Interfund Balances and Transfers

At June 30, 2017, 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 statute, 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 division 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. Prior to July 1, 2015, state law required \$50,000 be transferred to the State Treasurer each quarter for deposit in the Compulsive Gambling Prevention and Treatment Fund. Beginning July 1, 2015, by statute, \$80,000 must be transferred to the State Treasurer each quarter for deposit in the Compulsive Gambling Prevention and Treatment Fund. By statute, \$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 division are required to be transferred to 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, 2017 and 2016 were \$1,383,597 and \$1,819,340, including bonus commissions of \$44,900 and \$70,900, 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 a part of 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 will not be recognized as an inflow of resources (revenue) until that time.

Note 2. 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, 2017 and 2016 include \$7,097,335 and \$10,829,814, 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 3. Compensated Absences

A summary of compensated absences follows for 2017 and 2016:

Balance July 1, 2016	\$ 62,259
Addition	0
Reduction	(8,774)
Balance June 30, 2017	<u>\$ 53,485</u>
Amount payable within one year	<u>\$ 0</u>
Balance July 1, 2015	\$ 62,472
Addition	
Reduction	(213)
Balance June 30, 2016	<u>\$ 62,259</u>
Amount payable within one year	<u>\$ 0</u>

Note 4. Due to Other State Funds

At June 30, 2017 and 2016, accounts payable due to several state agencies and transfers of net proceeds due to the state general fund are:

	<u>June 30, 2017</u>	<u>June 30, 2016</u>
Due to the Department of Transportation	\$ 651	\$ 1,183
Due to the Information Technology Department	2,452	4,440
Due to the Office of Management and Budget	483	85
Due to the Office of the Secretary of State		36
Due to the Office of State Tax Commissioner	16,474	124,468
Due to the state General Fund	<u>6,200,000</u>	<u>9,580,000</u>
Total	<u>\$ 6,220,060</u>	<u>\$ 9,710,212</u>

Note 5. Equipment and Software

A summary of changes in equipment, software, and accumulated depreciation is as follows for 2017 and 2016:

	<u>Equipment</u>	<u>Software</u>	<u>Accumulated Depreciation</u>	<u>Net</u>
Balance, June 30, 2016	\$ 53,113	\$ 32,000	\$ 75,663	\$ 9,450
Additions			2,953	(2,953)
Disposals				
Balance, June 30, 2017	<u>\$ 53,113</u>	<u>\$ 32,000</u>	<u>\$ 78,616</u>	<u>\$ 6,497</u>

	<u>Equipment</u>	<u>Software</u>	<u>Accumulated Depreciation</u>	<u>Net</u>
Balance, June 30, 2015	\$ 53,113	\$ 32,000	\$ 70,695	\$ 14,418
Additions			4,968	(4,968)
Disposals				
Balance, June 30, 2016	<u>\$ 53,113</u>	<u>\$ 32,000</u>	<u>\$ 75,663</u>	<u>\$ 9,450</u>

Note 6. 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. Effective July 1, 2015, the board was expanded to include two members of the legislative assembly appointed by the chairman of the legislative management.

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). For members hired on or after January 1, 2016, the Rule of 85 will be replaced with the Rule of 90 with a minimum age of 60. The monthly 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.

Member and Employer Contributions

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

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 24 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

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

At fiscal years ending June 30, 2017 and 2016, the North Dakota Lottery reported a liability of \$574,007 and \$427,838, respectively for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2016 and June 30, 2015, respectively, 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 July 1, 2016 the North Dakota Lottery's proportion was 0.058897%, which was a decrease of 0.004022% from its proportion measured as of July 1, 2015, which was 0.062919%.

For the years ended June 30, 2017 and 2016, the North Dakota Lottery recognized pension expense of (\$13,387) and (\$22,258), respectively. At June 30, 2017, the North Dakota Lottery reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual experience	\$ 8,623	\$ 5,315
Changes of assumptions	52,916	28,516
Net difference between projected and actual earnings on pension plan investments	80,082	
Changes in proportion and difference between employer contributions and proportionate share of contributions	14,786	2,280
Employer contributions subsequent to the measurement date (see below)	43,610	
Total	<u>\$ 200,017</u>	<u>\$ 36,111</u>

The \$43,610 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, 2018.

At June 30, 2016 the North Dakota Lottery reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Differences between expected and actual experience	\$ 12,412	
Changes of assumptions		\$ 38,118
Net difference between projected and actual earnings on pension plan investments		9,032
Changes in proportion and difference between employer contributions and proportionate share of contributions		3,172
Employer contributions subsequent to the measurement date (see below)	42,260	
Total	<u>\$ 54,672</u>	<u>\$ 50,322</u>

The \$42,260 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, 2017.

