KPMG

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Financial Audit

For the Years Ended June 30, 2013 and 2012

Performed as Special Assistant Auditors
for the Auditor General, State of Illinois

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Table of Contents

AGENCY OFFICIALS

Director	Michael Jones – effective October 10, 2011 (confirmed by Illinois State Senate February 8, 2012) Victor Golden (Acting) – July 1, 2011 to October 9, 2011
Deputy Director	Victor Golden – effective July 1, 2011
Chief of Staff	Sara Barnett – effective January 17, 2012 Vacant – July 1, 2011 to January 16, 2012
Chief Financial Officer	Brett Finley (Acting) – August 9, 2013 James Scroggins – April 2, 2012 to July 31, 2013 Vacant – July 1, 2011 to April 1, 2012
Chief Operations Officer	Harold Mays – effective January 16, 2013 Michele Eichhorn (Acting) – July 1, 2011 to January 9, 2013
General Counsel	Daymon Ruttenberg – effective November 11, 2012 Agostino Lorenzini – February 14, 2012 to September 10, 2012 Vacant – July 1, 2011 to February 13, 2012
Chief Internal Auditor	Melinda Westwater – effective June 16, 2013 Shelly Banks – September 17, 2012 to May 5, 2013

Agency offices are located at:

101 West Jefferson Street
Springfield, Illinois 62702

122 South Michigan Avenue, 19th floor
Chicago, Illinois 60603

FINANCIAL STATEMENT REPORT

SUMMARY

The audit of the accompanying basic financial statements of the State of Illinois Department of the Lottery (Department) was performed by KPMG LLP.

Based on their audit, the auditors expressed an unmodified opinion on the Department's basic financial statements.

SUMMARY OF FINDINGS

The auditors identified matters involving the Department's internal control over financial reporting that they considered to be material weaknesses. The material weaknesses are described in the accompanying Schedule of Findings as findings 2013-001 and 2013-002.

Finding No.	Page No.	Description	Finding Type
2013-001	29	Weaknesses in Preparation of Accurate GAAP Reporting Forms submitted to the Illinois Office of the Comptroller and Preparation of Year-End Department Financial Statements	Material weakness
2013-002	32	Weaknesses in the General IT Control Environment over Key Systems	Material weakness

EXIT CONFERENCE

The Department elected to waive a formal exit conference.

The responses to the recommendations were provided by Brett Finley, Acting Chief Financial Officer, in an e-mail dated February 26, 2014.

KPMG

KPMG LLP
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Suite 5500
200 East Randolph Drive
Chicago, IL 60601-6436

Independent Auditors' Report

Honorable William G. Holland
Auditor General
State of Illinois

Report on the Financial Statements

As Special Assistant Auditors for the Auditor General, we have audited the accompanying basic financial statements of the State of Illinois Department of the Lottery (the Department), as of and for the years ended June 30, 2013 and 2012, and the related notes to the financial statements, which collectively comprise the Department'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 U.S. generally accepted accounting principles; 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.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

KPMG LLP is a Delaware limited liability partnership, the U.S. member firm of KPMG International Cooperative ("KPMG International"), a Swiss entity.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Department as of June 30, 2013 and 2012, and the changes in financial position, cash flows thereof for the years then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of Matter

As discussed in Note 2(a), the financial statements of the Department are intended to present the financial position, the changes in financial position and, where applicable, cash flows of only that portion of the business-type activities of the State of Illinois that is attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of the State of Illinois as of June 30, 2013 and 2012, and the changes in its financial position or, where applicable, its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

Other Matters

Required Supplementary Information

Management has omitted a management's discussion and analysis that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing 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 basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

Supplementary and Other Information

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Department's basic financial statements. The supplementary information as listed in the table of contents is presented for purposes of additional analysis and is not a required part of the basic financial statements.

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

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated February 27, 2014 on our consideration of the Department's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and 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 Department's internal control over financial reporting and compliance.

KPMG LLP

Chicago, Illinois
February 27, 2014

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY
Statements of Net Position
June 30, 2013 and 2012
(In thousands of dollars)

Assets		2013		2012
Current assets:				
Cash and cash equivalents	$	18,279	$	13,024
Cash equity in State Treasury		117,608		141,986
Investments, short-term		48,667		58,064
Accounts receivable, net of allowance of $11,367 and $8,485		24,910		22,106
Private management contract receivable, net of provision of $21,776 and $0		40,000		—
Other receivables		13,710		—
Total current assets		263,174		235,180
Noncurrent assets:				
Investments		264,600		302,031
Capital assets being depreciated, net		238		229
Total noncurrent assets		264,838		302,260
Total assets		528,012		537,440
Liabilities				
Current liabilities:				
Prizes payable		150,698		151,565
Accounts payable and accrued liabilities		52,454		34,679
Due to other Government – Federal		109		27
Due to other State funds		44,449		18,624
Unearned revenue		4,769		5,427
Other liabilities		1,193		1,113
Current portion of long-term annuity prizes payable		47,917		57,110
Total current liabilities		301,589		268,545
Noncurrent liabilities:				
Noncurrent portion of long-term annuity prizes payable		225,166		243,609
Noncurrent other		882		920
Total noncurrent liabilities		226,048		244,529
Total liabilities		527,637		513,074
Net Position				
Invested in capital assets		238		229
Unrestricted		137		24,137
Total net position	$	375	$	24,366

The accompanying notes to the financial statements are an integral part of these statements.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Statements of Revenues, Expenses, and Changes in Net Position

For the years ended June 30, 2013 and 2012

(In thousands of dollars)

	2013	2012
Operating revenues:		
Charges for sales and services	$ 2,832,576	$ 2,676,996
Private management contract fee	61,776	—
Other	8,006	5,378
Total operating revenues	2,902,358	2,682,374
Operating expenses:		
Cost of sales and services	163,966	151,421
Prizes and claims	1,743,686	1,620,405
General and administrative	153,731	152,210
Provision for private management contract fee	21,776	—
Depreciation	99	107
Total operating expenses	2,083,258	1,924,143
Operating income	819,100	758,231
Nonoperating revenues (expenses):		
Investment income	(9,354)	37,633
Interest expense	(14,347)	(17,192)
Total nonoperating revenues (expenses), net	(23,701)	20,441
Change in net position before transfers	795,399	778,672
Transfers to other State funds	(819,390)	(758,236)
Change in net position	(23,991)	20,436
Net position at beginning of year	24,366	3,930
Net position at end of year	$ 375	$ 24,366

