



Report of Independent Auditors and
Financial Statements for
Arizona State Lottery
A Proprietary Fund of the State of Arizona
June 30, 2016

MOSS-ADAMS_{LLP}

Certified Public Accountants | Business Consultants

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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, 2016 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, 2016, 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 7, the schedule of proportionate share of the net pension liability on page 26, and the schedule of pension contributions on page 27 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 January 24, 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
January 24, 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, 2016, 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, 2016. 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.

Nonoperating revenues consist of interest earned on prize fund cash investments from the State Treasurer, interest credited to the Lottery's Multistate Lottery Association (MUSL) unreserved account for interest earned on prize reserves at MUSL and income recognized from common stock. 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)

Sales Activities

Revenues from the sale of Lottery products for the fiscal year ended June 30, 2016 were higher than Fiscal Year 2015 and also a Lottery record high. As shown in the financial statements, sales increased 16.15% from the prior year, from \$749.9 million in Fiscal Year 2015 to \$871.0 million in the current year.

The following table compares Lottery product sales between fiscal years. Sales are presented in millions of dollars.

<u>Product Sales</u>	<u>FY 2015</u>	<u>FY 2016</u>	<u>Changes</u>	<u>Percentage</u>
Scratchers (including economic development)	\$ 542.0	\$ 590.7	\$ 48.7	8.99%
Powerball	93.6	160.3	66.7	71.26%
Mega Millions	46.8	44.7	(2.1)	-4.49%
The Pick	25.8	33.1	7.3	28.29%
Fantasy 5	17.1	16.3	(0.8)	-4.68%
Pick 3	9.7	10.6	0.9	9.28%
Weekly Winnings	3.6	0.7	(2.9)	-80.56%
Instant Tabs	5.1	6.1	1.0	19.61%
AON and 5 Card	6.2	8.5	2.3	37.10%
Total	<u>\$ 749.9</u>	<u>\$ 871.0</u>	<u>\$ 121.1</u>	<u>16.15%</u>

Total Revenues

Other operating revenues for the year ended June 30, 2016, were \$194,158 compared to \$938,833 for the year ended June 30, 2015. Other operating revenue is comprised of license fees and other miscellaneous revenue. Total operating revenues were \$871.1 million for the year ended June 30, 2016, as compared to \$750.9 million for the year ended June 30, 2015. As mentioned above, the increase was due to an increase in sales revenues.

Nonoperating revenues for the year ended June 30, 2016, were \$31,092 as compared to \$67,236 for the year ended June 30, 2015. Nonoperating revenue is comprised of interest earned on invested cash and periodic recognition of commissions earned by the Lottery.

**ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)**

Major Expenses

\$640.7 million of the Lottery's total operating expenses of \$660.4 million for the year ended June 30, 2016 were incurred in direct support of the sales of Lottery games. \$557.3 million of the Lottery's total operating expenses of \$579.9 million for the year ended June 30, 2015 were incurred in direct support of the sales of Lottery games. These expenses include prize expense, retailer commissions and incentives, purchases of Scratchers tickets, compensation to the vendor for Scratchers ticket distribution, and compensation to the vendor who maintains and supports the on-line gaming system.

The following table compares the game related expenses between fiscal years. All expenses are presented in millions of dollars.

<u>Game Related Expenses</u>	<u>FY 2015</u>	<u>FY 2016</u>	<u>Differences</u>	<u>Percentage</u>
Prize expense	\$ 486.7	\$ 557.5	\$ 70.8	14.5%
Retailer commissions	51.0	59.2	8.2	16.1%
On-line system expenses	7.5	10.1	2.6	34.7%
Scratchers system and distribution expenses	5.5	6.0	0.5	9.1%
Tickets purchased	6.6	7.9	1.3	19.7%
Total	<u>\$ 557.3</u>	<u>\$ 640.7</u>	<u>\$ 83.4</u>	<u>15.0%</u>

The increase in game related expenses is reflective of the increase in product sales. See the product sales schedule above.

