



FY17 ANNUAL REPORT



Moss Adams LLP has not been engaged to perform and has not performed, since the date of the report included herein, any procedures on the financial statements addressed in that report. Moss Adams LLP also has not performed any procedures relating to this annual report.

TABLE OF CONTENTS

Overview	4
Our Leadership	6
Product Innovation	7
Winner Stories	8
Beneficiary Transfers	10
Our Beneficiaries	11
Retail Partners	15
Financial Statements Table of Contents	17



ARIZONA LOTTERY OVERVIEW

ABOUT

The Arizona Lottery's mission is to support Arizona programs for the public benefit by maximizing net revenue in a responsible manner. The Arizona Lottery operates entirely from the revenue it generates through the sale of its products. Proceeds from sales of Lottery tickets, nearly \$4 million per week, fund a variety of state programs. Since July 1981, the Arizona Lottery has paid out more than \$6.1 billion in prizes to players, more than \$3.7 billion in net funding to the state of Arizona and more than \$800 million in commissions to retailers.

A MESSAGE FROM THE DIRECTOR

Gregory Edgar

As Arizona Lottery closes the books on fiscal year 2017, it is a great opportunity to reflect on the progress the agency has made, the challenges that we faced and, most importantly, the impact we were able to make throughout the state of Arizona.

The Arizona Lottery started FY17 with a significant challenge - the \$1.6 billion Powerball® jackpot from January 2016. This jackpot produced the Arizona Lottery's biggest return in history. Player excitement was unlike anything we had ever seen. The sales were unparalleled and the Arizona Lottery generated a record transfer to its beneficiaries. With success came the realization that we would have to match those gains in FY17. How could we sustain the growth of over \$70 million in gross sales generated from a once-in-a-decade \$1.6 billion Powerball run?



We found the answer in basic fundamental business practices and focusing our energies on sustainable opportunities. We launched a new \$30 Scratchers® price point; increased player awareness by adding 1,200 jackpot signs at retail locations and instituting system wide jackpot alerts; updated vending machines which increased focus on our products; developed games that increased the winning experience for our players; and invested in popular licensed properties. We worked diligently to make the retail experience more customer friendly for both our retail partners and our players.

How did we do?

I am pleased to say we were incredibly successful in FY17, and overall, our numbers have proven our strategy's success. In FY17, Arizona Lottery generated \$852 million in gross revenue. Approximately 23 percent of the revenue – more than \$198 million – was invested into vital state programs. Additionally, Lottery retailers and players saw great profit. Our nearly 3,000 retail partners earned over \$57 million in commissions and our players won a total of \$551 million in prizes.

Our FY17 sales were only 2 percent shy of meeting FY16's record shattering numbers, which occurred without the benefit of a \$70 million sales lift from a \$1.6 billion Powerball run. The Arizona Lottery is passionate about the undeniable impact this agency has on our state. Local non-profits, small businesses, corporations, individuals, families, and other state agencies all benefit from the dollars we raise. As I always say, the Arizona Lottery touches every corner of our great state.

From Arizona's foster children and vulnerable families, to its homeless population, parks and wildlife conservation and so much more, I witness the powerful impact that lottery-funded programs have every day. Lottery dollars better our community and help to make Arizona the best state to live, work and play.

Internally, our team grew exponentially through the implementation of the Arizona Management System. We challenged business processes that have been in action for decades and found ways to make them more efficient and less cumbersome for employees, while delivering more return to the agency.

Our team came together to achieve our FY17 results and it is because of them, that I am so thrilled to present Arizona Lottery's financial success. These numbers are a reflection of the blood, sweat and tears our employees have braved this past year and also tell a great story of how the Arizona Lottery recovered from the historic billion-dollar jackpot hangover to be able to give more back to Arizona Lottery's beneficiary programs.

As we look to FY18 and beyond, the Arizona Lottery is poised to increase our impact on our extraordinary beneficiaries and our great state. We look forward to continuing to create inventive and entertaining games for our players that help create a better quality of life for communities across Arizona.

OUR LEADERSHIP

Guided by its core values, the leadership team directs the Arizona Lottery through ongoing strategic planning and continued process improvement. The leadership team supports a culture of teamwork and professional staff development to realize incremental sales growth and subsequent monetary transfers to fund significant programs across Arizona.

Gregory Edgar

Executive Director

Chris Rogers

Deputy Director: Marketing and Products

Raynie Hosto

Deputy Director: Sales

Sherri Zendri

Deputy Director: Legal Services

Biju Kamaleswaran

Deputy Director: Operations

COMMISSION

Working alongside the Arizona Lottery leadership team is the agency's board of commissioners which oversee and manage the agency. Appointed by the Governor, five members serve on the Commission for a term of five years. These unique individuals conduct, administer and regulate the Arizona State Lottery. The Commission ensures the Lottery makes decisions to maximize sales, which in turn provides increased funding for important programs that serve every corner of our state.

Jeff Weintraub

Chair
Represents: CPA

Aimee Jolley

Commissioner
Represents: Public at Large

M.L. "Andy" Anderson

Commissioner
Represents: Law Enforcement

Debbie Roth

Commissioner
Represents: Retail

Chad Wilson

Commissioner
Represents: Marketing

PRODUCT INNOVATION

The Arizona Lottery provides players with an array of fun and engaging games ranging from draw games, to Scratchers, to second-chance play and more. Here is an overview of the products we offer:

DRAW GAMES

In FY17, a lucky Arizonan became a multi-millionaire playing our in-state jackpot game, The Pick™. The \$8.4 million jackpot was won in December 2016. A few months later in April 2017, another Arizona player won \$60 million playing Powerball!

SCRATCHERS

Scratchers sales soared to over \$640 million in FY17. In February 2017 the Arizona Lottery launched its first \$30 ticket, Ultimate Millions. With four top prizes of \$3.5 million, the game became an instant player favorite generating over \$55 million in sales in the final months of the fiscal year.

INSTANT TABS

In FY17, Instant Tabs gained popularity and surpassed FY16 sales by more than 13 percent. The Arizona Lottery continues to grow the category as more players are introduced to the product through added retail locations. Charitable retailers who become Instant Tab retailers, like veteran's and fraternal organizations, earn 20 percent commission on sales.



WINNER STORIES

KERRY & DIANE – THE PICK, \$2.5 MILLION, AND POWERBALL, \$1 MILLION

Diane and Kerry have both always enjoyed the lottery, so playing became a weekly routine and the couple won two separate jackpots!

MIKE – VIP CROSSWORD, \$100,000

A familiar voice of 1100 KFXX took home \$100,000 after playing the VIP Crossword! He even brought cheesecake in for the Arizona Lottery staff when he found out he had won.

MARY ELLEN – FANTASY 5™, \$384,000

Mary plans on increasing the donations she gives to charities and help out some friends with the money she won!

BREANNE – CARDINALS SCRATCHERS TICKET, \$50,000

Breanne is a huge Arizona Cardinals and Arizona Lottery fan. Her husband even proposed by making a faux Scratchers® ticket that she had to scratch!

MATT – WILLY WONKA GOLDEN TICKET, \$100,000

Matt immediately called his parents to tell them the good news, and then got on the phone with his son. He plans to take his son on vacation with his winnings!



NANCY – VIP CROSSWORD, \$100,000

Nancy was on her way back from Disneyland with her family and bought Scratchers® to scratch the rest of the way home. She stopped at Arizona Lottery Phoenix office on her way back to Show Low to cash it in. She couldn't believe she won. Nancy is thinking about using her winnings to take her husband on a cruise.

MARTIN – THE PICK, \$2,000

Martin is a loyal player and has played the Arizona Lottery for 25 years. He won \$2,000 playing Arizona's very own draw game!

RYAN – CASH EXPLOSION, \$1,000

Ryan celebrates every Friday with a Cash Explosion Scratchers ticket and he plans to buy a massage chair with his winnings!

LOTTERY LOVER FROM PHOENIX – ULTIMATE DAILY CASH GIVEAWAY, \$25,000

This winner couldn't believe it when she got the call that she won. She and her husband plan on using their winnings to go on a cruise, as well as fix up their house and pay some bills.

GRANDPARENT FROM GILBERT – ALL OR NOTHING™, \$25,000

This lucky winner received a wonderful birthday surprise when he won \$25,000 from All or Nothing.

DAVID AND GINA – \$200 MILLION CASH EXPLOSION, \$50,000

The lucky couple plan on taking a vacation and remodeling their kitchen with their winnings.



BENEFICIARY TRANSFERS

Through state statute, proceeds from Arizona Lottery ticket sales directly fund agencies and their programs that work to develop and enhance our state. Lottery transfer dollars waterfall to 13 legislatively mandated funds, which in turn reach 20 different programs.

