KPMG

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Financial Audit

For the Years Ended June 30, 2014 and 2013

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
Deputy Director	Vacant – effective November 15, 2014 Victor Golden – December 15, 2008 to November 14, 2014
Chief of Staff	Jayme Odom – effective January 23, 2015 Vacant – November 18, 2014 to January 22, 2015 Sara Barnett – January 17, 2012 to November 17, 2014
Chief Financial Officer	Christian Froelich – effective August 1, 2014 Brett Finley (Acting) – August 9, 2013 to July 31, 2014 James Scroggins – April 2, 2012 to July 31, 2013
Chief Operations Officer	Harold Mays
General Counsel	Nellie Ridsdale – effective March 5, 2015 Daymon Ruttenberg – November 11, 2012 to March 4, 2015
Chief Internal Auditor	Vacant – effective January 16, 2015 Melinda Westwater – June 17, 2013 to January 15, 2015

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 a material weakness and a significant deficiency. The material weakness and a significant deficiency are described in the accompanying Schedule of Findings as findings 2014-001 and 2014-002.

Finding No.	Page No.	Description	Finding Type
2014-001	28	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
2014-002	31	Weaknesses in the General IT Control Environment over Key Systems	Significant deficiency

EXIT CONFERENCE

The Department elected to waive a formal exit conference.

The responses to the recommendations were provided by Christian Froelich, Chief Financial Officer, in e-mails dated December 15, 2014 and December 18, 2014.

KPMG LLP
Aon Center
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, 2014 and 2013, 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.

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, 2014 and 2013, and the changes in financial position and cash flows 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, 2014 and 2013, 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 an opinion 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 March 12, 2015 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
March 12, 2015

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY
Statements of Net Position (Deficit)
June 30, 2014 and 2013
(In thousands of dollars)

Assets and Deferred Outflows of Resources		**2014**		**2013**
Current assets:				
Cash and cash equivalents	$	17,945	$	18,279
Cash equity in State Treasury		108,497		117,608
Investments, short-term		39,348		48,667
Accounts receivable, net of allowance of $13,839 and $11,367, respectively		26,858		24,910
Private management contract receivable, net of provision of $0 and $21,776, respectively		37,129		40,000
Other receivables		12,697		13,710
Total current assets		242,474		263,174
Noncurrent assets:				
Investments		257,335		264,600
Capital assets being depreciated, net		151		238
Total noncurrent assets		257,486		264,838
Total assets and deferred outflows of resources		499,960		528,012
Liabilities and Deferred Inflows of Resources				
Current liabilities:				
Prizes payable		168,026		150,698
Accounts payable and accrued liabilities		37,533		52,454
Due to other Government – Federal		184		109
Due to other State funds		6,930		44,449
Unearned revenue		1,650		4,769
Provision for private management contract dispute		21,776		—
Other liabilities		1,259		1,193
Current portion of long-term annuity prizes payable		37,622		47,917
Total current liabilities		274,980		301,589
Noncurrent liabilities:				
Noncurrent portion of long-term annuity prizes payable		229,207		225,166
Noncurrent other		929		882
Total noncurrent liabilities		230,136		226,048
Total liabilities and deferred inflows of resources		505,116		527,637
Net Position (Deficit)				
Invested in capital assets		151		238
Unrestricted		(5,307)		137
Total net position (deficit)	$	(5,156)	$	375

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 (Deficit)

Years ended June 30, 2014 and 2013

(In thousands of dollars)

	2014	2013
Operating revenues:		
Charges for sales and services	$ 2,802,310	$ 2,832,576
Private management contract fee	35,713	61,776
Other	4,484	8,006
Total operating revenues	2,842,507	2,902,358
Operating expenses:		
Cost of sales and services	159,124	163,966
Prizes and claims	1,749,177	1,743,686
General and administrative	156,486	153,731
Allowance for private management contract fee	—	21,776
Depreciation	73	99
Total operating expenses	2,064,860	2,083,258
Operating income	777,647	819,100
Nonoperating revenues (expenses):		
Investment income (expense)	7,406	(9,354)
Interest expense	(13,124)	(14,347)
Other	(20)	—
Total nonoperating expenses, net	(5,738)	(23,701)
Change in net position before transfers	771,909	795,399
Transfers to other State funds	(777,440)	(819,390)
Change in net position	(5,531)	(23,991)
Net position at beginning of year	375	24,366
Net position (deficit) at end of year	$ (5,156)	$ 375