The accompanying notes to the financial statements are an integral part of these statements.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Statements of Cash Flows

For the years ended June 30, 2013 and 2012

(In thousands of dollars)

	2013	2012
Cash flows from operating activities:		
Cash received from sales and services	$ 2,829,114	$ 2,669,984
Cash receipts from other operating activities	7,878	5,351
Cash payments for commissions and bonuses	(163,966)	(151,421)
Cash payments for general and administrative expenses	(149,609)	(123,459)
Cash payments for lottery prizes	(1,728,257)	(1,561,172)
Net cash provided by operating activities	795,160	839,283
Cash flows from noncapital financing activities:		
Cash transfers-out to other funds	(793,546)	(708,477)
Net cash used in noncapital financing activities	(793,546)	(708,477)
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(108)	(71)
Net cash used in capital and related financing activities	(108)	(71)
Cash flows from investing activities:		
Interest and dividends on investments	289	11
Purchase of investments	(20,918)	(19,814)
Proceeds from investment maturities	58,048	68,653
Cash paid for long-term annuity prizes payable	(58,048)	(68,653)
Net cash used in investing activities	(20,629)	(19,803)
Net increase (decrease) in cash and cash equivalents	(19,123)	110,932
Cash and cash equivalents at beginning of year	155,010	44,078
Cash and cash equivalents at end of year	$ 135,887	$ 155,010
Reconciliation of cash and cash equivalents to the statement of net position:		
Total cash and cash equivalents per the statement of net position	$ 18,279	$ 13,024
Add: Cash equity in State Treasury	117,608	141,986
Cash and cash equivalents at end of year	$ 135,887	$ 155,010

(Continued)

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Statements of Cash Flows

For the years ended June 30, 2013 and 2012

(In thousands of dollars)

	2013	2012
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 819,100	$ 758,231
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	99	107
Provision for uncollectible accounts	2,882	779
Provision for private management contract fee	21,776	—
Changes in assets and liabilities:		
Increase in accounts receivable	(5,686)	(9,523)
Increase in other receivables	(13,710)	—
Increase in private management contract receivable	(61,776)	—
Decrease in inventory	—	248
Decrease in prepaid expenses	—	120
Increase (decrease) in prizes payable	(885)	39,011
Increase in accounts payable and accrued liabilities	17,775	28,953
Increase in intergovernmental payables	82	27
Increase (decrease) in unearned revenues	(658)	1,642
Increase (decrease) in other liabilities	80	(257)
Increase in long-term annuity prizes payable	16,119	19,814
Increase (decrease) in noncurrent other liabilities	(38)	131
Net cash provided by operating activities	$ 795,160	$ 839,283
Noncash investing, capital and financing activities:		
Increase (decrease) in unrealized gains on investments	$ (23,991)	$ 20,436
Interest accreted on investments	14,342	17,186
Interest accretion on long-term annuity prizes payable	(14,342)	(17,186)
Transfer of assets to other State funds	—	(4)

The accompanying notes to the financial statements are an integral part of these statements.

(1) Organization

The Department of the Lottery (the Department) is a part of the executive branch of government of the State of Illinois (State) and operates under the authority of and reviews by the Illinois General Assembly. The Department operates under a budget approved by the General Assembly in which resources primarily from the State Lottery Fund are appropriated for the use of the Department. Activities of the Department are subject to the authority of the Office of the Governor, the State's chief executive officer, and other departments of the executive and legislative branches of government (such as the Department of Central Management Services, the Governor's Office of Management and Budget, the State Treasurer's Office, and the State Comptroller's Office) as defined by the Illinois General Assembly. All funds appropriated to the Department and all other cash received are under the custody and control of the State Treasurer, with the exception of the security deposits for Lottery agents.

Effective October 15, 2011, the Department of Revenue transferred all functions performed for the Illinois Lottery and all associated powers, duties, rights and responsibilities to the Department in accordance with Public Act 97-0464. As a means of easing the transition of accounting records between the entities, management elected to use an effective transition date of July 1, 2011. Accordingly, these financial statements include all of fiscal year 2012 activity for the funds administered by the Department of the Lottery. The transfer has been reflected as a restatement of July 1, 2011 net position in the accompanying financial statements.

The Department is organized to provide for administering and overseeing the operations of the Illinois Lottery with the assistance of a private manager under a management agreement.

Financial Reporting Entity

As defined by U.S. generally accepted accounting principles (GAAP), the financial reporting entity consists of a primary government, as well as its component units, which are legally separate organizations for which the elected officials of the primary government are financially accountable. Financial accountability is defined as:

1) Appointment of a voting majority of the component unit's board and either (a) the primary government's ability to impose its will, or (b) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the primary government; or
2) Fiscal dependency on the primary government.

Based upon the required criteria, the Department has no component units and is not a component unit of any other entity. However, because the Department is not legally separate from the State of Illinois, the financial statements of the Department are included in the financial statements of the State of Illinois. The State of Illinois' Comprehensive Annual Financial Report may be obtained by writing to the State Comptroller's Office, Division of Financial Reporting, 325 West Adams Street, Springfield, Illinois, 62704-1871.

(2) Summary of Significant Accounting Policies

The financial statements of the Department have been prepared in accordance with GAAP, as prescribed by the Governmental Accounting Standards Board (GASB). To facilitate the understanding of data included in the financial statements, summarized below are the more significant accounting policies.

(a) Basis of Accounting and Presentation

The financial statements of the State of Illinois, Department of the Lottery, are intended to present the financial position, changes in financial position, and cash flows of only that portion of the activities of the State of Illinois that are attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of the State of Illinois as of June 30, 2013 and 2012, the changes in financial position and the cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The basic financial statements provide information about the Department’s proprietary (enterprise) fund. Proprietary fund financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded at the time liabilities are incurred, regardless of when the related cash flow takes place.