These beneficiaries include:

FY17 BENEFICIARIES		
	General Fund	\$105,926,112
	University Bond Fund	\$39,926,998
	Healthy Arizona	\$20,701,600
	Mass Transit (LTAF)	\$11,529,000
	Heritage Fund	\$10,000,000
	Commerce Authority Arizona Competes Fund	\$3,500,000
	Court-Appointed Special Advocate Fund	\$3,965,599
	Economic Security Homeless Services	\$1,000,000
	Internet Crimes Against Children/ Victim's Rights Enforcement	\$1,000,000
	Department of Gaming	\$300,000
	Tribal College Dual Enrollment Fund	\$250,000
Total Transfers to Other State Funds		\$198,099,309

OUR BENEFICIARIES

COURT APPOINTED SPECIAL ADVOCATES OF ARIZONA

CASA stands for Court Appointed Special Advocates. CASA volunteers are everyday people appointed by a judge to speak up for abused and neglected children in court. CASA of Arizona and its volunteers have been advocating for abused and neglected children in Arizona for over 30 years and have served more than 20,600 children.

CASA strives to ensure that society is fulfilling its most fundamental obligation to children in need. CASA trains and supports qualified, compassionate adults that will fight for and protect a child's right to be safe, to be treated with dignity and respect, and to learn and grow in the security of a loving family.

TRIBAL COLLEGE DUAL ENROLLMENT PROGRAM FUND

Administered by the Department of Education, the Tribal College Dual Enrollment program provides choice and access to higher education for Native American high school students. The program gives thousands of students the opportunity to take a college course for both high school and college credit.

INTERNET CRIMES AGAINST CHILDREN TASK FORCE

The Internet Crimes Against Children Task Force program helps state and local law enforcement agencies develop an effective response to cyber enticement and child pornography cases. Funds support forensic and investigative components, training and technical assistance, victim services, and community education.

The Arizona Internet Crimes Against Children Task Force is comprised of investigators from city, county, state and federal agencies. Special emphasis is placed on locating, prosecuting, and imprisoning people who intentionally exploit children. Lead by the Phoenix Police Department's Internet Crimes Against Children Unit, the AZICAC Task Force diligently pushes to fulfill this goal with highly trained and professional investigators and cutting edge forensics and technology.



LOCAL TRANSPORTATION ASSISTANCE FUND

The Local Transportation Assistance Fund was established in 1981 and is supported by the Arizona Lottery. Funds from the Arizona Lottery are distributed to counties, cities and towns to maintain and improve public transportation programs.

HERITAGE FUND

The Heritage Fund is used to protect endangered species, acquire habitat for the benefit of sensitive species, provide access to outdoor recreational opportunities, and educate children and adults about wildlife.

The Heritage Fund is critical to recovering or sustaining Arizona's unique native wildlife and to managing more than 800 species. For nearly 30 years, the fund has contributed to significant and nationally-recognized wildlife conservation success stories, including the Bald Eagle Nestwatch Program, acquiring 18,000 acres of land for wildlife conservation and public enjoyment, the reintroduction of critical species to Arizona, and much more.

COMMERCE AUTHORITY ARIZONA COMPETES FUND

The Arizona Lottery contributes to the Arizona Competes Fund, which awards grants for attracting, expanding or retaining Arizona's core enterprises. These vital funds also support and advance programs for rural businesses, small businesses and business development projects that enhance Arizona's economic development.



DIVISION OF PROBLEM GAMBLING

Through the Arizona Department of Gaming, the Office of Problem Gambling provides and supports effective problem gambling prevention, treatment and education programs throughout Arizona. The Arizona Lottery helps support a sustainable continuum of services that reduces the impact of problem gambling in Arizona.

The Division of Problem Gambling strives to accomplish its mission by being culturally sensitive and responsive to the needs of partners and those it serves. They focus on being professional, collaborative, equitable and innovative in their solutions to address problem gambling.

VICTIMS' RIGHTS ENFORCEMENT FUND

The fund, administered by the Department of Public Safety, benefits the Arizona Attorney General's Office of Victim Services. Primary focuses of the fund are providing legal representation to enforce the rights of crime victims as counsel of record in criminal cases, as well as providing social services to assist crime victims during the course of legal representation.

HOMELESS SERVICES

Administered by the Department of Economic Security, this fund is used to provide grants to nonprofit organizations for homeless emergency programs, transitional shelters, rapid re-housing and rental assistance. These programs focus on placing Arizona's homeless in permanent housing and advocate for homelessness prevention education across Arizona.

UNIVERSITY BOND FUND

Used for the University Capital Improvement Lease-to-Own and Bond (UCI) Fund, these dollars to date have provided valuable debt service for nearly \$673 million in financing. This financing has allowed the university system to build out critical research and academic expansions while also addressing deferred maintenance on older buildings.

HEALTHY ARIZONA

This unique fund, administered by the Department of Health Services, impacts five different programs across Arizona that assist individuals and families with health-related needs. The various programs that benefit from this fund include Women, Infants and Children (WIC), Arizona Area Health Educational Centers, Health Start, Pregnancy Prevention and the Arizona Biomedical Research Commission.

HEALTHY FAMILIES ARIZONA

The Department of Child Safety's Healthy Families Arizona is a voluntary home visitation program that serves pregnant women and families of newborns. Program services are designed to strengthen families during the critical first years of a child's life. Through its efforts to support and educate families, the program has shown to reduce incidences of child abuse and neglect, provide stability for at-risk families and has grown a new generation of healthy families in the state.



RETAIL PARTNERS

The Arizona Lottery is proud to have a network of more than 3,000 retailers across the state. These accessible locations create an exciting experience and lasting relationship for their loyal customers.

To find the nearest retailer, visit www.ArizonaLottery.com/Retailers

RETAILER COMMISSION

As an Arizona Lottery retail partner, every store receives a 6.5 percent commission on all Lottery sales, of the highest commissions in the country. Retailers have the opportunity to earn an additional .5 percent performance incentive as well as a variety of additional incentives through Lottery promotions.

In Fiscal Year 2017, the Arizona Lottery gave \$57 million in commissions to retailers across the state. Customers benefit while shopping at an Arizona Lottery retailer, and the retailer is able to increase traffic to their store, sell more products and create lasting relationships with their customers. Since its inception, the Arizona Lottery has given more than \$850 million in commissions to its retail partners.

For licensing and licensing renewal information, please contact 480.921.4486.



Table of Contents

	PAGE
Report of Independent Auditors	1-2
Management's Discussion and Analysis (Unaudited)	3-10
Basic Financial Statements	
Statements of net position	11
Statements of revenues, expenses, and changes in net position	12
Statements of cash flows	13
Notes to basic financial statements	14-27
Required Supplementary Information	
Schedule of proportionate share of the net pension liability	29
Schedule of pension contributions	30
Notes to required supplementary information	31
Report of Independent Auditors of Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	32-33
Schedule of prior year audit findings	34

Report of Independent Auditors

To the Commissioners of
Arizona State Lottery
Phoenix, Arizona

Report on the Financial Statements

We have audited the accompanying financial statements of the Arizona State Lottery (the “Lottery”, a proprietary fund of the State of Arizona) as of and for the year ended June 30, 2017, and the related notes to the financial statements, which collectively comprise the Lottery’s basic financial statements as listed in the table of contents.

Management’s Responsibility for the Financial Statements

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

Auditor’s Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in conformity 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 auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Lottery'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 respective financial position of the Arizona State Lottery, as of June 30, 2017, and the respective changes in financial position, and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3 through 10, the schedule of proportionate share of the net pension liability on page 28, and the schedule of pension contributions on page 29 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in conformity with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we also have issued our report dated December 8, 2017 on our consideration of the Lottery'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 Lottery's internal control over financial reporting and compliance.

Moss Adams LLP

Scottsdale, Arizona
December 8, 2017

Arizona State Lottery A Proprietary Fund of the State of Arizona Management's Discussion and Analysis (Unaudited)

This discussion and analysis of the Lottery's financial statements is a required component of financial reporting under *Governmental Accounting Standards* and was prepared by Arizona Lottery Management. It provides an overview of financial activities as of and for the year ended June 30, 2017, and should be read in conjunction with the Lottery's financial statements and notes to the financial statements.

This annual report consists of three types of financial statements and accompanying notes that provide explanations and details of accounting policies, account balances and activities. Account balances and activities are shown as of and for the year ended June 30, 2017. The statement of net position; the statement of revenues, expenses, and changes in net position; and the notes are presented using the accrual method of accounting. Under this method, financial transactions are recorded when earned or incurred regardless of when cash is received or disbursed. The statement of cash flows reflects cash receipts and disbursements during the same 12-month period.

The statement of net position provides information about the assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position of the Lottery. Assets consist of cash, substantially all held by the State Treasurer, amounts owed to the Lottery from licensed Lottery retailers and other State agencies, ticket inventory, and property. Liabilities represent amounts owed by the Lottery to vendors, to employees for wages and benefits, to prize winners, and to other State funds. Fund net position represents the portion of the Lottery's assets that are not encumbered by liabilities. It serves as an indicator of the net worth of the Lottery.

A summary of the financial results of operations for the 12-month period is presented in the statement of revenues, expenses, and changes in net position. Operating revenues include sales of Lottery tickets, retailer licensing fees, and commissions earned on the sales of Lottery tickets at Lottery offices and special events. Direct costs and administrative expenses comprise the operating expenses section of this statement. Direct costs are variable expenses that fluctuate with the level of sales. Marketing and overhead costs are included in the administrative expenses category.