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

Years ended June 30, 2014 and 2013

(In thousands of dollars)

	2014	2013
Cash flows from operating activities:		
Cash received from sales and services	$ 2,792,341	$ 2,829,114
Cash receipts from other operating activities	46,856	7,878
Cash payments for commissions and bonuses	(159,124)	(163,966)
Cash payments for general and administrative expenses	(148,508)	(149,609)
Cash payments for lottery prizes	(1,699,647)	(1,728,257)
Net cash provided by operating activities	831,918	795,160
Cash flows from noncapital financing activities:		
Cash transfers-out to other funds	(815,356)	(793,546)
Net cash used in noncapital financing activities	(815,356)	(793,546)
Cash flows from capital and related financing activities:		
Acquisition and construction of capital assets	(6)	(108)
Net cash used in capital and related financing activities	(6)	(108)
Cash flows from investing activities:		
Interest and dividends on investments	(730)	80
Purchase of investments	(56,526)	(20,918)
Proceeds from investment maturities	80,693	58,048
Cash paid for long-term annuity prizes payable	(49,438)	(57,839)
Net cash used in investing activities	(26,001)	(20,629)
Net decrease in cash and cash equivalents	(9,445)	(19,123)
Cash and cash equivalents at beginning of year	135,887	155,010
Cash and cash equivalents at end of year	$ 126,442	$ 135,887
Reconciliation of cash and cash equivalents to the statement of net position:		
Total cash and cash equivalents per the statement of net position	$ 17,945	$ 18,279
Add cash equity in State Treasury	108,497	117,608
Cash and cash equivalents at end of year	$ 126,442	$ 135,887

(Continued)

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Statements of Cash Flows

Years ended June 30, 2014 and 2013

(In thousands of dollars)

	2014	2013
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$ 777,647	$ 819,100
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	73	99
Provision for uncollectible accounts	2,472	2,882
Provision for private management contract fee	—	21,776
Changes in assets and liabilities:		
Increase in accounts receivable	(4,420)	(5,686)
(Increase) decrease in other receivables	1,013	(13,710)
(Increase) decrease in private management contract receivable	2,871	(61,776)
Increase (decrease) in prizes payable	17,328	(885)
Increase (decrease) in accounts payable and accrued liabilites	(14,921)	17,775
Increase in intergovernmental payables	75	82
Increase in due to other State funds	397	—
Decrease in unearned revenues	(3,119)	(658)
Increase in provision for private management contract dispute	21,776	—
Increase in other liabilities	66	80
Increase in long-term annuity prizes payable	30,613	16,119
Increase (decrease) in noncurrent other liabilities	47	(38)
Net cash provided by operating activities	$ 831,918	$ 795,160
Noncash investing, capital and financing activities:		
Decrease in unrealized gains on investments	$ (5,531)	$ (23,991)
Interest accreted on investments	13,113	14,342
Interest accretion on long-term annuity prizes payable	(13,113)	(14,342)
Release of long-term annuity prizes payable	(542)	—
Loss on disposal of capital assets	(20)	—

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 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.

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 (CAFR) 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 as of June 30, 2014 and 2013, 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 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 the 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, 2014 and 2013, 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 is in dispute with the Private Manager regarding certain provisions of the Private Management Agreement (PMA). As a result of the uncertainty of the resolution of these disputes, a provision was established for the receivable from the Private Manager for a $21.8 million net income shortfall payment estimated by the Department for the year ended June 30, 2012. During the year ended June 30, 2014, the receivable was satisfied through offset of amounts owed to the Private Manager in accordance with the terms of the PMA. See notes 10 and 11(b) for additional information regarding the PMA and disputes with the Private Manager.

(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 (SERS) 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, 2014 and 2013.

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 and private manager contract fees, 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.

(Continued)

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 are 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. 65, *Items Previously Reported as Assets and Liabilities,* was 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. 66, *Technical Corrections – 2012 – An Amendment of GASB Statements No. 10 and No. 62*, was 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 a government financial reporting entity by resolving conflicting guidance that resulted from the issuance of two pronouncements, GASB Statements No. 54*, Fund Balance Reporting and Governmental Fund Type Definitions*, and No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*.