The Department of the Lottery accounts for operations of the State Lottery in which a statutorily defined amount of the net income is used for the support of the State’s Common School Fund. Any net income remaining after the required transfers to Common School Fund is transferred to the State’s Capital Projects Fund. Certain ticket sales are dedicated for other State funds prior to the determination of the net income available for transfers to the Common School Fund or the Capital Projects Fund.

(b) Cash and Cash Equivalents

Cash equivalents are defined as short-term, highly liquid investments readily convertible to cash with maturities of less than 90 days at time of purchase. Cash and cash equivalents include cash on hand and cash in banks for locally held funds.

(c) Investments

Investments are reported at fair value based on quoted market prices.

(d) Allowances and Provisions

The allowance for doubtful accounts at June 30, 2013 and 2012, is based on an analysis of the historical collection experience for accounts receivable, which considers the age of the receivable and current economic conditions.

The Department and the Private Manager participated in non-binding mediation over certain private management agreement (PMA) disputes, including the net income shortfall payment for the year ended June 30, 2012. The parties were not able to reach an agreement during the mediation. Under the PMA, the Private Manager has the option to pursue litigation related to the net income shortfall payment for the year ended June 30, 2012. As the outcome of any potential litigation is uncertain, a provision has been established for the $21.8 million net income shortfall payment for the year ended June 30, 2012.

(e) Interfund Transactions

The Department has the following types of interfund transactions between Department funds and funds of other State agencies:

Services provided and used—sales and purchases of goods and services between funds for a price approximating their external exchange value. Interfund services provided and used are reported as revenues in seller funds and expenditures or expenses in purchaser funds. Unpaid amounts are reported as interfund receivables and payables in the statements of net position.

Transfers—flows of assets (such as cash or goods) without equivalent flows of assets in return and without a requirement for repayment. Transfers are reported after nonoperating revenues and expenses.

(f) Capital Assets

Capital assets, which consist of equipment, automobiles and internally developed computer software, are reported at historical cost. Contributed assets are reported at estimated fair value at the time received. Capital assets are depreciated using the straight-line method. The capitalization threshold for capital assets is $5,000 and the estimated useful lives range from 3 to 15 years.

(g) Compensated Absences

The liability for compensated absences reported in the statements of net position consists of unpaid, accumulated vacation and sick leave balances for Department employees. The liability has been calculated using the vesting method, in which leave amounts for both employees who currently are eligible to receive termination payments and other employees who are expected to become eligible in the future to receive such payments upon termination are included. The liability has been calculated based on the employees' current salary level and includes salary related costs (e.g., social security and Medicare tax).

Legislation that became effective January 1, 1998 capped the paid sick leave for all State Employees' Retirement System members at December 31, 1997. Employees continue to accrue 12 sick days per year, but will not receive monetary compensation for any additional time earned after December 31, 1997. Sick days earned between January 1, 1984 and December 31, 1997 (with a 50 percent cash value) would only be used after all days with no cash value are depleted. Any sick days earned and unused after December 31, 1997 were converted to service time for purposes of calculating employee pension benefits.

(h) Net Position

In the statements of net position, equity is displayed in three components as applicable:

Invested in Capital Assets – This consists of capital assets, net of accumulated depreciation.

Restricted – This consists of net position that is legally restricted by outside parties or by law through constitutional provisions or enabling legislation. When both restricted and unrestricted resources are available for use, generally it is the State's policy to use restricted resources first, then unrestricted resources when they are needed. There is no restricted net position as of June 30, 2013 and 2012.

Unrestricted – This consists of net position that does not meet the definition of "restricted" or "invested in capital assets."

(i) Classification of Revenues and Expenses

The Department classifies its revenues and expenses as either operating or nonoperating in the statements of revenues, expenses, and changes in net position according to the following criteria:

Revenue

Operating revenues, such as sale of lottery tickets, result from exchange transactions associated with the principal activity of the fund. Nonoperating revenues, such as investment income, result from nonexchange transactions or ancillary activities.

Expenses

All expenses are classified as operating, except for interest expense and losses on disposal of capital assets which are classified as nonoperating.

(j) Lottery Revenue

Draw Games

Revenue from ticket sales for Lotto, Pick 3, PowerBall and other draw games is recognized when the related drawing takes place. Receipts from subscription sales and other ticket sales for future drawings are recorded as unearned revenue and will not be recognized as revenue until the related drawing takes place.

Instant Games

Revenue from instant games is recognized based on the dollar value of the total books of tickets settled. Tickets are available for sale upon being activated at the retailer locations.

(k) Prizes and Claims – Ticket Expense

Prize expense is accrued for instant game sales at a percentage equivalent to the total prizes included in all tickets printed for each game. Prize expense and prizes payable are reduced for an estimate of prizes that will go unclaimed and increased if amounts claimed exceed the amounts accrued (i.e., early redemption expense). Instant games are closed at the end of the final redemption period and any remaining net payable accrued in prior periods is reversed and recorded as a reduction to prize expense.

(l) Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(m) Current Adoption of GASB Statements

GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, was effective for the Department beginning with its year-end June 30, 2013. The objective of this statement is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in FASB pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements.

GASB Statement No. 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position,* was effective for the Department beginning with its year-end June 30, 2013. The objective of this statement is to provide financial reporting guidance for deferred outflows and inflows of resources and to rename the residual measure from "Net Assets" to "Net Position."

The Department has determined that these statements do not have a material impact on financial reporting.

(n) Future Adoption of GASB Statements

GASB Statement No. 65, *Items Previously Reported as Assets and Liabilities,* will be effective for the Department beginning with its year-end June 30, 2014. The objective of this statement is to establish accounting and financial reporting standards that reclassify, as deferred outflows of resources or deferred inflows of resources, certain items that were previously reported as assets and liabilities and recognizes, as outflows of resources or inflows of resources, certain items that were previously reported as assets and liabilities.

GASB Statement No. 68, *Accounting and Financial Reporting for Pensions,* will be effective for the Department beginning with its year-end June 30, 2015. The objective of this statement is to improve accounting and financial reporting by state and local governments for pensions.