Non-operating revenues consist of interest earned on prize fund cash investments from the State Treasurer and interest credited to the Lottery's Multistate Lottery Association (MUSL) unreserved account for interest earned on prize reserves at MUSL. The transfer's category includes transfers to other state funds as required by Lottery statutes.

The statement of cash flows includes cash receipts and disbursements from operating, noncapital financing, and investment earnings. This statement also includes a reconciliation of operating income presented on the accrual basis of accounting to net cash provided by operating activities. The notes to the financial statements present information on accounting policies, transfers and statutory requirements, commitments, contingencies, and retirement benefits. These notes are an integral part of the financial statements.

Arizona State Lottery

A Proprietary Fund of the State of Arizona

Management's Discussion and Analysis (Unaudited)

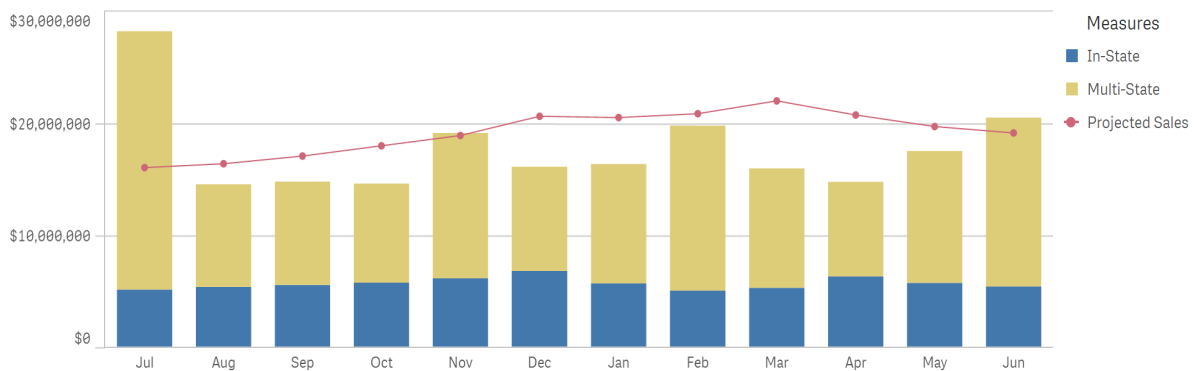
FINANCIAL HIGHLIGHTS

- The Lottery achieved sales of \$852.0 million in fiscal year 2017, a 2.2% decline over the prior fiscal year, but closing a substantial sales gap created by the \$1.5 billion Powerball jackpot from fiscal year 2016.
- The Lottery returned over \$198 million to designated state programs in fiscal year 2017, with all beneficiaries receiving full funding. Since its inception, the Lottery has generated \$3.8 billion for Arizona programs.
- Scratcher games continued to be strong performers with record sales of \$632.8 million in fiscal year 2017, an increase of \$42.1 million over the prior year. The Lottery introduced its first \$30 game in FY 2017; sales from this game and demand for \$10 and \$20 price point tickets helped drive this sales increase.
- The instant tab product line exhibited substantial growth in its niche market, with an increase of \$1.7 million over the prior fiscal year, representing a growth rate of almost 28%.
- The Lottery's retail partners earned more than \$57 million in commissions and incentives in fiscal year 2017.

REVENUES

Total game sales were \$852.0 million in fiscal year 2017 as compared to \$871.0 million in fiscal year 2016. Some decline was not unexpected due to the record-setting \$1.5 billion Powerball jackpot in FY 2016. Powerball sales were \$102.4 million for FY 2017 and \$160.3 for FY 2016. In general, draw game sales are largely jackpot-driven, impacting sales increases or decreases in any given year. A comparison of draw game sales broken down by multi-state and in-state games for FY 2017 is depicted in the chart below.

FY 2017 Draw Sales by Multi-State & In-State

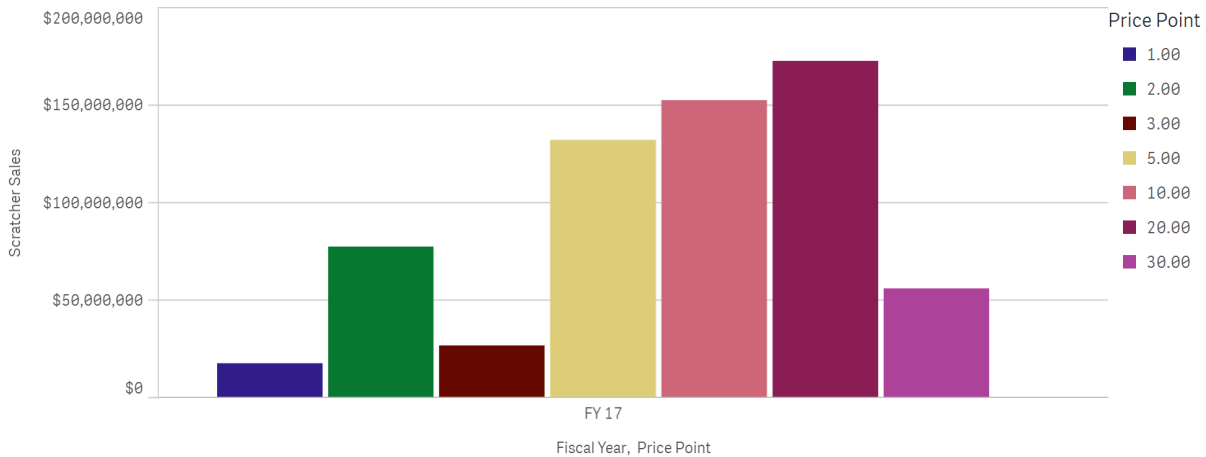


Arizona State Lottery A Proprietary Fund of the State of Arizona Management's Discussion and Analysis (Unaudited)

The Lottery closed the total year-over-year sales gap to within \$19 million, resulting in only a 2.2% decrease from the prior year. The instant ticket product line was the largest contributor to offsetting the Powerball decrease, with an increase of \$43.8 million over the prior year (42.1 million from the Scratchers product line and \$1.7 million from instant tab tickets). The Lottery's first \$30 Scratchers game and continued growth in the \$10 and \$20 price points helped to generate this increase.

The following chart shows Scratchers sales for FY 2017 by price point and the subsequent table summarizes Lottery product sales and the incremental change between fiscal years.

FY 2017 Instant Sales by Price Point



Product Sales	FY 2016	FY 2017	Change	Percentage
Scratchers	\$ 590.7	\$ 632.8	\$ 42.1	7.1%
Instant Tabs	6.1	7.8	1.7	27.9%
Powerball	160.3	102.4	(57.9)	-36.1%
Mega Millions	44.7	41.4	(3.3)	-7.4%
The Pick	33.1	31.5	(1.6)	-4.8%
Fantasy 5	16.3	18.4	2.1	12.9%
Pick 3	10.6	11.1	0.5	4.7%
All or Nothing	3.5	2.9	(0.6)	-17.1%
Weekly Winnings	0.7	-	(0.7)	-100.0%
5 Card Cash	5.0	3.7	(1.3)	-26.0%
Total	\$ 871.0	\$ 852.0	\$ (19.0)	-2.2%

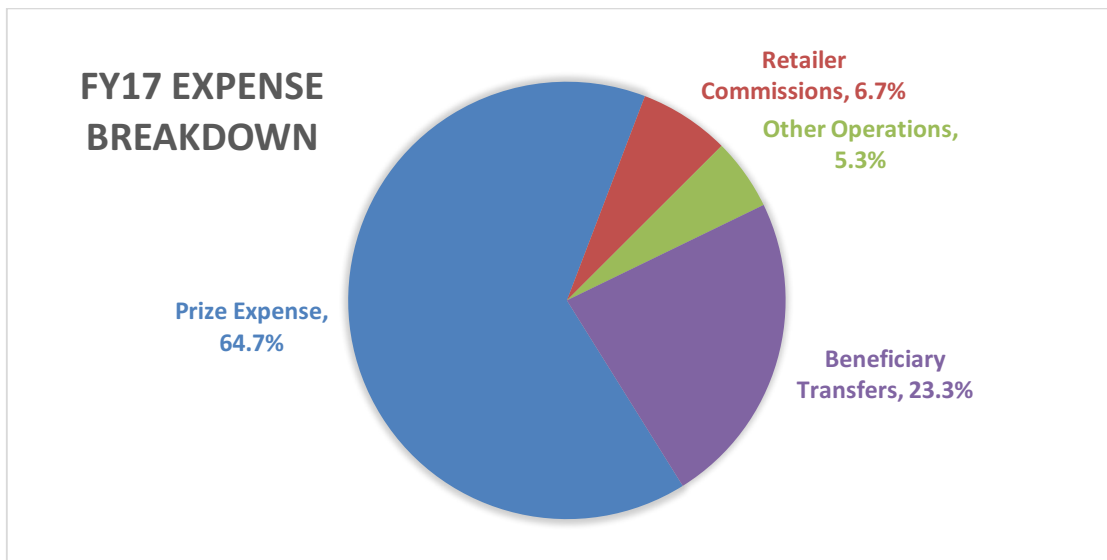
Arizona State Lottery A Proprietary Fund of the State of Arizona Management's Discussion and Analysis (Unaudited)

As shown in the financial statements, other operating revenues for the year ended June 30, 2017, were \$1,190,432 compared to \$194,158 for the year ended June 30, 2016. Other operating revenue is comprised of license fees and other miscellaneous revenue. The increase in FY 2017 was a result of prior year revenues recognized from Lottery on-site store locations in Phoenix and Tucson. Total operating revenues, the sum of game sales and other operating revenues, were \$853.2 million for the year ended June 30, 2017, as compared to \$871.1 million for the year ended June 30, 2016. The largest contributor to the year-over-year decline in total operating revenues was decreased draw game sales.