Of the \$19.7 million in Fiscal Year 2016 in other operating expenses, \$10.8 million was used for advertising and promotion and \$5.2 million was used to compensate Lottery employees. In comparison, of the \$22.6 million in Fiscal Year 2015 in other operating expenses, \$13.8 million was used for advertising and promotion and \$5.9 million was used to compensate Lottery employees.

Transfers to Other State Funds

Note 3 to the financial statements details the amounts transferred to other State Funds. In Fiscal Year 2016 the Lottery transferred \$205.8 million to other State Funds. In comparison, in Fiscal Year 2015 the Lottery transferred \$176.0 million to other State Funds.

**ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)**

Other Financial Information

Statement of Net Position	FY 2015	FY 2016
Current assets	\$ 55.9	\$ 109
Capital assets	3.4	3.7
Other assets - deposits	9.9	9.6
Total assets	69.2	122.3
Deferred outflows of resources	0.7	0.5
Total assets and deferred outflows of resources	69.9	122.8
Current liabilities	63.6	111.9
Net pension liability	6.3	6.5
Total liabilities	69.9	118.4
Deferred inflows of resources	1.3	0.7
Net position	(1.3)	3.7
Total liabilities and net position	\$ 69.9	\$ 122.8

The Lottery's total assets at June 30, 2016 were \$122.8 million. Assets consisted of cash held substantially by the State Treasurer of \$91.5 million, net receivables from Lottery retailers for the sale of Lottery products of \$12.7 million, Scratchers ticket and pull tab inventory of \$4.8 million, net investment in capital assets of \$3.7 million, and a deposit with MUSL of \$9.6 million.

Comparable figures at June 30, 2015 were \$69.9 million. Assets consisted of cash held substantially by the State Treasurer of \$42.5 million, net receivables from Lottery retailers for the sale of Lottery products of \$8.6 million, Scratchers ticket and pull tab inventory of \$4.8 million, net investment in capital assets of \$3.4 million, and a deposit with MUSL of \$9.9 million.

Total liabilities at June 30, 2016, were \$118.5 million, consisting of \$7.2 million in accounts payable and accrued expenses, prize liabilities of \$10 million, amounts due to other funds of \$30.5 million amounts due to other State Funds of \$64.3 million, and \$6.5 million of net pension liability. \$111.9 million of the Lottery's liabilities were current liabilities.

The Lottery's total liabilities at June 30, 2015, were \$69.9 million, consisting of \$2.8 million in accounts payable and accrued expenses, prize liabilities of \$12.6 million, amounts due to other funds of \$ 20.8 million amounts due to other State Funds of \$27.4 million, and \$6.3 million of net pension liability. \$63.6 million of the Lottery's liabilities were current liabilities.

**ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
MANAGEMENT'S DISCUSSION AND ANALYSIS (UNAUDITED)**

At June 30, 2016, the Lottery recorded a deferred outflow of resources of \$0.5 million and a deferred inflow of resources of \$0.7 million relating to pensions.

Total net position increased from a negative \$1.3 million at June 30, 2015 to \$3.7 million at June 30, 2016.

In the sixth special session of the State Legislature in 2010, amendments were made to the Lottery statutes allowing 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 a biennial basis. The budgets for Fiscal Years 2015 and 2016 were set in the regular legislative session of 2014. The Lottery's Fiscal Year 2016 budget was amended in the regular legislative session of 2015. The Lottery's appropriation for sales-related expenditures is based on approved percentages of projected revenues and is allowed to increase for these items 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 appropriation was \$108.4 million for Fiscal Year 2016.

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 2016 and to demonstrate the Lottery's accountability for the money it received from the sale of Lottery products.

If you have questions about the MD&A or need additional information, contact the Arizona Lottery's Chief Financial Officer, 4740 East University, Phoenix, Arizona 85034.

ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
STATEMENT OF NET POSITION

ASSETS AND DEFERRED OUTFLOWS OF RESOURCES		June 30, 2016
CURRENT ASSETS		
Cash and investments, substantially all held by the State Treasurer		\$ 91,527,784
Accounts receivable, net of allowance for doubtful accounts of \$290,000		12,696,733
Scratch ticket inventory		4,659,946
Pull tab inventory		183,109
Total current assets		<u>109,067,572</u>
CAPITAL ASSETS		
Land and land improvements		1,268,695
Buildings		4,494,206
Furniture, fixtures, and equipment		2,706,845
Intangible assets		599,324
Less accumulated depreciation and amortization		<u>(5,389,590)</u>
Total capital assets		<u>3,679,480</u>
OTHER ASSETS		
Deposit - MUSL		<u>9,574,340</u>
Total assets		<u>122,321,392</u>
DEFERRED OUTFLOWS OF RESOURCES		
Deferred outflows related to pensions		<u>540,594</u>
Total assets and deferred outflows of resources		<u>\$ 122,861,986</u>
LIABILITIES, DEFERRED INFLOWS OF RESOURCES, AND NET POSITION		
CURRENT LIABILITIES		
Accounts payable		\$ 7,017,332
Accrued expenses		209,053
Prize liability		9,979,159
Due to other funds		30,452,914
Due to other state funds		<u>64,268,070</u>
Total current liabilities		111,926,528
NET PENSION LIABILITY		
Total liabilities		<u>118,465,341</u>
DEFERRED INFLOWS OF RESOURCES		
Deferred inflows related to pensions		<u>723,660</u>
Total liabilities and deferred inflows of resources		<u>119,189,001</u>
NET POSITION		
Net investment in capital assets		3,679,480
Unrestricted (deficit)		<u>(6,495)</u>
Total net position		<u>\$ 3,672,985</u>

ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION

	Year Ended June 30, 2016
OPERATING REVENUES	
Ticket sales	
Scratchers	\$ 590,705,714
Powerball	160,329,555
Mega Millions	44,658,835
The Pick	33,067,826
Fantasy 5	16,279,219
Pick 3	10,556,314
Weekly Winnings	744,488
Instant Tab	6,068,982
AON	8,534,892
	870,945,825
Total ticket sales	870,945,825
Other operating revenues	194,158
	871,139,983
OTHER EXPENSES	
Direct costs	
Prize expense	557,439,184
Retailer commissions and incentives	59,183,636
Online system expense	10,144,332
Scratcher system and distribution expenses	5,998,643
Tickets purchased	7,869,753
	640,635,548
Total direct costs	640,635,548
Advertising and promotion	10,803,959
Wages and related expenses	5,191,545
Contract services	1,395,329
Depreciation	268,779
Administrative expenses	2,082,733
	660,377,893
Total operating expenses	660,377,893
OPERATING INCOME	210,762,090
NONOPERATING REVENUES - Investment income and other	31,092
	210,793,182
INCOME BEFORE TRANSFERS	210,793,182
TRANSFERS TO OTHER STATE FUNDS	205,828,826
	4,964,356
CHANGE IN NET POSITION	4,964,356
NET POSITION, beginning of year	(1,291,371)
	\$ 3,672,985
NET POSITION, end of year	\$ 3,672,985

ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
STATEMENT OF CASH FLOWS

	Year Ended June 30, 2016
CASH FLOWS FROM OPERATING ACTIVITIES	
Cash received from retailers-net of validations, commissions, and incentives	\$ 380,526,062
Cash from other sources (Pollard A/R, MUSL, assignment fees, Superior Court)	5,028,402
Cash payments for prizes and related taxes	(128,156,749)
Cash payments to suppliers of goods or services	(32,988,867)
Cash payments to employees	(5,361,219)
	<u>219,047,629</u>
CASH FLOWS USED BY NONCAPITAL FINANCING ACTIVITIES	
Payments to beneficiaries per Arizona Statutes	<u>(169,643,421)</u>
CASH FLOWS USED BY CAPITAL FINANCING ACTIVITIES	
Payments for acquisition of capital assets	<u>(442,031)</u>
CASH FLOWS FROM INVESTING ACTIVITIES	
Receipts of interest	<u>18,212</u>
	48,980,389
CASH AT BEGINNING OF YEAR	<u>42,547,395</u>
CASH AT END OF YEAR	<u><u>\$ 91,527,784</u></u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES	
Operating income	\$ 210,762,090
Adjustments to reconcile operating income to net cash provided by operating activities	
Depreciation	268,779
Pension expense	237,325
Employer pension contribution	(362,004)
Changes in operating assets and liabilities	
Accounts receivable	(4,138,341)
MUSL interest	12,892
Ticket and pull tab inventory	(58,844)
Deposit - MUSL	284,412
Accounts payable and accrued expenses	4,354,626
Prizes payable and due to other funds	7,686,694
	<u>\$ 219,047,629</u>