GASB Statement No. 69, *Government Combinations and Disposals of Government Operations*, will be effective for the Department beginning with its year-end June 30, 2015. The objective of this statement is to provide specific accounting and financial reporting guidance for combinations and disposals in the governmental environment.

GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, will be effective for the Department beginning with its year-end June 30, 2014. The objective of this statement is to improve accounting and financial reporting for state and local governments that either offer or receive nonexchange financial guarantees.

The Department has determined that these statements will not have a material impact on financial reporting.

(3) Deposits and Investments

The State Treasurer is the custodian of the Department's deposits and investments for funds maintained in the State Treasury. These amounts are classified as "Cash equity in State Treasury" on the statements of net position. The Department independently manages deposits and investments maintained outside the State Treasury.

(a) Deposits

Deposits in the custody of the State Treasurer of approximately \$118 million and \$142 million as of June 30, 2013 and 2012, respectively, are pooled and invested with other State funds in accordance with the Deposit of State Moneys Act of the Illinois Compiled Statutes (15 ILCS 520/11). Funds held by the State Treasurer have not been categorized as to credit risk because the Department does not own individual securities. Details on the nature of these deposits and investments are available within the State of Illinois' Comprehensive Annual Financial Report.

Bank deposits for the enterprise funds held outside of the State Treasury of approximately \$18 million and \$13 million as of June 30, 2013 and 2012, respectively, are held in Federal Deposit Insurance Corporation (FDIC) insured depository institutions. The Department has agreements under which these institutions insure balances in excess of FDIC insurance limits from loss by pledging securities as collateral. The collateral amounts equal or exceed the excess deposit amounts.

(b) Investments

As of June 30, 2013 and 2012, the Department had the following investments outside of the State Treasury:

		2013		2012	
		Fair value (thousands)	**Weighted average maturity (years)**	**Fair value (thousands)**	**Weighted average maturity (years)**
Annuities	$	482	4.791	531	5.037
U.S. Treasury bonds		312,785	6.674	359,564	6.497
Total	$	313,267		360,095	

Interest Rate Risk: The Department does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

Credit Risk: The Department is limited to investing in direct obligations of the United States of America or backed by the full faith and credit of the United States of America. The Department's investments in annuities are not rated.

(4) Interfund Balances and Activity

(a) Balances Due from /to Other Funds

The following balances (amounts expressed in thousands) at June 30, 2013 and 2012, represent amounts due to other State funds.

		Due to other State funds		
Fund		**2013**	**2012**	**Description/Purpose**
Lottery	$	44,449	18,624	Due to other State funds for allocation of lottery proceeds.

(b) Transfers to Other Funds

The Department reports transfers out in the statements of revenues, expenses, and changes in net position, for the amounts required by statute to be transferred to the Common School Fund, Capital Projects Fund, and other State funds set forth by statute for special purposes designated lottery games. The following balances (amounts expressed in thousands) for the years ended June 30, 2013 and 2012, represent amounts transferred to other State funds:

Fund	Transfers out to Other State funds		2013	2012	Description/Purpose
Lottery	Common School	$	655,624	639,875	Transfers to Common School, Capital Projects, and other State funds pursuant to statutory requirements.
	Capital Projects		161,184	115,009	
	Other State funds		2,582	3,352	
		$	819,390	758,236	

(5) Capital Assets

Capital asset activity (amounts expressed in thousands) for the year ended June 30, 2013, was as follows:

		Balance June 30, 2012	Additions	Deletions	Net transfers	Balance June 30, 2013
Capital assets being depreciated:						
Equipment	$	1,917	108	—	(99)	1,926
Less accumulated depreciation		(1,688)	(99)	—	99	(1,688)
Total capital assets, net	$	229	9	—	—	238

Capital asset activity (amounts expressed in thousands) for the year ended June 30, 2012, was as follows:

		Balance June 30, 2011	Additions	Deletions	Net transfers	Balance June 30, 2012
Capital assets being depreciated:						
Equipment	$	2,033	71	129	(58)	1,917
Less accumulated depreciation		(1,764)	(107)	(129)	54	(1,688)
Total capital assets, net	$	269	(36)	—	(4)	229

(Continued)

(6) Long-Term Obligations

(a) Changes in Long-Term Obligations

Changes in long-term obligations (amounts expressed in thousands) for the year ended June 30, 2013 were as follows:

	Balance June 30, 2012	Additions	Deletions	Balance June 30, 2013	Amounts due within one year
Compensated absences	$ 990	717	758	949	67
Obligations to Lottery prize winners - group contracts	531	—	49	482	60
Obligations to Lottery prize winners – annuities	300,188	30,461	58,048	272,601	47,857
Total long-term obligations	$ 301,709	31,178	58,855	274,032	47,984

Changes in long-term obligations (amounts expressed in thousands) for the year ended June 30, 2012 were as follows:

	Balance July 1, 2011	Additions	Deletions	Balance June 30, 2012	Amounts due within one year
Compensated absences	$ 1,416	502	928	990	70
Obligations to Lottery prize winners - group contracts	525	6	—	531	60
Obligations to Lottery prize winners – annuities	331,779	19,814	51,405	300,188	57,050
Total long-term obligations	$ 333,720	20,322	52,333	301,709	57,180

(b) Obligations to Lottery Prize Winners

The Department has obligations to certain lottery prize winners for awards payable in annual installments ranging from 19 years to the life of the prize winner, with the first payment made shortly after the claim is presented for payment.