GASB Statement No. 70, *Accounting and Financial Reporting for Nonexchange Financial Guarantees*, was 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 adoption of these statements did not have a material impact on financial reporting.

(n) Future Adoption of GASB Statements

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. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date – An Amendment of GASB Statement No. 68*, will be effective for the Department beginning with its year-end June 30, 2015. The objective of this Statement is to address an issue regarding application of the transition provisions of Statement No. 68, *Accounting and Financial Reporting for Pensions*. The issue relates to amounts associated with contributions, if any, made by a state or local government employer or nonemployer contributing entity to a defined benefit pension plan after the measurement date of the government's beginning net pension liability.

The Department has not yet determined the impact on its financial statements as a result of adopting these statements.

(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 $108 million and $118 million as of June 30, 2014 and 2013, 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's Comprehensive Annual Financial Report.

Bank deposits for the enterprise funds held outside of the State Treasury of approximately $18 million as of June 30, 2014 and 2013, 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, 2014 and 2013, the Department had the following investments outside of the State Treasury:

		2014		2013	
		Fair value (thousands)	**Weighted average maturity (years)**	**Fair value (thousands)**	**Weighted average maturity (years)**
Annuities	$	433	4.481	482	4.791
U.S. Treasury bonds		296,250	7.089	312,785	6.674
Total	$	296,683		313,267	

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, 2014 and 2013, represent amounts due to other State funds.

		Due to other State funds		
Fund		**2014**	**2013**	**Description/Purpose**
Lottery	$	6,930	44,449	Due to other State funds for allocation of lottery proceeds and for administrative expenses.

(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.

(Continued)

The following balances (amounts expressed in thousands) for the years ended June 30, 2014 and 2013 represent amounts transferred to other State funds:

Fund	Transfers out to Other State funds		2014	2013	Description/Purpose
Lottery	Common School	$	668,100	655,624	Transfers to Common School, Capital Projects, and other State funds pursuant to statutory requirements.
	Capital Projects		107,032	161,184	
	Other State funds		2,308	2,582	
		$	777,440	819,390	

(5) Capital Asset

Capital asset activity (amounts expressed in thousands) for the year ended June 30, 2014 was as follows:

		Balance June 30, 2013	Additions	Deletions	Net transfers	Balance June 30, 2014
Capital assets being depreciated:						
Equipment	$	1,926	6	349	(140)	1,443
Less accumulated depreciation		(1,688)	(73)	(329)	140	(1,292)
Total capital assets, net	$	238	(67)	20	—	151

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

(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, 2014 were as follows:

	Balance June 30, 2013	Additions	Deletions	Balance June 30, 2014	Amounts due within one year
Compensated absences	$ 949	753	724	978	49
Obligations to Lottery prize winners – group contracts	482	—	49	433	60
Obligations to Lottery prize winners – annuities	272,601	43,726	49,931	266,396	37,562
Total long-term obligations	$ 274,032	44,479	50,704	267,807	37,671

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

(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 (group contracts) were purchased in the name of the Department for which the Department 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, 2014:

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

Fiscal year		Current	Long-term	Total
2015	$	62	—	62
2016		—	62	62
2017		—	62	62
2018		—	62	62
2019		—	62	62
2020-2024		—	174	174
Total future prize payments		62	422	484
Less present value adjustments		2	49	51
Present value at June 30, 2014	$	60	373	433

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 approximated $296 million and $313 million at June 30, 2014 and 2013, respectively. Interest rates range from 1.8% to 7.7%, and prizes payable are scheduled annually through 2038 as follows (amounts expressed in thousands):

Fiscal year		Current	Long-term	Total
2015	$	39,821	—	39,821
2016		—	34,882	34,882
2017		—	27,182	27,182
2018		—	19,795	19,795
2019		—	18,164	18,164
2020-2038		—	227,154	227,154
Total future prizes		39,821	327,177	366,998
Adjustments to present value		2,259	98,343	100,602
Present value of future prizes		37,562	228,834	266,396
Adjustments to fair value		1,726	28,128	29,854
Fair value of future prizes at June 30, 2014	$	39,288	256,962	296,250

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 $13.1 million and $14.3 million for the years ended June 30, 2014 and 2013, 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 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's CAFR for the years ended June 30, 2014 and 2013. 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's 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 2014 and 2013, the employer contribution rate was 40.31 percent and 37.99 percent, respectively. The employer contribution amount for fiscal years 2014 and 2013 was $3.4 million and $3.2 million, respectively.