Non-operating revenues (investment income) for the year ended June 30, 2017, were \$213,272 as compared to \$31,092 for the year ended June 30, 2016. Non-operating revenue is comprised of interest earned on invested cash. The increase year-over-year was due to changes in cash management strategies.

EXPENSES

The Lottery is required to return no less than 50% of annual revenues as prizes and to spend no more than 18.5% of annual revenues on Lottery operations. Remaining funds are statutorily dedicated and transferred to various state beneficiaries. The following chart provides a general breakdown of Lottery funds expended for FY 2017:



Lottery total operating expenses were \$655.3 million for fiscal year ended June 30, 2017 as compared to \$660.4 million for fiscal year ended June 30, 2016. Of this amount, \$632.5 million were incurred in direct support of Lottery game sales in FY 2017. In comparison, \$640.7 million of Lottery total operating expenses for FY 2016 were direct game-related expenses. These expenses include instant and online prize expense, retailer commissions and incentives, instant ticket printing, vendor compensation for instant ticket distribution, and vendor compensation for maintaining and supporting the on-line gaming system.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Management's Discussion and Analysis (Unaudited)

Other operating expenses not directly related to Lottery game sales include items such as marketing, personnel expenses, depreciation/amortization, and other administrative costs. These expenses totaled \$22.7 million in FY 2017 as compared to \$19.7 million in FY 2016. Additional spending for advertising and promotional purposes was the largest contributor to the increase for FY 2017. The following table compares Lottery operating expenses between fiscal years. All expenses are presented in millions of dollars.

Operating Expenses	FY 2016	FY 2017	Change	Percentage
Instant & On-Line Prizes	\$ 557.5	\$ 551.0	\$ (6.5)	-1.2%
Retailer Commissions & Incentives	59.2	57.2	(2.0)	-3.4%
On-Line Vendor Fees	10.1	8.9	(1.2)	-11.9%
Instant Ticket Distribution Expenses	6.0	6.7	0.7	11.7%
Instant Ticket Printing Expenses	7.9	8.7	0.8	10.1%
Total Direct Costs	640.7	632.5	(8.2)	-1.3%
Operating Expenses	19.7	22.8	3.1	15.7%
Total	\$ 660.4	\$ 655.3	\$ (5.1)	-0.8%

The decrease in prize expenses, retailer commissions, and on-line system expenses is reflective of the decrease in product sales. Although overall prize expenses were lower (consistent with decreased sales), prize expense represented approximately 65% of product sales in FY 2017 as compared to 64% of product sales in FY 2016. This is largely due to a higher market share of Scratchers tickets in the \$20 and \$30 price points. These tickets carry a higher associated prize expense, driving up the overall prize percentage. The increase in instant ticket distribution and printing expenses of \$1.5 million corresponds to higher sales for that product line.

Of the \$22.8 million for other operating expenses in fiscal year 2017, \$14.8 million was used for advertising and promotion, \$5.0 million was used to compensate Lottery employees, and \$2.9 million was used for other administrative expenses. In comparison, of the \$19.7 million in total operating expenses for fiscal year 2016, \$10.8 million was used for advertising and promotion, \$5.2 million was used to compensate Lottery employees, and \$3.7 million was used for other administrative expenses.

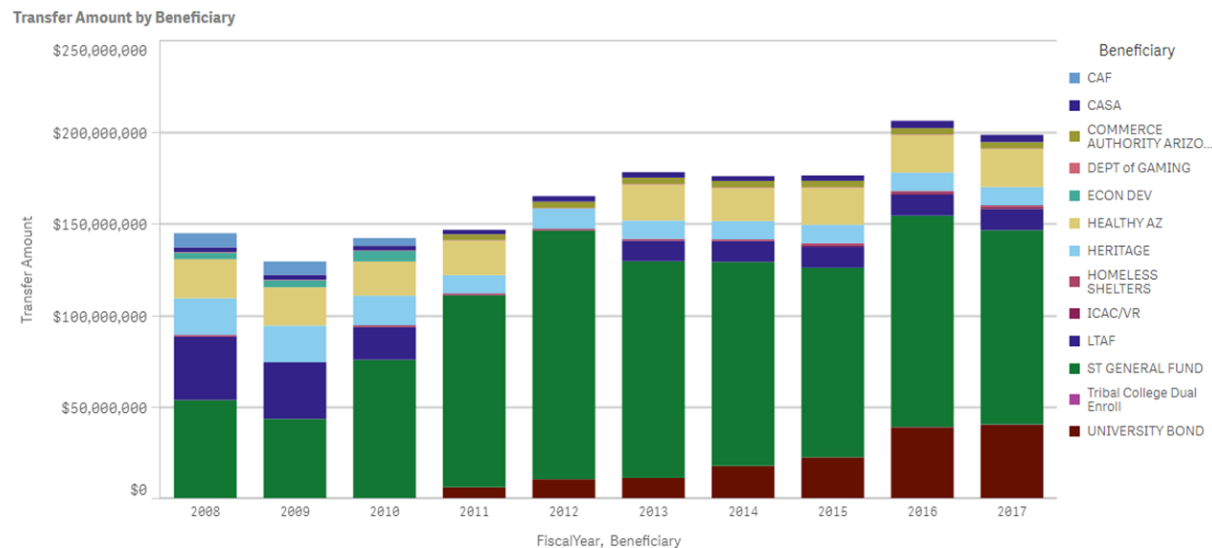
TRANSFERS TO OTHER STATE FUNDS

Lottery proceeds are statutorily directed to various benefiting funds. Note 3 to the financial statements details the amounts transferred to other State Funds. The Lottery transferred \$198.1 million in fiscal year 2017, as compared to \$205.8 million transferred in fiscal year 2016. The decrease in product sales resulted in a corresponding decrease in transfer of \$7.6 million. Although total transfers declined, all designated beneficiary programs received full funding. The total transfer rate as a percentage of sales was 23.3% in fiscal year 2017 and 23.6% in fiscal year 2016. The following chart displays transfers to Lottery beneficiaries over the last 10 years:

Arizona State Lottery

A Proprietary Fund of the State of Arizona

Management's Discussion and Analysis (Unaudited)



OTHER FINANCIAL INFORMATION

The Lottery's total net position was \$3.7 million at June 30, 2017, the same amount as June 30, 2016. The statement of net position is summarized in the table below.

Statement of Net Position	FY 2016	FY 2017
Current assets	\$ 109.0	\$ 85.1
Capital assets	3.7	3.7
Other assets - deposits	9.6	9.5
Total assets	122.3	98.3
Deferred outflows of resources	0.5	1.0
Total assets and deferred outflows of resources	122.8	99.3
Current liabilities	111.9	88.1
Net pension liability	6.5	5.7
Total liabilities	118.4	93.8
Deferred inflows of resources	0.7	1.8
Net position	3.7	3.7
Total liabilities and net position	\$ 122.8	\$ 99.3

The Lottery's total assets at June 30, 2017 were \$98.3 million, as compared to \$122.3 million the previous year. Assets consisted primarily of cash held by the State Treasurer, net receivables from Lottery retailers for the sale of Lottery products, Scratchers ticket and instant tab inventory, net investment in capital assets, and deposits with MUSL (Multi-State Lottery).

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Management's Discussion and Analysis (Unaudited)

Total liabilities at June 30, 2017, were \$93.8 million, as compared to \$118.4 million the previous year. Liabilities consisted of accounts payable and accrued expenses, prize liabilities, amounts due to other funds, amounts due to other State Funds, and net pension liability.