For certain prize winners, annuities were purchased in the name of the State for which the State has retained the rights of ownership. The present value of these annuities and the related liability installments owed to prize winners were as follows at June 30, 2013:

Present value of investment annuities and related prize liabilities (in thousands)

Fiscal year		Current	Long-term	Total
2014	$	62	—	62
2015		—	62	62
2016		—	62	62
2017		—	62	62
2018		—	62	62
2019 - 2023		—	236	236
Total future prize payments		62	484	546
Less: present value adjustments		2	62	64
Present value at June 30, 2013	$	60	422	482

The present value of these annuities and the related liability installments owed to prize winners were as follows at June 30, 2012:

Present value of investment annuities and related prize liabilities (in thousands)

Fiscal year		Current	Long-term	Total
2013	$	62	—	62
2014		—	62	62
2015		—	62	62
2016		—	62	62
2017		—	62	62
2018 - 2022		—	298	298
Total future prize payments		62	546	608
Less: present value adjustments		2	75	77
Present value at June 30, 2012	$	60	471	531

Effective July 30, 1985, State law provides that the State Treasurer, with the consent of the Director of the Lottery, may contract to invest in securities, which provide payments corresponding to the Department's obligation to these winners. The Department has provided for other payments corresponding to the Department's obligation to other prize winners through the purchase of direct obligations of the federal government, primarily in the form of United States Treasury zero coupon bonds. As established by State law, such securities shall be maintained separate and apart from all public money or funds of the State. These investments are purchased in amounts to provide for annual annuity payments to the prize winner(s) of each qualifying individual drawing.

The fair value of the investments of the fund approximated $313 million and $360 million at June 30, 2013 and 2012, respectively. Interest rates range from 1.8 percent to 9.4 percent, and prizes payable are scheduled annually through 2037 as follows (amounts expressed in thousands):

Fiscal year		Current	Long-term	Total
2014	$	48,138	—	48,138
2015		—	37,480	37,480
2016		—	32,541	32,541
2017		—	24,841	24,841
2018		—	17,454	17,454
2019 - 2037		—	209,317	209,317
Total future prizes		48,138	321,633	369,771
Adjustments to present value		281	96,889	97,170
Present value of future prizes		47,857	224,744	272,601
Adjustments to fair value		750	39,434	40,184
Fair value of future prizes at June 30, 2013	$	48,607	264,178	312,785

The amortized discount on the prizes payable reflects the interest rates earned by the investments held to fund the related liabilities. The amortization of discount is recorded as investment expense in the statements of revenues, expenses, and changes in net position and amounted to $14.3 million and $17.2 million for the years ended June 30, 2013 and 2012, respectively.

(7) Pension Plan

Substantially all of the Department's full-time employees who are not eligible for participation in another state-sponsored retirement plan participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois reporting entity. The SERS is a single-employer defined benefit public employee retirement system (PERS) in which State employees participate, except those covered by the State Universities, Teachers’, General Assembly, and Judges’ Retirement Systems. The financial position and results of operations of the SERS are included in the State of Illinois’ Comprehensive Annual Financial Report (CAFR) for the years ended June 30, 2013 and 2012. The SERS issues a separate CAFR that may be obtained by writing to the SERS, 2101 South Veterans Parkway, Springfield, Illinois, 62794-9255.

A summary of SERS benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the SERS’ CAFR. Also included is a discussion of employer and employee obligations to contribute and the authority under which those obligations are established.

The Department pays employer retirement contributions based upon an actuarially determined percentage of their payrolls. For fiscal years 2013 and 2012, the employer contribution rate was 37.99 percent and 34.19 percent, respectively.

(8) Post-employment Benefits

The State provides health, dental, vision, and life insurance benefits for retirees and their dependents in a program administered by the Department of Central Management Services. Substantially all State employees become eligible for postemployment benefits if they eventually become annuitants of one of the State-sponsored pension plans. Health, dental, and vision benefits include basic benefits for annuitants and dependents under the State's self-insurance plan and insurance contracts currently in force. Annuitants may be required to contribute towards health, dental, and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed healthcare plan. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefit becomes $5,000.

The total cost of the State’s portion of health, dental, vision, and life insurance benefits of all members, including postemployment health, dental, vision, and life insurance benefits, is recognized as an expense by the State in the Illinois CAFR. The State finances the costs on a pay-as-you-go basis. The total costs incurred for health, dental, vision, and life insurance benefits are not separated by department or component unit for annuitants and their dependents nor active employees and their dependents.

A summary of postemployment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the Department of Central Management Services. A copy of the financial statements of the Department of Central Management Services may be obtained by writing to the Department of Central Management Services, William G. Stratton Building 401 S. Spring St., Springfield, IL 62706.

(9) Risk Management

The Department is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; workers’ compensation; and natural disasters. The State retains the risk of loss (i.e., self-insured) for these risks.

The Department’s risk management activities are financed through appropriations to the Illinois Department of Central Management Services and are accounted for in the general fund of the State. The claims are not considered to be a liability of the Department; and accordingly, have not been reported in the Department’s financial statements for the years ended June 30, 2013 and 2012.

(10) Private Management Agreement

The State of Illinois (acting through the Department) entered into a 10-year private management agreement (PMA) with Northstar Lottery Group, LLC (Northstar) effective January 18, 2011, for the purpose of providing all equipment, services and functions necessary to operate the Lottery for the State, except for those specifically retained by the State as defined within the PMA. Under the terms of the agreement, effective July 1, 2011, the compensation to be paid under the PMA is comprised of the reimbursement of operating expenses and incentive compensation payments. Incentive compensation is subject to annual adjustments in accordance with the agreement. For the years ended June 30, 2013 and 2012, total compensation for reimbursement of operating expenses to Northstar under the PMA was $131.6 million and $128.7 million, respectively. Of this amount, $48.4 million and $31.4 million was outstanding at June 30, 2013 and 2012, respectively.

The Department has recorded a total receivable due from Northstar at June 30, 2013, in the amount of $75.5 million. Of this amount, $61.8 million represents shortfall payments proscribed by the PMA when certain annual net income targets are not met, and $13.7 million represents excess advances for expense reimbursements. The net income shortfall payments proscribed by the PMA amounts to $40.0 million and $21.8 million for the years ended June 30, 2013 and 2012, respectively. As indicated below in Note 11, the Department and Northstar participated in non-binding mediation over certain PMA disputes, including the net income shortfall payment for the year ended June 30, 2012. The parties were not able to reach an agreement during the mediation. Under the PMA, Northstar has the option to pursue litigation related to the net income shortfall payment for the year ended June 30, 2012. As the outcome of any potential litigation is uncertain, a provision has been established for the $21.8 million net income shortfall payment for the year ended June 30, 2012.

The State can terminate the PMA with a 90-day advance notice.