(8) Postemployment 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 (CMS). 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.

Public Act 97-0695 was signed into law on June 21, 2012. Effective July 1, 2013, all retirees within state retirement systems began paying a premium for health and vision benefits at a rate determined by CMS. The rate was a percentage of the retiree's annuity and differed depending on whether the retiree was enrolled in Medicare. Due to an Illinois Supreme Court decision in July 2014, Public Act 97-0695 was suspended and the collection of premiums was stopped. All premiums collected are expected to be refunded.

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 State's 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, 2014 and 2013.

(10) Private Management Agreement

The State (acting through the Department) entered into a 10-year PMA with Northstar Lottery Group, LLC (Private Manager) 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, 2014 and 2013, total compensation for reimbursement of operating expenses to Northstar under the PMA was $132.4 million and $131.6 million, respectively, and is included in General and administrative expenses. Of this amount, $36.3 million and $48.4 million was outstanding at June 30, 2014 and 2013, respectively, and is included in Accounts payable and accrued liabilities.

The Department has recorded a total receivable due from Northstar at June 30, 2014 in the amount of $49.8 million. Of this amount, $37.1 million represents shortfall payments proscribed by the PMA when certain annual net income targets are not met, and $12.7 million represents excess advances for expense reimbursements. The net income shortfall payments proscribed by the PMA amounts to $37.1 million and $40.0 million for the years ended June 30, 2014 and 2013, respectively.

As described in note 11(b), the Department and Northstar face a potential dispute related to the PMA. The Office of the Governor, the Department, Northstar and its member entities executed a Termination Agreement on December 9, 2014. In accordance with the terms of the Termination Agreement, the Department delivered a Termination Notice to Northstar on December 10, 2014, exercising the State's right to terminate the PMA for convenience. Subsequently, the Termination Agreement was disapproved by the State of Illinois Attorney General on January 16, 2015.

(11) Commitments and Contingencies

(a) Lease Commitments

The Department leases certain facilities and equipment necessary for operations, primarily from other State agencies. All leases are operating leases and the majority are month-to-month. Total lease costs for the years ended June 30, 2014 and 2013 amounted to $930 thousand and $275 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 may have a dispute with Northstar related to the PMA as a result of the Attorney General's letter dated January 16, 2015.

One of the potential disputes under the PMA relates to proposed adjustments to net income, where the Department proposed upward adjustments and Northstar proposed downward adjustments prior to the execution of the Termination Agreement.

Additionally, under the PMA, Northstar disputed (1) the Lottery's methodology for calculating net income for the years ended June 30, 2012, 2013 and 2014; and (2) the amount of the shortfall payment owed under the PMA for the years ended June 30, 2012, 2013 and 2014. Northstar does not dispute that it owes a Net Income Shortfall Payment for the years ended June 30, 2012, 2013 and 2014. Rather, Northstar's dispute with the Department is over the methodogy used to calculate Net Income and the resulting amount of the Net Income Shortfall Payment. As a result of the uncertainties surrounding the on-going disputes, as of June 30, 2013, the Department recorded a provision of $21.8 million related to the shortfall payment for the year ended June 30, 2012. As of June 30, 2014, the provision was reclassified as a contingent liability. No provision has been made for the shortfall payments for the years ended June 30, 2014 or 2013.

The Department and the Private Manager 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 mediation.

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 (Deficit)

June 30, 2014

(In thousands of dollars)