Year-over-year comparisons for assets and liabilities are as follows:

ASSETS			LIABILITIES & NET POSITION		
Category	FY16 (M)	FY17 (M)	Category	FY16 (M)	FY17 (M)
Cash Held by State Treasurer	91.5	75.6	Accounts Payable/Accrued Exp.	7.2	6.0
Net Receivables	12.7	5.4	Prize Liabilities	10.0	4.9
Scratchers/Instant Tab Inventory	4.8	4.1	Due to Other Funds	30.4	29.7
Capital Assets	3.7	3.7	Due to State Funds	64.3	47.4
MUSL Deposit	9.6	9.5	Pension Liability	6.5	5.8
Deferred Outflows	0.5	1.0	Deferred Inflows	0.7	1.8
			Net Position	3.7	3.7
	<u>\$ 122.8</u>	<u>\$ 99.3</u>		<u>\$ 122.8</u>	<u>\$ 99.3</u>

Laws 2010, Sixth Special Session of the State Legislature, amended Lottery statutes to allow the State to issue Lottery Revenue Bonds. These bonds provide additional working capital to pay appropriated expenditures of the State's General Fund. The bonds are payable solely from and secured by pledged revenues consisting of, until July 1, 2012, amounts distributable to the State General Fund from the Lottery pursuant to Lottery law, and from and after July 1, 2012 all Lottery revenues deposited to the Lottery fund net of Lottery operating expenses. (See Note 3 to the financial statements.)

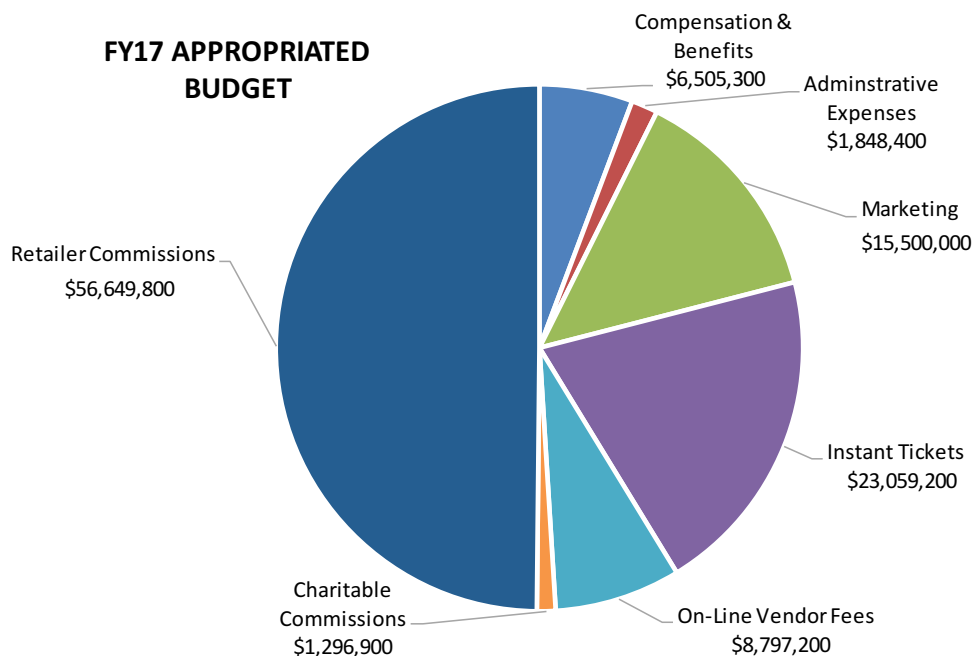
BUDGETARY HIGHLIGHTS

The Lottery's budget is set by the legislative appropriations process on an annual basis. The budget for fiscal year 2017 was set in the regular legislative session of 2016. The Lottery's appropriation for sales-related expenditures is based on approved percentages of projected revenues and is allowed to adjust without a supplemental appropriations request if actual revenues exceed projected revenues. The appropriation does not include an amount for prizes because Lottery statutes set this amount at "not less than 50% of the total annual revenues accruing from the sale of Lottery tickets or shares."

The Lottery's approved appropriation was \$113.4 million for Fiscal Year 2017 based on an estimated \$851.4 million in total sales, but was increased slightly to \$113.7 million as a result of actual revenues exceeding projections.

**Arizona State Lottery
A Proprietary Fund of the State of Arizona
Management’s Discussion and Analysis (Unaudited)**

The following chart depicts the fiscal year 2017 appropriated budget based on actual sales:



CONTACTING THE LOTTERY’S FINANCIAL MANAGEMENT

This management’s discussion and analysis (MD&A) is designed to provide Arizona citizens, Arizona government officials, our players, retailers, and other interested parties with an overview of the Lottery’s financial activity for Fiscal Year 2017 and to demonstrate the Lottery’s accountability for the money received from the sale of Lottery products.

If you have questions about the MD&A or need additional information, contact the Arizona Lottery’s Deputy Director: Operations, 4740 East University, Phoenix, Arizona 85034.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Statements of Net Position

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES		June 30, 2017
CURRENT ASSETS		
Cash and investments, substantially all held by the State Treasurer	\$	75,604,143
Accounts receivable, net of allowance for doubtful accounts of \$227,019		5,372,489
Scratch ticket inventory		4,033,575
Pull tab inventory		148,541
Total current assets		85,158,748
CAPITAL ASSETS		
Land and land improvements		1,268,695
Buildings		4,309,192
Furniture, fixtures, and equipment		2,443,367
Intangible assets		599,324
Leasehold improvements		352,544
Less accumulated depreciation and amortization		(5,293,808)
Total capital assets		3,679,314
OTHER ASSETS		
Deposit - MUSL		9,477,589
Total assets		98,315,651
DEFERRED OUTFLOWS OF RESOURCES		
Deferred outflows related to pensions		1,020,390
Total assets and deferred outflows of resources	\$	99,336,041
LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND NET POSITION		
CURRENT LIABILITIES		
Accounts payable	\$	5,815,337
Accrued expenses		264,909
Prize liability		4,894,164
Due to other funds		29,718,265
Due to other state funds		47,403,050
Total current liabilities		88,095,725
NET PENSION LIABILITY		
		5,751,040
Total liabilities		93,846,765
DEFERRED INFLOWS OF RESOURCES		
Deferred inflows related to pensions		1,809,962
Total liabilities and deferred inflows of resources		95,656,727
NET POSITION		
Net investment in capital assets		3,679,314
Unrestricted (deficit)		-
Total net position	\$	3,679,314

See accompanying notes.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Statements of Revenues, Expenses, and Changes in Net Position

	Year Ended June 30 2017
OPERATING REVENUES	
Ticket sales	
Scratchers	\$ 632,781,377
Powerball	102,449,615
Mega Millions	41,374,249
The Pick	31,496,190
Fantasy 5	18,436,608
Pick 3	11,124,467
5 Card Cash	3,717,420
Instant Tab	7,751,982
AON	2,872,714
	<hr/>
Total ticket sales	852,004,622
Other operating revenues	1,190,432
	<hr/>
Total operating revenues	853,195,054
	<hr/>
OTHER EXPENSES	
Direct costs	
Prize expense	551,057,536
Retailer commissions and incentives	57,177,961
On-line system expense	8,804,308
Scratcher system and distribution expenses	6,693,604
Tickets purchased	8,723,167
	<hr/>
Total direct costs	632,456,576
Advertising and promotion	14,766,514
Wages and related expenses	5,071,696
Contract services	-
Depreciation	291,670
Administrative expenses	2,716,231
	<hr/>
Total operating expenses	655,302,687
	<hr/>
OPERATING INCOME	197,892,367
NONOPERATING REVENUES - Investment income and other	213,271
	<hr/>
INCOME BEFORE TRANSFERS	198,105,638
TRANSFERS TO OTHER STATE FUNDS	198,099,309
	<hr/>
CHANGE IN NET POSITION	6,329
	<hr/>
NET POSITION, beginning of year	3,672,985
	<hr/>
NET POSITION, end of year	\$ 3,679,314
	<hr/> <hr/>

See accompanying notes.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Statements of Cash Flows

	Year Ended June 30, 2017
CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from retailers-net of validations, commissions, and incentives	\$ 348,179,830
Cash from other sources (Pollard A/R, MUSL, assignment fees, Superior Court)	38,966,371
Cash payments for prizes and related taxes	(141,523,473)
Cash payments to suppliers of goods or services	(41,898,780)
Cash payments to employees	(5,281,795)
Net cash provided by operating activities	<u>198,442,153</u>
CASH FLOWS USED BY NONCAPITAL FINANCING ACTIVITIES	
Payments to beneficiaries per Arizona Statutes	<u>(214,329,639)</u>
CASH FLOWS USED BY CAPITAL FINANCING ACTIVITIES	
Payments for acquisition of capital assets	<u>(235,953)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Receipts of interest	<u>199,798</u>
Net increase (decrease) in cash	(15,923,641)
CASH AT BEGINNING OF YEAR	<u>91,527,784</u>
CASH AT END OF YEAR	<u><u>\$ 75,604,143</u></u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES	
Operating income	\$ 197,892,367
Adjustments to reconcile operating income to net cash provided by operating activities	
Depreciation	291,670
Pension expense	(154,137)
Employer pension contribution	(27,130)
Changes in operating assets and liabilities	
Accounts receivable	7,314,720
MUSL interest	13,474
Ticket and pull tab inventory	660,941
Deposit - MUSL	50,722
Accounts payable and accrued expenses	(1,146,134)
Prizes payable and due to other funds	(6,454,340)
Net cash provided by operating activities	<u><u>\$ 198,442,153</u></u>

See accompanying notes.