(11) Commitments and Contingencies

(a) Lease Commitments

The Department leases certain facilities and equipment necessary for operations, primarily from other State funds. All leases are operating leases and the majority are month-to-month. Total lease costs for the years ended June 30, 2013 and 2012, amounted to $275 thousand and $711 thousand, respectively.

(b) Litigation

The Department is routinely involved in a number of legal proceedings and claims that cover a wide range of matters. In particular, the Department has pending disputes related to the Lottery PMA with Northstar. One of the disputes relates to proposed adjustments to net income, where the Department has proposed upward adjustments and Northstar has proposed downward adjustments. Additionally, Northstar is disputing: (1) the Lottery's methodology for calculating net income; and (2) the amount of the shortfall payment owed under the PMA for the year ended June 30, 2012. Northstar does not dispute that it owes a Net Income Shortfall Payment for the year ended June 30, 2012. Rather, Northstar's dispute with the Department is over the amount of the net income shortfall payment.

The parties participated in non-binding mediation for both of these disputes without reaching an agreement. The PMA allows for, and the Deparment intends to, recover the shortfall payment despite the pending dispute on the methodology for calculating net income.

The Department does not believe the outcome of matters unrelated to the PMA will have any material adverse effect on the financial position or results of operations of the Department.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Combining Schedule of Net Position

June 30, 2013

(In thousands of dollars)

Assets		State Lottery (0711)	Deferred Prize Winners (0978)	Lottery Security Deposits (1309)	Eliminations	Total
Current assets:						
Cash and cash equivalents		17,324	—	955	—	18,279
Cash equity in State Treasury	$	116,847	761	—	—	117,608
Investments, short-term		60	48,607	—	—	48,667
Accounts receivable, net of allowance of $11,367		24,910	—	—	—	24,910
Private management contract receivable, net of provision of $21,776		40,000	—	—	—	40,000
Other receivables		13,710	—	—	—	13,710
Due from other Department funds		5,419	—	30	(5,449)	—
Total current assets		218,270	49,368	985	(5,449)	263,174
Noncurrent assets:						
Investments		422	264,178	—	—	264,600
Capital assets being depreciated, net		238	—	—	—	238
Total noncurrent assets		660	264,178	—	—	264,838
Total assets		218,930	313,546	985	(5,449)	528,012
Liabilities						
Current liabilities:						
Prizes payable		150,698	—	—	—	150,698
Accounts payable and accrued liabilities		52,454	—	—	—	52,454
Due to other Government - Federal		109	—	—	—	109
Due to other Department funds		30	5,419	—	(5,449)	—
Due to other State funds		44,449	—	—	—	44,449
Unearned revenue		4,769	—	—	—	4,769
Other liabilities		67	141	985	—	1,193
Current portion of long-term annuity prizes payable		60	47,857	—	—	47,917
Total current liabilities		252,636	53,417	985	(5,449)	301,589
Noncurrent liabilities:						
Noncurrent portion of long-term annuity prizes payable		422	224,744	—	—	225,166
Noncurrent other		882	—	—	—	882
Total noncurrent liabilities		1,304	224,744	—	—	226,048
Total liabilities		253,940	278,161	985	(5,449)	527,637
Net Position						
Invested in capital assets		238	—	—	—	238
Unrestricted (deficit)		(35,248)	35,385	—	—	137
Total net position	$	(35,010)	35,385	—	—	375

See accompanying independent auditors' report.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Combining Schedule of Net Position

June 30, 2012

(In thousands of dollars)

Assets		State Lottery (0711)	Deferred Prize Winners (0978)	Lottery Security Deposits (1309)	Eliminations	Total
Current assets:						
Cash and cash equivalents		12,088	—	936	—	13,024
Cash equity in State Treasury	$	141,435	551	—	—	141,986
Investments, short-term		60	58,004	—	—	58,064
Accounts receivable, net of allowance of $8,485		22,106	—	—	—	22,106
Due from other Department funds		444	—	—	(444)	—
Total current assets		176,133	58,555	936	(444)	235,180
Noncurrent assets:						
Investments		471	301,560	—	—	302,031
Capital assets being depreciated, net		229	—	—	—	229
Total noncurrent assets		700	301,560	—	—	302,260
Total assets		176,833	360,115	936	(444)	537,440
Liabilities						
Current liabilities:						
Prizes payable		151,565	—	—	—	151,565
Accounts payable and accrued liabilities		34,679	—	—	—	34,679
Due to other Government - Federal		27	—	—	—	27
Due to other Department funds		—	444	—	(444)	—
Due to other State funds		18,624	—	—	—	18,624
Unearned revenue		5,427	—	—	—	5,427
Other liabilities		70	107	936	—	1,113
Current portion of long-term annuity prizes payable		60	57,050	—	—	57,110
		210,452	57,601	936	(444)	268,545
Noncurrent liabilities:						
Noncurrent portion of long-term annuity prizes payable		471	243,138	—	—	243,609
Noncurrent other		920	—	—	—	920
Total noncurrent liabilities		1,391	243,138	—	—	244,529
Total liabilities		211,843	300,739	936	(444)	513,074
Net Position						
Invested in capital assets		229	—	—	—	229
Unrestricted (deficit)		(35,239)	59,376	—	—	24,137
Total net position	$	(35,010)	59,376	—	—	24,366

See accompanying independent auditors' report.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Combining Schedule of Revenues, Expenses and Changes in Net Position

For the year ended June 30, 2013

(In thousands of dollars)

	State Lottery (0711)	Deferred Prize Winners (0978)	Eliminations	Total
Operating revenues:				
Charges for sales and services	$ 2,832,576	—	—	2,832,576
Private management contract fee	61,776	—	—	61,776
Other	8,006	—	—	8,006
Total operating revenues	2,902,358	—	—	2,902,358
Operating expenses:				
Cost of sales and services	163,966	—	—	163,966
Prizes and claims	1,743,686	—	—	1,743,686
General and administrative	153,731	—	—	153,731
Provision for private management contract fee	21,776			21,776
Depreciation	99	—	—	99
Total operating expenses	2,083,258	—	—	2,083,258
Operating income	819,100	—	—	819,100
Nonoperating revenues (expenses):				
Investment income	295	(9,649)	—	(9,354)
Interest expense	(5)	(14,342)	—	(14,347)
Other	(4,975)	4,975	—	—
Total nonoperating revenues (expenses), net	(4,685)	(19,016)	—	(23,701)
Change in net position before transfers	814,415	(19,016)	—	795,399
Transfers from other State funds	4,975	—	(4,975)	—
Transfers to other State funds	(819,390)	(4,975)	4,975	(819,390)
Change in net position	—	(23,991)	—	(23,991)
Net position, July 1, 2012	(35,010)	59,376	—	24,366
Net position, June 30, 2013	$ (35,010)	35,385	—	375