Assets and Deferred Outflows of Resources	State Lottery (0711)	Deferred Prize Winners (0978)	Lottery Security Deposits (1309)	Eliminations	Total
Current assets:					
Cash and cash equivalents	$ 16,883	—	1,062	—	17,945
Cash equity in State Treasury	107,193	1,304	—	—	108,497
Investments, short-term	60	39,288	—	—	39,348
Accounts receivable, net of allowance of $13,839	26,858	—	—	—	26,858
Private management contract receivable	37,129	—	—	—	37,129
Other receivables	12,697	—	—	—	12,697
Due from other Department funds	1,156	—	—	(1,156)	—
Total current assets	201,976	40,592	1,062	(1,156)	242,474
Noncurrent assets:					
Investments	373	256,962	—	—	257,335
Capital assets being depreciated, net	151	—	—	—	151
Total noncurrent assets	524	256,962	—	—	257,486
Total assets and deferred outflows of resources	202,500	297,554	1,062	(1,156)	499,960
Liabilities and Deferred Inflows of Resources					
Current liabilities:					
Prizes payable	168,026	—	—	—	168,026
Accounts payable and accrued liabilities	37,533	—	—	—	37,533
Due to other Government - Federal	184	—	—	—	184
Due to other Department funds	—	1,156	—	(1,156)	—
Due to other State funds	6,930	—	—	—	6,930
Unearned revenue	1,650	—	—	—	1,650
Provision for private management contract dispute	21,776	—	—	—	21,776
Other liabilities	49	148	1,062	—	1,259
Current portion of long-term annuity prizes payable	60	37,562	—	—	37,622
Total current liabilities	236,208	38,866	1,062	(1,156)	274,980
Noncurrent liabilities:					
Noncurrent portion of long-term annuity prizes payable	373	228,834	—	—	229,207
Noncurrent other	929	—	—	—	929
Total noncurrent liabilities	1,302	228,834	—	—	230,136
Total liabilities and deferred inflows of resources	237,510	267,700	1,062	(1,156)	505,116
Net Position (Deficit)					
Invested in capital assets	151	—	—	—	151
Unrestricted	(35,161)	29,854	—	—	(5,307)
Total net position (deficit)	$ (35,010)	29,854	—	—	(5,156)

See accompanying independent auditors' report.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Combining Schedule of Net Position

June 30, 2013

(In thousands of dollars)

Assets and Deferred Outflows of Resources	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 and deferred outflows of resources	218,930	313,546	985	(5,449)	528,012
Liabilities and Deferred Inflows of Resources					
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 liabilites	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 liabilites	1,304	224,744	—	—	226,048
Total liabilities and deferred inflows of resources	253,940	278,161	985	(5,449)	527,637
Net Position (Deficit)					
Invested in capital assets	238	—	—	—	238
Unrestricted	(35,248)	35,385	—	—	137
Total net position (deficit)	$ (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 (Deficit)

For the year ended June 30, 2014

(In thousands of dollars)

		State Lottery (0711)	Deferred Prize Winners (0978)	Eliminations	Total
Operating revenues:					
Charges for sales and services	$	2,802,310	—	—	2,802,310
Private management contract fee		35,713	—	—	35,713
Other		4,484	—	—	4,484
Total operating revenues		2,842,507	—	—	2,842,507
Operating expenses:					
Cost of sales and services		159,124	—	—	159,124
Prizes and claims		1,749,177	—	—	1,749,177
General and administrative		156,486	—	—	156,486
Depreciation		73	—	—	73
Total operating expenses		2,064,860	—	—	2,064,860
Operating income		777,647	—	—	777,647
Nonoperating revenues (expenses):					
Investment income		(176)	7,582	—	7,406
Interest expense		(11)	(13,113)	—	(13,124)
Other		(556)	536	—	(20)
Total nonoperating revenues (expenses), net		(743)	(4,995)	—	(5,738)
Change in net position (deficit) before transfers		776,904	(4,995)	—	771,909
Transfers from other State funds		536	—	(536)	—
Transfers to other State funds		(777,440)	(536)	536	(777,440)
Change in net position		—	(5,531)	—	(5,531)
Net position (deficit), July 1, 2013		(35,010)	35,385	—	375
Net position (deficit), June 30, 2014	$	(35,010)	29,854	—	(5,156)

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
Allowance 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 (deficit) 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 (deficit), July 1, 2012	(35,010)	59,376	—	24,366
Net position (deficit), June 30, 2014	$ (35,010)	35,385	—	375

See accompanying independent auditors' report.

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

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, 2014, 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 March 12, 2015.

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 a material weakness and a significant deficiency.

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 deficiency described in the accompanying schedule of findings as item 2014-001 to be a material weakness.

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. We consider the deficiency described in the accompanying schedule of findings as item 2014-002 to be a significant deficiency.

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
March 12, 2015

Finding 2014-001 - 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 errors in certain accounts.