Arizona State Lottery

A Proprietary Fund of the State of Arizona

Notes to Basic Financial Statements

Note 1 – Nature of Operations and Summary of Significant Accounting Policies

The Arizona State Lottery (the "Lottery") was created by enactment of Title 5, Chapter 5 to the Arizona Revised Statutes (A.R.S.), which was an initiative measure approved by the voters of the State of Arizona (the "State") in 1980. The Lottery commenced operations in 1981. The accompanying financial statements present information as to the transactions of the Lottery.

For the period July 1, 2016 through June 30, 2017, the Lottery held 123 instant games of which 86 games expired during the fiscal year. During 2017, the Lottery continued the "The Pick," "Fantasy 5," "Pick 3," "Powerball," "Mega Millions," "Five Card Cash," and "All Or Nothing" on-line games. As required, the Lottery has deposits with "Powerball," and "Mega Millions," multistate on-line lottery games, of \$9.5 million and \$9.6 million at June 30, 2017 and 2016, respectively. The Lottery also sold instant tab lottery tickets to non-profit organizations and aged-restricted outlets. These games are printed and sold by the Lottery, though are administered and paid out by the purchasing non-profit organizations. The Lottery prepares its financial statements in accordance with accounting principles generally accepted in the United States of America.

State Lottery Fund – The State Lottery Fund (the "Fund"), which is a proprietary fund of the State, accounts for revenues received from the sale of lottery tickets and the receipt of license fees. The Fund is operated in a manner similar to a private business enterprise where the governing body has decided that periodic determination of revenues earned, expenses incurred, and net income is appropriate for capital maintenance, management control, accountability, or other purposes. Activities accounted for in the proprietary fund follows all applicable Governmental Accounting Standards Board pronouncements. The Fund accounts for prize payments, operational expenses (including consulting), promotional, advertising expenses, and transfers of monies to other State funds. Receipts from each type of lottery game are allocated as follows:

- Not less than 50% of the total annual revenue from Lottery ticket sales is apportioned for the payment of prizes to the holders of winning tickets for the period July 1, 2016 to June 30, 2017.
- Not more than 18.5% is apportioned for payment of Lottery operating expenditures as defined by Arizona Revised Statute 5-555. Legislation enacted in 2008 set this limit and also removed a 4% cap on advertising expenditures.

Cash and investments – Substantially all the Lottery's cash is held by the State Treasurer for pooled investment purposes. Statutes require the State Treasurer to invest these pooled funds in obligations of the U.S. government and are recorded at fair value.

Accounts receivable – Retailers are billed weekly for tickets sold. Payments from retailers are mainly received through electronic withdrawals from retailer accounts one week after the amounts are billed. Accounts receivable represents amounts that have been billed but not yet collected. An allowance for doubtful accounts is recorded in the amount of any balances that are not paid by retailers, generally one week after amounts are billed.

Arizona State Lottery

A Proprietary Fund of the State of Arizona

Notes to Basic Financial Statements

Note 1 – Nature of Operations and Summary of Significant Accounting Policies (continued)

Ticket inventory – Ticket inventory is stated at cost, which represents the amount incurred by the Lottery for purchasing the tickets located in the vendor's warehouses or held by retailers. The cost of tickets is charged to agency operations upon the recognition of revenue under the procedures described above.

Capital assets – Capital assets of the Fund, which consists principally of buildings, land, land improvements, and office furniture and equipment are stated at historical cost. The Lottery defines capital assets as assets with an individual cost of more than \$5,000. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets' lives are not capitalized. Expenditures for normal repairs and maintenance are charged to operations as incurred, whereas expenditures for major renewals, replacements, and betterments are capitalized and depreciated. Depreciation is computed using the straight-line method. Capital assets are depreciated on the following basis:

Buildings	40 years
Improvements	40 years
Fixtures and equipment	3–10 years
Intangible assets	6 years

Investments and investment income – The provisions of GASB Statement No. 72, *Fair Value Measurement and Application*, have been implemented in the Lottery as of June 30, 2016. This standard addresses the Lottery's reporting related to fair value measurements and provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements.

The Lottery reports investments at fair value on the statement of net position as determined by quoted market prices with any realized or unrealized gains and losses reported in the statement of revenues, expenses, and changes in net position. Investment income from all investments is recognized by the Lottery in the period it is earned and gains and losses are recognized as revenue in the period in which they occur. Investment income also includes earnings on invested cash held by the State Treasurer and invested prize, reserves held by the Multistate Lottery Association (MUSL).

Sales and revenue recognition – Revenue is recognized and the related direct expenses of ticket sales, including prize expense, are accrued based upon the known relationship of the amount of ticket sales to the amount of prizes for each game. This method of measuring revenue is necessary in order to properly match revenues and expenses. The Lottery's operating revenues result from exchange transactions associated with the principle activity of the fund. Non-operating revenues result from non-exchange transactions or from ancillary activities of the fund.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 1 – Nature of Operations and Summary of Significant Accounting Policies (continued)

Prize expense and prize liability – Instant ticket prize expense is estimated and recognized when ticket packs are settled and is based on the design of the game. Game designs include certain guaranteed prizes in each pack of tickets and prizes placed randomly by the gaming vendor. When validations for the game have ended, differences between estimated and actual prizes awarded for the randomly placed tickets are adjusted to prize expense and prize liability. Prize expense for draw games is recognized as drawings are held, based on the estimated or known cost of the prize payments. Prize expense is adjusted as prizes are claimed and the actual cost of the prize is known. Prize liabilities for prizes are recorded when the prize expense is recognized. The prize liability represents a liability for prizes which are unclaimed for games in progress. Prizes unclaimed for 180 days after the drawing date are forfeited by the ticket holder. The Lottery retains 70% of all forfeited unclaimed prizes, under State statute, for use as additional prizes in future games. State statute also requires that 30% of all forfeited unclaimed prizes be transferred to the Court Appointed Special Advocate Account, a fund within the State's General Fund. In April 2015, Senate Bill (SB) 1477 was signed by the Governor of Arizona which requires that 15% of all forfeited unclaimed prizes be transferred to the tribal college dual enrollment program fund but not to exceed \$250,000 in any fiscal year. SB 1477 adjusted the 70% retained for additional prizes in future games to 55%. All remaining forfeited unclaimed prizes offset prize expense. SB 1477 was effective starting in FY 2016.

Compensated absences – Vacation leave vests with the employee as it is earned. Employees may carry forward only the amount of vacation benefits equal to the maximum allowable accumulated credits for the preceding calendar year. Accordingly, at June 30, 2017, the Fund's accounts payable and accrued expenses balance includes an accrual of vacation pay and related benefits of \$264,909. Upon termination or retirement, an employee will be compensated for accumulated leave dependent upon accumulated time. Payment will be based on the individual's rate of pay at termination or retirement. Upon death, the same benefits shall be paid to the employee's beneficiary.

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

Deferred outflows and inflows of resources – The statement of net position and balance sheet include separate sections for deferred outflows of resources and deferred inflows of resources. Deferred outflows of resources represent a consumption of net position that applies to future periods that will be recognized as an expense or expenditure in future periods. Deferred inflows of resources represent an acquisition of net position or fund balance that applies to future periods and will be recognized as revenue in future periods.

Arizona State Lottery

A Proprietary Fund of the State of Arizona

Notes to Basic Financial Statements

Note 1 – Nature of Operations and Summary of Significant Accounting Policies (continued)

Commissions – Retailers receive a commission of 6.5% on gross ticket sales. Charitable instant tab retailers receive a commission of 20% on gross ticket sales.

Advertising costs – Advertising costs are expensed as incurred.

Income taxes – The Lottery is exempt from Federal and Arizona income taxes. Accordingly, no provision for income taxes has been made.

Net position – Net position of the Lottery are classified and displayed as two components:

- a. Net investment in capital assets – Consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets.
- b. Unrestricted net position – All other net funds that do not meet the definition of "net investment in capital assets" or "restricted".

Use of estimates – The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 – Cash and Investments Held by the State Treasurer

All cash is deposited or invested with the Arizona State Treasurer (Treasurer). The Treasurer is part of the State's financial reporting entity and issues a separately published Annual Financial Report. A copy of the Treasurer's Annual Financial Report can be obtained from its website at www.aztreasury.gov or by contacting the Treasurer's Office at 1700 West Washington St., 1st Floor, Phoenix, AZ, 85007-2812.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 2 – Cash and Investments Held by the State Treasurer (continued)

A.R.S. requires state agencies' monies to be deposited with the Treasurer, and further requires those deposits to be invested in various pooled funds. Cash and investments held by the Treasurer represent the Board's portion of those monies. The Treasurer invests idle monies of the state agencies in an internal investment pool (Pool 3) and distributes interest to the participants. Interest earned from these invested monies is allocated monthly based on the average daily balance. Participant shares in the pool are purchased and sold based on the net asset value of the shares, and a participant's portion of the pool is not identified with specific investments. Accordingly, the Board's portion of these deposits and investments approximates the Board's value of pool shares. The Treasurer's internal investment Pool 3 is not required to be registered (and is not registered) with the Securities and Exchange Commission under the Investment Company Act of 1940. In accordance with A.R.S. §35-311, the State Board of Investments reviews the activities and performance of the pool monthly.