See accompanying independent auditors' report.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Combining Schedule of Revenues, Expenses and Changes in Net Position

For the year ended June 30, 2012

(In thousands of dollars)

	State Lottery (0711)	Deferred Prize Winners (0978)	Eliminations	Total
Operating revenues:				
Charges for sales and services	$ 2,676,996	—	—	2,676,996
Other	5,378	—	—	5,378
Total operating revenues	2,682,374	—	—	2,682,374
Operating expenses:				
Cost of sales and services	151,421	—	—	151,421
Prizes and claims	1,620,405	—	—	1,620,405
General and administrative	152,210	—	—	152,210
Depreciation	107	—	—	107
Total operating expenses	1,924,143	—	—	1,924,143
Operating income	758,231	—	—	758,231
Nonoperating revenues (expenses):				
Investment income	11	37,622	—	37,633
Interest expense	(6)	(17,186)	—	(17,192)
Total nonoperating revenues (expenses), net	5	20,436	—	20,441
Change in net position before transfers	758,236	20,436	—	778,672
Transfers to other State funds	(758,236)	—		(758,236)
Change in net position	—	20,436	—	20,436
Net position, July 1, 2011, as restated (note 2(m))	(35,010)	38,940	—	3,930
Net position, June 30, 2012	$ (35,010)	59,376	—	24,366

See accompanying independent auditors' report.

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Independent Auditors' 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 William G. Holland
Auditor General
State of Illinois

As Special Assistant Auditors for the Auditor General, 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 State of Illinois Department of the Lottery (the Department), which comprise the statement of financial position as of June 30, 2013, and the related statements of Revenues, Expenses, and Changes in Net Position and cash flows for the year then ended, and the related notes to the financial statements, and have issued our report thereon dated February 27, 2014.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Department'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 opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, as described in the accompanying schedule of findings, we identified certain deficiencies in internal control that we consider to be material weaknesses.

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 combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the Department's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying schedule of findings to be material weaknesses and are listed as 2013-001, 2013-002.

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department'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*.

Department's Response to Findings

The Department's responses to the findings identified in our audit are described in the accompanying schedule of findings. The Department's responses were not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the responses.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the Department'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 Department's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

KPMG LLP

Chicago, Illinois
February 27, 2014

Finding 2013-001 - Weaknesses in Preparation of Accurate GAAP Reporting Forms Submitted to the Illinois Office of the Comptroller and Preparation of Year-End Department Financial Statements

The State of Illinois Department of the Lottery's (Department or Lottery) year-end financial reporting in accordance with generally accepted accounting principles (GAAP) to the Illinois Office of the Comptroller contained numerous errors/inaccuracies and incomplete data.

During the audit of the June 30, 2013 Department financial statements, auditors noted errors in the Department's GAAP Reporting forms submitted to the Office of the Comptroller and Department financial statements and deficiencies in internal controls over financial reporting as follows:

- During testing of the estimate of the Prizes payable liability for instant games errors and inaccuracies in the calculation were identified. The errors and inaccuracies included the following:
  - Auditors noted the prize structure utilized in the calculation of the Instant prize liability, for numerous instant games, was inaccurate. The inaccuracies resulted in Prize expense and the associated liability being understated by $18,538,189. These inaccuracies were discussed with Department management at which time they made a correcting entry.
  - Auditors determined the estimate of the Prizes payable liability for Instant games was inaccurately updated for prizes that were validated prior to year end and where the prize would be paid with an annuity. This resulted in Prize expense and the associated liability being understated by $1,925,301 for fiscal year 2013. During the fiscal year 2012 audit, auditors identified similar differences which resulted in Prize expense and the associated liability being overstated by $2,473,006. Department management considered the fiscal year 2012 amount to be immaterial and did not make a correcting entry. By not correcting the fiscal year 2012 amount, the error resulted in an understatement of fiscal year 2013 expense of the same amount. The net effect of the fiscal year 2012 and 2013 differences was an understatement of fiscal year 2013 expense of $4,398,307. Department management considered this amount to be immaterial to the financial statements and did not record a correcting entry.
- During testing of the Department's accounts payable an error in recording "vouchers in transit" as of June 30, 2013 was identified. Auditors noted total payments made by the Department subsequent to June 30, 2013 for expenses incurred during fiscal year 2013 (lapse period) did not agree to payments disbursed by the Comptroller. The difference/reconciling item related to "vouchers in transit"; i.e., the warrants/checks requested to be paid by the Department before year-end, but were not issued by the Comptroller until after year-end. Such amounts were not recorded by the Department in fiscal year 2013 resulting in Accounts payable – General and Operating expenses each being understated by $12,105,750. These inaccuracies were discussed with Department management at which time they made a correcting entry.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Schedule of Findings

Current Findings

Government Auditing Standards

For the year ended June 30, 2013

- Auditors found an error in recording payments as of year-end. The Department made a journal entry to correct a previously identified error which inappropriately debited Operating expense instead of Prizes payable, resulting in Operating expense and Prizes payable each being overstated by $13,111,389. These inaccuracies were discussed with Department management at which time they made a correcting entry.
- During evaluation of the financial statements, auditors identified an error where revenue for subscription sales was not recorded. This error resulted in both Deferred revenue and Accounts receivable being understated by $3,515,266. Department management considered this amount to be immaterial to the financial statements and did not record a correcting entry.
- The Illinois Lottery Law (20 ILCS 1605/9.1(o)), as amended by Public Act 96-0034 effective July 1, 2009, requires the Department to distribute all proceeds of lottery tickets and shares sold in a specific priority and manner. The last priority requires the Department to transfer any remaining proceeds to the Capital Projects Fund on or before the last day of each fiscal year. Since the change in the Lottery Law, the Department has made an estimate of the remaining proceeds and made the required transfer based on that estimate. As a result of normal end of year financial adjustments and completion of the annual audit, there has been a difference between transfers of estimated remaining proceeds and actual net income. The Department made approximately $47.5 million in adjustments to record the effects of the audit for Capital Projects Fund transfers. As of June 30, 2013, the Department has a balance of $44.4 million due to the Capital Projects Fund, reflecting actual net income in excess of amounts previously transferred to the Capital Projects Fund through that date.