During the audit of the June 30, 2014 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. Some of the specific errors noted during testing are as follows:

- Manual errors and inaccuracies in the calculation of the estimate of the Prizes payable liability for Instant games were identified. The inaccuracies resulted in Prize expense and the associated liability being overstated by $7.314 million. These inaccuracies were discussed with Department management at which time they made an adjusting entry to their accounting records.
- An unreconciled difference was identified in the Department's Accounts receivable, Upon further research, Department management determined that this difference was the result of an error. The error resulted in Accounts receivable being overstated by $4.901 million. This inaccuracy was discussed with Department management at which time they made an adjusting entry to Ticket expense for $1.220 million and Other income for $3.681 million.
- Auditors identified that the Department recorded an annuity in error. The error resulted in Current annuity prizes payable and Long-term annuity prizes payable being overstated by $244 thousand and $4.494 million, respectively, and Investment income and Interest expense being overstated and understated by $4.798 million and $60 thousand, respectively. This error was discussed with Department management at which time they made an adjusting entry to their accounting records.
- Auditors identified revenue for subscription sales was not recorded in the Statement of Net Position. This error resulted in both Deferred revenue and Accounts receivable being understated by $215 thousand. This error was discussed with Department management at which time they made an adjusting entry to their financial statements.
- Auditors noted the purchase and subsequent sale of a security that was purchased in error was excluded in the Statement of Cash Flows. As such, Purchases of investments and Proceeds from investment maturities were understated by $25.884 million and $25.913 million, respectively. This error was discussed with Department management at which time they made an adjusting entry to their financial statements. Lottery management indicated when recording the transaction they considered netting of the purchase and subsequent sale of the security to more accurately reflect the essence of the transaction.

- Other errors and inaccuracies were also identified and brought to Department management's attention. Department management indicated that while certain differences identified by auditors were not detected during the standard review process, certain others were known and were deemed immaterial to the overall accuracy of the financial statements and adjusting entries for these items were not recorded.

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. As a result of audit differences noted above, there was an additional impact to the Capital Projects Fund transfers and associated amounts due to the Capital Projects Fund. Because of the audit differences the Department made a $2.413 million adjustment which resulted in an increase to both the Capital Projects Fund transfers and amounts due to the Capital Projects Fund.

Lottery management indicated certain year end processes did not detect the issues that were identified by the auditors.

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 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. 2014-001, 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 2014-002 - Weaknesses in the General IT Control Environment over Key Systems

The State of Illinois Department of the Lottery (Department or Lottery) has not implemented sufficient level of controls over its computing environment to ensure protection from unauthorized access.

During the audit of the June 30, 2014 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. Although the Department made certain changes since the prior audit, the following specific weaknesses were identified:

- **Access Reviews-**Access reviews were not performed for Shared Services personnel assigned to support Lottery operations.

- **Access Termination-** Access rights were not removed for three terminated users in a timely manner.

- **Monitoring of Service Provider-**The Department reviewed the Service Organization's Control Report, which had a modified opinion, and assessed the risk to the Department for all deficiencies noted in the report. However, the Department did not document how the deficiencies with a high risk impact to the Department were mitigated.

- **Information Technology Policy-**The Lottery Information Technology and Security Policy was not finalized and approved as of June 30, 2014.

Department management indicated the weaknesses noted resulted from the controls put in place during the audit period not fully addressing all areas.

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.

Without adequate controls over the computing environment, there is a risk of unauthorized access and unauthorized or improper changes to Department financial data. The auditors consider the weaknesses to be a significant deficiency in the Department's internal control over financial and fiscal operations. 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. (Finding Code No. 2014-002, 2013-002, 12-02)

Recommendation:

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

- Review access rights to systems and applications on a periodic basis for all individuals with access to Lottery systems. Additionally, the Department should retain documentation of such reviews.

- Remove user access rights for terminated users in a timely manner.

- Further develop and document the monitoring process to include determining and implementing mitigating controls related to deficiencies noted in the Service Organizations' Control Reports to the Department's environment to support the appropriateness of the data utilized in preparing the financial statements.

- Establish a documented information technology and security policy explicitly stating procedures to be followed by end users as well as control owners in order to help manage related risks around the applications.

Lottery response:

The Lottery agrees. The Lottery will continue to make improvements in its controls to ensure sufficient protection in its IT environment and further reduce the number of or totally eliminate weaknesses. In those areas where there are weaknesses, mitigating controls will also continue to be used to help minimize their potential impact.