At June 30, 2017, the Lottery's deposits with the Treasurer were as follows:

	2017
Cash	\$ 43,400,253
Prize fund cash	32,203,890
Total cash and investments held by State Treasurer	\$ 75,604,143

Custodial credit risk – For cash and investments, custodial credit risk is the risk that, in the event of the failure of the counterparty to a transaction, the Lottery will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. As of June 30, 2017, all of the Lottery's securities are held by the State of Arizona in the Lottery's name. The Lottery manages custodial credit risk in accordance with A.R.S. and its investment policy. The A.R.S. require collateral for deposits at 102 percent of all deposits that federal depository insurance does not cover.

Concentration of credit risk – Statutes do not include any requirements for concentration of credit risk.

Interest rate risk – Statutes require that public monies invested in securities and deposits have a maximum maturity of 5 years. The maximum maturity for investments in repurchase agreements is 180 days.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 3 – Transfers and Statutory Requirements

As required by A.R.S. Section 5-505, the Lottery recorded transfers during the year ended June 30, 2017, as follows:

	<u>2017</u>
General Fund	\$ 105,926,112
University Bond Fund	39,926,998
Healthy Arizona	20,701,600
Mass Transit (LTAF)	11,529,000
Heritage Fund	10,000,000
Commerce Authority Arizona Competes Fund	3,500,000
Court-appointed Special Advocate Fund	3,965,599
Economic Security Homeless Services	1,000,000
Internet Crimes Against Children / Victim's Rights Enforcement	1,000,000
Department of Gaming	300,000
Tribal College Dual Enrollment Fund	<u>250,000</u>
Total transfers to other State funds	<u><u>\$ 198,099,309</u></u>

These transactions met the minimum percentage requirements imposed upon the Lottery by statute.

Of the transfer balances above, the following was included in due to other State funds as of June 30, 2017:

	<u>2017</u>
University capital debt services fund	\$ 39,926,998
State general fund	6,286,112
Internet Crimes Against Children/Victim's Right Enforcement	251,700
Court-appointed special advocates fund	<u>938,240</u>
Total due to other state funds	<u><u>\$ 47,403,050</u></u>

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 4 – Capital Assets

Capital asset activity for the year ended June 30, 2017 is as follows:

	2017				Ending Balance
	Beginning Balance	Increases	Decreases	Transfers	
Capital assets, not being depreciated:					
Land	\$ 937,830	\$ -	\$ -	\$ -	\$ 937,830
Capital assets, being depreciated:					
Land improvements	330,865	-	-	-	330,865
Buildings	4,494,206	167,530	-	-	4,661,736
Furniture, fixtures, and equipment	2,706,845	123,974	(386,134)	(1,319)	2,443,366
Intangible assets	599,324	-	-	-	599,324
Total capital assets	<u>9,069,070</u>	<u>291,504</u>	<u>(386,134)</u>	<u>(1,319)</u>	<u>8,973,121</u>
Less accumulated depreciation for:					
Land improvements	(330,865)	-	-	-	(330,865)
Buildings	(2,279,831)	(106,235)	-	1,478	(2,384,588)
Furniture, fixtures, and equipment	(2,479,234)	(69,004)	386,134	(16,703)	(2,178,807)
Intangible assets	(299,660)	(99,887)	-	-	(399,547)
Total accumulated depreciation	<u>(5,389,590)</u>	<u>(275,126)</u>	<u>386,134</u>	<u>(15,225)</u>	<u>(5,293,807)</u>
Total capital assets, net	<u>\$ 3,679,480</u>	<u>\$ 16,378</u>	<u>\$ -</u>	<u>\$ (16,544)</u>	<u>\$ 3,679,314</u>

Note 5 – Pledged Revenues

The Lottery has pledged portions of its gross revenues towards the payment of debt service on the State Lottery Revenue Bonds Series 2010A issued by the State. These bonds provide additional working capital to the State to pay appropriated expenditures of the State's General Fund. The bonds are payable solely from and secured by pledged revenues consisting of, until July 1, 2012, amounts distributable to the State General Fund from the Lottery pursuant to Lottery law, and from and after July 1, 2012, all Lottery revenues deposited to the Fund net of operating expenses of the Lottery. At June 30, 2017, pledged revenues totaled approximately \$193,254,654, of which \$33,751,350 was required to be transferred to cover debt service. Future pledged revenues required to be transferred to pay all remaining debt service for the bonds through final maturity of July 1, 2029 is approximately \$450,012,000.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 6 – Commitments

The Lottery enters into various contracts for goods and services during the normal course of its business. All contracts and purchasing activity are subject to the Arizona State Procurement Code and the rules of the Arizona State Procurement Office. All contracts have incorporated into them the "Standard Terms and Conditions" as required by the Arizona State Procurement Office. These terms and conditions in all the contracts allow for cancellation for lack of funding in the current fiscal year or next fiscal year. The contract may also be terminated for the Lottery's convenience at any time with no penalty when it is in the best interest of the State. The Lottery entered into a five-year contract with Scientific Games, Inc. for computer processing services at a base contract rate of 4.256% of on-line sales in August 2016.

The Lottery entered a commercial rental agreement effective December 1, 2014 to lease a facility in Tucson, Arizona for approximately \$5,947 per month, and payment of certain additional expenses relating to the leased premises to November 30, 2019. Rent expense for the facilities was approximately \$65,412, for the year ended June 30, 2017.

In 2015, the Lottery entered into a three year lease agreement for retail space at the Phoenix Sky Harbor Airport for approximately \$4,999 per month. Rent expense for the facilities was approximately \$54,991 for the year ended June 30, 2017.

Future minimum rental payments due under the lease agreements are as follow:

Year ending June 30,		
2018	\$	131,352
2019		131,352
2020		29,735
2021		-
		<hr/>
Total	\$	<u>292,439</u>

Note 7 – Loss Contingencies

Winners are offered the option of cash or 30-year annuity for the PICK on-line game. The annuities are purchased from qualifying insurance companies, which have the highest ratings from among A.M. Best Company, Standard & Poor's, Moody's, Duff & Phelps, or Weiss. Purchases of annuities transfer liabilities for prizes to the insurance company. However, the Lottery may incur liabilities for prizes in the event of a default of an insurance company. Aggregate future payments to prize winners on existing annuities totaled \$51,512,982 at June 30, 2017. Approximately \$47,458,248 of the total aggregate future payments at June 30, 2017, relate to annuities purchased from five separate insurance companies, of which \$22,324,799 relates to a single insurance company.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 7 – Loss Contingencies (continued)

Tort claims against the Lottery, its agents, officers, and employees who are acting in the scope and course of their employment with the Lottery are covered pursuant to the State Risk Management statute, A.R.S. § 41-621. There is no limit to that coverage. Therefore, as to any claims based on tort, there is no contingent liability to the budget of the Lottery. The Lottery is involved in various legal proceedings, which arose in the normal course of business. Management of the Lottery does not believe that the ultimate resolution of these matters will have a material effect on the financial position, results of operations, or cash flows of the Lottery.

Note 8 – Pensions and Other Postemployment Benefits

The Lottery contributes to the Arizona State Retirement Plan (the "Plan"), a retirement plan administered by the Arizona State Retirement System (ASRS). The Plan is a component of the State of Arizona. The Lottery reported \$(254,137) of pension expenditure related to the pension plan to which it contributes. In addition, the Lottery reported \$334,930 of other post-employment benefit expenses related to health insurance premium benefit.

Arizona State Retirement Plan

Plan description – The ASRS administers a cost-sharing multi-employer defined benefit pension plan, a cost-sharing multiple -employer defined benefit health insurance premium benefit (OPEB) plan, and a cost-sharing multiple-employer defined benefit long-term disability (OBEP) plan. The Arizona State Retirement System Board governs the ASRS according to the provisions of A.R.S. Title 38, Chapter 5, Articles 2 and 2.1. The ASRS issues a publicly available financial report that includes its financial statements and required supplementary information. The report is available on its website at www.azasrs.gov.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 8 – Pensions and Other Postemployment Benefits (continued)

Benefits provided – The ASRS provides retirement, health insurance premium supplement, long-term disability, and survivor benefits. State statute establishes benefits terms. Retirement benefits are calculated on the basis of age, average monthly compensation, and service credit as follows:

	Retirement Initial membership date:	
	<u>Before July 1, 2011</u>	<u>On or After July 1, 2011</u>
Years of service and age required to achieve benefit	Sum of years and age equals 80 10 years, age 62 5 years, age 50+ any years, age 65+	30 years, age 55 25 years, age 60 10 years, age 62 5 years, age 50* any years, age 65+
Final average salary is based on	Highest 36 months of last 120 months	Highest 60 months of last 120 months
Benefit percent per year of service	2.1% to 2.3%	2.1% to 2.3%