The aggregate impact of all auditor recommended adjustments made by the Department since the initial June 30, 2013 GAAP Reporting forms were submitted to the Illinois Office of the Comptroller was approximately a $17.5 million increase in liabilities and expenses.

Lottery management indicated that similar to the fiscal year 2012 audit, certain issues emerged during fiscal year 2013 with the financial data generated by the private manager's gaming system leading to certain inaccuracies. Lottery management also indicated that certain year end processes did not detect the incorrect recording of certain vouchers.

The Illinois Office of the Comptroller requires State agencies to prepare GAAP Reporting Packages for each of their funds to assist in the annual preparation of the Statewide financial statements and the Lottery financial statements. GAAP Reporting Package instructions are specified in the Comptroller's Statewide Accounting Management System (SAMS) Manual, Chapter 27.

In addition, the Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires all State agencies to establish and maintain a system of internal fiscal and administrative controls which shall provide assurance that revenues, expenditures, and transfers of assets, resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial and statistical reports and to maintain accountability over the State's resources.

Because of the significance of the errors and inaccuracies noted, we consider this to be a material weakness in the Lottery's internal control over financial and fiscal operations. 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 occur and not be prevented or detected and corrected on a timely basis.

The errors and inaccuracies noted, if not detected and corrected, could materially misstate the Lottery's financial statements and negatively impact the Statewide financial statements. Accurate and timely preparation of the Lottery's financial information for GAAP reporting purposes is important due to the impact Lottery adjustments have on the Statewide financial statements. (Finding Code No. 2013-001, 12-01)

Recommendation:

We recommend the Lottery implement procedures to ensure GAAP Reporting Packages and financial statements are prepared in an accurate and complete manner. This should include allocating sufficient staff resources and following formal procedures to ensure financial information is prepared and submitted to the Illinois Office of the Comptroller in accordance with GAAP, and that supporting documentation be maintained in a contemporaneous manner to support the financial information being reported.

Lottery Response:

The Lottery agrees and will continue to review current procedures to ensure they are up-to-date and implement any additional procedures, as necessary, to ensure GAAP financial reporting and the financial statements are prepared completely, accurately and timely with appropriate supporting documentation. The Lottery will also ensure sufficient staff resources are allocated to this process.

Finding 2013-002 - Weaknesses in the General IT Control Environment over Key Systems

The State of Illinois Department of the Lottery (Department or Lottery) had not implemented controls over its computing environment to ensure the controls provided sufficient protection.

During the audit of the June 30, 2013 financial statements, auditors noted a number of control deficiencies related to the various computer systems utilized by the Department. Several of the Department's computer systems generate reports that are used to process, accumulate and analyze financial information. Specific weaknesses identified are as follows:

- **Access Reviews-**Although access was reviewed on an ad hoc basis, documentation was not maintained.
- **Access Provisioning and Termination-**Requests to grant one user's access to one application was not maintained. Additionally, access rights were not timely removed for eight terminated users.
- **Change Management-**A system generated list of changes was not available for one of the Department's applications. A change ticketing tool was not in use and there was not a logging feature within the application. The Department manually compiled a listing of four changes to the application, which we reviewed. The review indicated the testing documentation was not retained for all the changes implemented into the production environment.
- **Segregation of Duties-**From July 2012 through April 2013, one user was responsible for the development and migration of changes to the production environment. In April 2013, the Department implemented a control where the developer had to request the Department to provide access to the production environment once changes had been tested and approved.
- **Access to Drawing Room-**The Department could not provide documentation confirming the Drawing Room was locked at all times when Department staff was not present.
- **Monitoring of Service Providers-**The Department reviewed the two Service Organizations' Control Reports, but the documentation did not evidence the impact assessment of noted deficiencies on the Department's IT environment. In addition, the Department had not ensured the Complimentary User Controls identified in one Service Organizations' Control Report were in place and operating effectively.

Lottery management stated that this finding is for the most part a duplicate of the finding issued with the fiscal year 2012 audit which was received by the Department in late fiscal year 2013 with little time for corrective actions prior to the end of fiscal year 2013.

The Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires all State agencies to establish and maintain a system or systems, of internal fiscal and administrative controls, which shall provide assurance that funds, property, and other assets and resources are safeguarded against waste, loss, unauthorized user and misappropriation.

Due to the severity of the deficiencies noted, auditors were unable to rely upon the IT environment controls. As such, auditors consider the weaknesses to be a material weakness in the Department's internal control over financial and fiscal operations. (Finding Code No. 2013-002, 12-02)

Recommendation:

We recommend the Department implement and document adequate controls over its computing environment and ensure the controls provide sufficient protection. Specifically, we recommend the Department:

- Review access rights to systems and applications on a periodic basis. Additionally, the Department should retain documentation of such reviews.
- Maintain documentation of access provisioning and termination. In addition, the Department should timely terminate user access rights.
- Implement a process to create a system generated list of changes for Department applications. If a system generated list is not feasible, develop a method of logging and tracking all changes. Additionally, the Department should ensure all documentation related to changes is maintained.
- Ensure the segregation of development activities and migration activities.
- Maintain documentation for the security of the Drawing Room.
- Develop and document a monitoring process to determine the impact of noted deficiencies in the Service Organizations' Control Reports to the Department's environment. In addition, the Department should review the Complimentary User Controls identified in the Service Organizations' Control Reports to ensure they were in place and operating effectively.

Lottery Response:

The Lottery agrees with the recommendations the auditors have put forth.