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:	
2018	\$ (21,895)
2019	(21,895)
2020	(39,364)
2021	(26,136)
2022	(11,006)
Thereafter	0

Actuarial assumptions

The total pension liability in the July 1, 2016 actuarial valuation was determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.50%
Salary increases	4.50% per annum
Investment rate of return	8.00% net of investment expenses
Cost-of-living adjustments	None

The total pension liability in the July 1, 2015 actuarial valuation was determined using the following actuarial assumptions, applied to all periods included in the measurement:

Inflation	3.50%
Salary increases	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 set back two years for males and three years for females, projected generationally using the SSA 2014 Intermediate Cost scale from 2014. For disabled retirees, mortality rates were based on the RP-2000 Disabled Mortality Table set back one year for males (no setback for females) multiplied by 125%.

The actuarial assumptions used were based on the results of an actuarial experience study completed in 2015. They are the same as the assumptions used in the July 1, 2016 and 2015, funding actuarial valuations for NDPERS, respectively.

As a result of the 2015 actuarial experience study, the NDPERS Board adopted several changes to the actuarial assumptions effective July 1, 2015. This includes changes to the mortality tables, disability incidence rates, retirement rates, administrative expenses, salary scale, and percent married assumption.

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 as of June 30, 2016 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%	1.52%
International Fixed Income	5%	0.45%
Global Real Assets	20%	5.38%
Cash Equivalents	1%	0.00%

Best estimates of arithmetic real rates of return for each major asset class included in the Fund's target asset allocation as of June 30, 2015 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%	1.52%
International Fixed Income	5%	45.00%
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 percent as of June 30, 2016 and 2015, respectively. 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, 2016 and 2015, Actuarial Valuation Report, respectively. 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, 2016 and 2015, respectively. 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, 2016 and 2015, respectively.

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 as of June 30, 2017, 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	\$814,218	\$574,007	\$371,617

The following presents the employer's proportionate share of the net pension liability as of June 30, 2016, 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	\$656,068	\$427,838	\$241,104

Pension Plan Fiduciary Net Position

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

Note 7. Multi-State Lottery Association

The Lottery is a member of 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, 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% and 66% after the free tickets as of June 30, 2017 and 2016, respectively. 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 are 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:

	<u>June 30, 2017</u>	<u>June 30, 2016</u>
MUSL prize reserve pool account	\$ 162,284,980	\$ 157,414,163
Lottery's share of the MUSL prize reserve pool account (on deposit)	\$ 967,517	\$ 981,858

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 Lottery board and game group dues and other MUSL related expenses may be paid from this fund.

	<u>June 30, 2017</u>	<u>June 30, 2016</u>
MUSL unreserved account	\$ 15,316,619	\$ 16,259,687
Lottery's share of the MUSL's unreserved account	\$ 148,655	\$ 45,040

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 prize 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, 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 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 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, 2017, and 2016, 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.

During fiscal year ended June 30, 2016, the Lottery was licensed to begin selling the Lucky for Life game as offered by the group of lotteries known as the New England Lotteries. The New England Lotteries consists of the Connecticut Lottery Corporation, the Main State Liquor & Lottery Commission, the Massachusetts State Lottery Commission, the New Hampshire Lottery Commission, the Rhode Island Division of Lotteries and the Vermont Lottery Commission.

Lucky for Life is a double matrix-style game, drawn each Monday and Thursday, in which players select five (5) unique numbers in the Matrix 1 from one (1) to forty-eight (48) inclusive, plus one

(1) Lucky Ball number in the Matrix 2 from one (1) to eighteen (18) inclusive. There are 10 prize levels ranging from the top prize of \$7,000 per week for life and the second prize of \$25,000 per year for life to the minimum low-tier prize of \$4. The top prize and second prize may be paid at the cash value or as an annuity. All low-tier prizes (all prizes except the top prize and second prize) are paid in one single cash payment.

The Lottery is responsible for the purchase of an insurance annuity or other financial instrument to fully fund the respective annuitized prize won in North Dakota. The Lottery has contracted MUSL to purchase annuities following a claim of a lifetime prize that requires the acquisition of an annuity. The Lottery is currently not paying any prize winner annuity prize payments.

The Lottery is assessed dues quarterly in proportion to the Lottery's percentage of game sales to pay for operating expenses incurred during the assessed quarter. The Lottery is required to engage an independent auditor to perform agreed upon procedures each year for the one year period ending March 31st completed within 180 calendar days of March 31st and distributed to the all participating lotteries. MUSL is contracted by the New England Lotteries as the Lucky for Life game administrator. The Lottery launched Lucky for Life on January 31, 2016.

On February 24, 2016, the Wild Card 2 game ended due to the declining popularity of the game in some of the participating jurisdictions.

Note 8. Commitments and Contingencies

The Lottery entered into contracts with:

1. Scientific Games International, Inc. (SGI) of Alpharetta, GA provides an online lottery gaming system; retailer network including retailer training, communications, equipment, ticket stock and management; and full a service internet lottery subscription service. The contract was signed on February 19, 2014 with an operations date of July 6, 2014 and shall continue through June 30, 2022.