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, 2015 through June 30, 2016, the Lottery held 126 instant games of which 86 games expired during the fiscal year. During 2016, the Lottery continued the "The Pick," "Fantasy 5," "Pick 3," "Powerball," "Mega Millions," "Weekly Winnings," and "All Or Nothing" on-line games. As required, the Lottery has deposits with "Powerball," and "Mega Millions," multistate on-line lottery games, of \$9.6 million at June 30, 2016. 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, 2015 to June 30, 2016.
- 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 Lottery's warehouses or held by retailers. The cost of tickets is charged to 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 \$160,000 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 FY16.

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, 2016, the Fund's accounts payable and accrued expenses balance includes an accrual of vacation pay and related benefits of \$209,053. Upon termination or retirement, an employee will be compensated for accumulated leave up to a maximum of 240 hours, dependent upon accumulated time and the individual's benefits associated with their rank as defined by State personnel rule #R2-5-403. 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.

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 Web site at www.aztreasury.gov or by contacting the Treasurer's Office at 1700 West Washington St., 151 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, 2016, the Lottery's deposits with the Treasurer were as follows:

Cash	\$ 80,897,157
Prize fund cash	<u>10,630,627</u>
Total cash and investments held by State Treasurer	<u><u>\$ 91,527,784</u></u>

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, 2016, 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, 2016, as follows:

General Fund	\$ 115,276,818
University Bond Fund	38,647,533
Healthy Arizona	20,476,300
Mass Transit (LTAF)	11,502,000
Heritage Fund	10,000,000
Commerce Authority Arizona Competes Fund	3,500,000
Court-appointed Special Advocate Fund	3,966,175
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>160,000</u>
Total transfers to other State funds	<u><u>\$ 205,828,826</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, 2016:

University capital debt services fund	\$ 38,647,533
State general fund	20,426,570
Arizona commerce authority fund	3,500,000
Court appointed special advocates fund	<u>1,693,967</u>
Total due to other state funds	<u><u>\$ 64,268,070</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, 2016 is as follows:

	Beginning Balance	Increases	Decreases	Transfers	Ending Balance
Capital assets, not being depreciated:					
Land	\$ 937,830	\$ -	\$ -	\$ -	\$ 937,830
Capital assets, being depreciated:					
Land improvements	330,865	-	-	-	330,865
Buildings	4,036,728	457,478	-	-	4,494,206
Furniture, fixtures, and equipment	2,667,721	39,124	-	-	2,706,845
Intangible assets	599,324	-	-	-	599,324
Total capital assets	<u>8,572,468</u>	<u>496,602</u>	<u>-</u>	<u>-</u>	<u>9,069,070</u>
Less accumulated depreciation for:					
Land improvements	(330,865)	-	-	-	(330,865)
Buildings	(2,172,118)	(107,713)	-	-	(2,279,831)
Furniture, fixtures, and equipment	(2,418,055)	(61,179)	-	-	(2,479,234)
Intangible assets	(199,773)	(99,887)	-	-	(299,660)
Total accumulated depreciation	<u>(5,120,811)</u>	<u>(268,779)</u>	<u>-</u>	<u>-</u>	<u>(5,389,590)</u>
Total capital assets, net	<u>\$ 3,451,657</u>	<u>\$ 227,823</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,679,480</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, 2016, pledged revenues totaled approximately \$200,769,350, of which \$37,501,750 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 \$487,513,500.