* with actuarially reduced benefits

Retirement benefits for members who joined the ASRS prior to September 13, 2013, are subject to automatic cost-of-living adjustments based on excess investment earnings. Members with a membership date on or after September 13, 2013, are not eligible for cost-of-living adjustments. Survivor benefits are payable upon a member's death. For retired members, the survivor benefit is determined by the retirement benefit option chosen. For all other members, the beneficiary is entitled to the member's account balance that includes the member's contributions and employer's contributions, plus interest earned.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 8 – Pensions and Other Postemployment Benefits (continued)

Contributions – In accordance with State statutes, annual actuarial valuations determine active member and employer contribution requirements. The combined active member and employer contribution rates are expected to finance the costs of benefits employees earn during the year, with an additional amount to finance any unfunded accrued liability. For the year ended June 30, 2017, active ASRS members were required by statute to contribute at the actuarially determined rate of 11.48 percent (11.34 percent for retirement and 0.14 percent for long-term disability) and 11.47 percent (11.35 percent for retirement and 0.12 percent for long-term disability) of the members' annual covered payroll, and the Lottery was required by statute to contribute at the actuarially determined rate of 11.48 percent (10.78 percent for retirement, 0.56 percent for health insurance premium benefit, and 0.14 percent for long-term disability) and 11.47 percent (10.85 percent for retirement, 0.50 percent for health insurance premium benefit, and 0.12 percent for long-term disability) of the active members' annual covered payroll. In addition, the Lottery was required by statute to contribute at the actuarially determined rate of 9.47 percent (9.38 percent for retirement and 0.09 percent for long-term disability) and 9.36 percent (9.30 percent for retirement and 0.06 percent for long-term disability) of annual covered payroll of retired members who worked for the Lottery in positions that would typically be filled by an employee who contributes to the ASRS. The Lottery's contributions to the pension plan for the year ended June 30, 2017, were \$362,060. The Lottery's contributions for the current and 2 preceding years for OPEB, all of which were equal to the required contributions, were as follows:

Years ended June 30,	Health Benefit Supplement Fund	Long-Term Disability Fund
2017	\$ 18,600	\$ 4,650
2016	16,700	4,003
2015	22,821	4,641

Pension liability – At June 30, 2017, the Lottery reported a liability of \$5,751,040 for its proportionate share of the ASRS' net pension liability. The Lottery's reported liability at June 30, 2017 decreased by \$787,773. The net pension liability was measured as of June 30, 2016. The total pension liability used to calculate the net pension liability was determined using updated procedures to roll forward the total pension liability from an actuarial valuation as of June 30, 2015, to the measurement date of June 30, 2016.

The Lottery's proportion of the net pension liability was based on fiscal year employer contributions. The Lottery's proportion measured as of June 30, 2016, was 0.03563 percent, which was a decrease of 0.00635 percent from its proportion measured as of June 30, 2015.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 8 – Pensions and Other Postemployment Benefits (continued)

Pension expense and deferred outflows/inflows of resources – For the year ended June 30, 2017, the Lottery recognized a negative pension expense for ASRS of \$154,137. At June 30, 2017, the Lottery reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	2017	
	Deferred Outflows of Resources	Deferred Inflows of Resources
Difference between expected and actual experience	\$ 34,949	\$ 395,630
Changes of assumptions or other inputs	-	639,206
Net difference between projected and actual earnings on pension plan investments	623,381	-
Changes in proportion and differences between Lottery contributions and proportionate share of contributions	-	775,126
Lottery contributions subsequent to the measurement date	<u>362,060</u>	<u>-</u>
Total	<u>\$ 1,020,390</u>	<u>\$ 1,809,962</u>

The \$362,060 reported as deferred outflows of resources related to ASRS pensions resulting from Lottery contributions subsequent to the measurement date will be recognized as a reduction of the net pension liability in the year ended June 30, 2017. Other amounts reported as deferred outflows of resources and deferred inflows of resources related to ASRS pensions will be recognized in pension expense as follows:

Year ended June 30,	
2018	\$ 531,368
2019	(188,597)
2020	(174,749)

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 8 – Pensions and Other Postemployment Benefits (continued)

Actuarial assumptions – The significant actuarial assumptions used to measure the total pension liability are as follows:

Actuarial valuation date	June 30, 2015
Actuarial roll forward date	June 30, 2016
Actuarial cost method	Entry age normal
Asset valuation	Fair Value
Discount rate	8.00%
Project salary increases	3.00 - 6.57%
Inflation	3.00%
Permanent benefit increases	Included
Mortality rates	1994 GAM Scale BB

Actuarial assumptions used in the June 30, 2015 valuation were based on the results of an actuarial experience study for the 5-year period ended June 20, 2012. The ASRS Board adopted the experience study which recommended changes and those changes were effective as of the June 30, 2013 actuarial valuation.

The long-term expected rate of return on ASRS pension plan investments was determined to be 8.75 percent using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. The target allocation and best estimates of arithmetic real rates of return for each major asset class are summarized in the following table:

Asset Class	2017	
	Target Allocation	Long-Term Expected Real Rate of Return
Equity	58%	3.90%
Fixed income	25%	0.93%
Real estate	10%	0.42%
Multi-asset	5%	0.17%
Commodities	2%	0.08%
Total	<u>100%</u>	<u>5.50%</u>
Inflation		<u>3.25%</u>
Expected arithmetic nominal return		<u>8.75%</u>

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Basic Financial Statements

Note 8 – Pensions and Other Postemployment Benefits (continued)

Discount rate – The discount rate used to measure the ASRS total pension liability was 8 percent, which is less than the long-term expected rate of return of 8.75 percent. The projection of cash flow used to determine the discount rate assumed that contributions from participating employers will be made based on the actuarially determined rates based on the ASRS Board's funding policy, which establishes the contractually required rate under Arizona statute. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of the Lottery's proportionate share of the ASRS net pension liability to changes in the discount rate – The following table presents the Lottery's proportionate share of the net pension liability calculated using the discount rate of 8 percent, as well as what the Lottery's proportionate share of the net pension liability would be if it were calculated using a discount rate that is 1 percentage point lower (7 percent) or 1 percentage point higher (9 percent) than the current rate:

	June 30, 2017		
	1% Decrease (7% Discount Rate)	Current (8% Discount Rate)	1% Increase (9% Discount Rate)
Lottery's proportionate share of the net pension liability	\$ 7,333,013	\$ 5,751,040	\$ 4,482,644

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

Pension liability – At June 30, 2017, the Lottery reported a liability of \$5,751,040, for its proportionate share of the ASRS' net pension liability.

Note 9 – Major Vendors

The Lottery has three vendors that represent approximately 83% of its purchases for the years ended June 30, 2017, respectively.

Note 10 – Risk Management

The Lottery is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Lottery purchases commercial insurance to cover these risks. The amount of coverage has not been exceeded by claims in the last four years.

Required Supplementary Information

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Schedule of Proportionate Share of the Net Pension Liability

	Fiscal Year	
	2017 (2016)*	2016 (2015)*
Lottery's proportion of the net pension liability	0.035630%	0.041980%
Lottery's proportionate share of the net pension liability	\$ 5,751,040	\$ 6,538,813
Lottery's covered-employee payroll	\$ 3,321,318	\$ 3,039,467
Lottery's proportionate share of the net pension liability as a percentage of its covered employees payroll	173.16%	215.13%
Plan fiduciary net position as a percentage of the total pension liability	67.05%	68.35%

*This year represents the measurement period.

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Schedule of Pension Contributions

	Fiscal Year	
	2017	2016
Statutorily required contribution	\$ 362,060	\$ 362,004
Lottery's contributions in relation to the statutorily required contribution	<u>362,060</u>	<u>362,004</u>
Lottery's contribution deficiency (excess)	<u>\$ -</u>	<u>\$ -</u>
Lottery's covered-employee payroll	<u>\$ 3,321,318</u>	<u>\$ 3,336,442</u>
Lottery's contribution as a percentage of covered-employee payroll	10.90%	10.85%

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Notes to Required Supplementary Information

Note 1 – Changes of Assumptions

The Arizona State Retirement System (ASRS) annual actuarial valuation as of June 30, 2016 report is available at <https://www.azasrs.gov/sites/default/files/pdf/2015%20CAFR.pdf>.

For details about actuarial assumptions, see Note 8.

Report of Independent Auditors 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*

To the Commissioners of
Arizona State Lottery
Phoenix, Arizona

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the business-type activities of the Arizona State Lottery (the "Lottery") as of and for the year ended June 30, 2017, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements, and have issued our report thereon dated December 8, 2017.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Lottery's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control. Accordingly, we do not express an opinion on the effectiveness of the Lottery's internal control.

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

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, not to provide an opinion on the Lottery's internal control or compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering an entity's internal control and compliance. Accordingly, this communication is not suitable for any other purposes.

Moss Adams LLP

Scottsdale, Arizona
December 8, 2017

Arizona State Lottery
A Proprietary Fund of the State of Arizona
Schedule of Prior Year Audit Findings
Year Ended June 30, 2017

There were no prior audit findings.



4740 E. University Dr.
Phoenix, AZ 85034
ArizonaLottery.com