Payments for the fiscal years ended June 30, 2017 and 2016 totaled \$2,882,289 and \$3,730,664, respectively based on 10.473% of ticket sales. The Lottery's future obligation through June 30, 2022 is based on 10.473% of ticket sales. Additionally, SGI is paid an annual minimum fee of \$325,000 to provide the Player's Club Points for Prizes program. In addition, SGI provides other products and services for which the Lottery pays various contracted fees. The total fees paid to SGI for all services for the fiscal years ended June 30, 2017 and 2016 were \$3,207,289 and \$4,055,664, respectively.

2. KKBold of Bismarck, ND provides marketing and related services, and their contract runs from July 1, 2012, through June 30, 2017. Payments for the fiscal years ended June 30, 2017, and 2016 totaled \$485,540 and \$544,801, 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, 2017, this contract expired and a new marketing and related services contract was competitively bid. The new contract was awarded to KKBold with a term from July 1, 2017 through June 30, 2020.

The Lottery has a contingent gain estimated at \$195,638 on June 30, 2017, 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. The contingent gain at June 30, 2016 was \$426,642.

Note 9. 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 MUSL. The line of credit may not exceed \$1 million in the aggregate. Short-term debt activity for the year fiscal years ending June 30, 2017 and 2016 were as follows:

Balance July 1, 2016 <u>\$ 1,000,000</u>	Draws <u>\$ -</u>	Repayments <u>\$ -</u>	Balance June 30, 2017 <u>\$ 1,000,000</u>
Balance July 1, 2015 <u>\$ 1,000,000</u>	Draws <u>\$ 600,000</u>	Repayments <u>\$ (600,000)</u>	Balance June 30, 2016 <u>\$ 1,000,000</u>

Note 10. 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 office contents. 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 at this point.

Note 11. 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, 2017, 2016 and 2015 were \$6,980, \$6,766 and \$6,390, respectively.

Note 12. Lease Commitments

The North Dakota Lottery entered into an operating lease for its office space at 1050 E Interstate Ave – Suite 200, Bismarck, ND 58503-5574. Lease expenditures for the fiscal year ended June 30, 2017 and 2016 totaled \$50,464 and \$50,464, respectively. The lease expires on June 30, 2017. A new operating lease was signed with a term that runs July 1, 2017 through June 30, 2021. The future annual rental commitments are as follows:

Lease Commitments June 30, 2017:		Lease Commitments June 30, 2016:	
<u>Years Ending</u>		<u>Years Ending</u>	
2018	\$ 50,464	2017	\$ 50,464
2019	50,464		
2020	52,489		
2021	52,489		
Total	<u>\$ 205,906</u>	Total	<u>\$ 50,464</u>

Required Supplementary Information

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

	2017	2016	2015
Employer's proportion of the net pension liability (asset)	.588970%	.062919%	.065803%
Employer's proportionate share of the net pension liability (asset)	\$ 574,007	\$ 427,838	\$ 417,667
Employer's covered-employee payroll	\$ 593,541	\$ 560,531	\$ 554,314
Employer's proportionate share of the net pension liability (asset) as a percentage of its covered-employee payroll	96.71%	76.33%	75.35%
Plan fiduciary net position as a percentage of the total pension liability	70.46%	77.15%	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*

	2017	2016	2015
Statutorily required contribution	\$ 42,972	\$ 42,577	\$ 39,467
Contributions in relation to the statutorily required contribution	\$ (43,789)	\$ (42,514)	\$ (39,467)
Contribution deficiency (excess)	\$ (817)	\$ 63	
Employer's covered-employee payroll	\$ 593,541	\$ 560,531	\$ 554,314
Contributions as a percentage of covered-employee payroll	7.38%	7.60%	7.12%

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

**Notes to the Required Supplementary Information
For the Fiscal Years Ended June 30, 2017 and 2016**

Changes of assumptions

Amounts reported in 2017 reflect actuarial assumption changes effective July 1, 2016, based on the results of an actuarial experience study completed in 2015. This includes changes to the mortality tables, disability incidence rates, retirement rates, administrative expenses, salary scale, and percent married assumption.



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 Doug Burgum, 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, 2017, and the related notes to the financial statements, which collectively comprise the North Dakota Lottery’s financial statements, and have issued our report thereon dated March 22, 2018.

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.

Joshua C. Gallion
State Auditor

Bismarck, North Dakota

March 22, 2018

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.

No.

LAFRC Audit Communications

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

None noted.

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

Governance Communications

March 22, 2018

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, 2017, and have issued our report thereon dated March 22, 2018. 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.

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 March 22, 2018.

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.

There were no formal or informal recommendations made in this audit.

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.

Sincerely,

Cindi Pedersen, CPA

Cindi Pedersen, CPA
Audit Manager

You may obtain audit reports on the internet at:

www.nd.gov/auditor/

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