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 contacts 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 G-Tech Services, Inc. for computer processing services at a base contract rate of 3.7% of on-line sales in September 2009.

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 \$77,304 for the year ended June 30, 2016.

In 2015, the Lottery entered into a three year lease agreement for retail space at the Phoenix Sky Harbor Airport for approximately \$4,417 per month. The lease agreement commenced on May 16, 2016 and therefore there was no lease expense for this facility in fiscal year 2016.

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

Year ending June 30,	
2017	\$ 124,364
2018	124,364
2019	124,364
2020	<u>82,735</u>
Total	<u>\$ 455,827</u>

Note 7 – Loss Contingencies

Annuities are purchased for all prizes over \$400,000 for which winners will receive the jackpot in annual installments 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 \$47,222,253 at June 30, 2016. Approximately \$44,816,363 of the total aggregate future payments at June 30, 2016, relate to annuities purchased from five separate insurance companies, of which \$20,934,780 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 \$237,325 of pension expenditure related to the pension plan to which it contributes.

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, 2016, active ASRS members were required by statute to contribute at the actuarially determined rate of 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 11.47 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 9.36 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, 2016, were \$378,686. 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,	<u>Health Benefit Supplement Fund</u>	<u>Long-Term Disability Fund</u>
2016	\$ 16,700	\$ 4,003
2015	22,821	4,641
2014	22,565	9,178

Pension liability – At June 30, 2016, the Lottery reported a liability of \$6,538,813 for its proportionate share of the ASRS' net position liability. The net pension liability was measured as of June 30, 2015. 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, 2014, to the measurement date of June 30, 2015.

The Lottery's reported liability at June 30, 2016, increased by \$258,857 from the Lottery's prior year liability of \$6,279,956 because of changes in the ASRS' net pension liability and the Lottery's proportionate share of that liability. The ASRS' publicly available financial report provides details on the change in the net pension liability.

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, 2015, was 0.04198 percent, which was a decrease of 0.000462 percent from its proportion measured as of June 30, 2014.

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, 2016, the Lottery recognized pension expense for ASRS of \$237,325. At June 30, 2016, the Lottery reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

	<u>Deferred Outflows of Resources</u>	<u>Deferred Inflows of Resources</u>
Difference between expected and actual experience	\$ 178,430	\$ 342,640
Changes of assumptions or other inputs	-	-
Net difference between projected and actual earnings on pension plan investments	-	209,554
Changes in proportion and differences between Lottery contributions and proportionate share of contributions	-	171,466
Lottery contributions subsequent to the measurement date	<u>362,164</u>	<u>-</u>
Total	<u>\$ 540,594</u>	<u>\$ 723,660</u>

The \$362,164 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,	
2017	\$ 286,372
2018	156,283
2019	(151,273)

**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, 2014
Actuarial roll forward date	June 30, 2015
Actuarial cost method	Entry age normal
Amortization method:	
Plan amendments	Immediate
Investment gain/loss	5 years
Assumption gain/loss	Average future service lives
Experience gain/loss	Average future service lives
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, 2014 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.

ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
NOTES TO BASIC FINANCIAL STATEMENTS

Note 8 – Pensions and Other Postemployment Benefits (continued)

The long-term expected rate of return on ASRS pension plan investments was determined to be 8.79 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	<u>Target Allocation</u>	<u>Long-Term Expected Real Rate of Return</u>
Equity	58%	3.94%
Fixed income	25%	0.93%
Real estate	10%	0.42%
Multi-asset class	5%	0.17%
Commodities	2%	0.08%
Total	<u>100%</u>	<u>5.54%</u>
Inflation		<u>3.25%</u>
Expected arithmetic nominal return		<u>8.79%</u>

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 8.79 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.

**ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
NOTES TO BASIC FINANCIAL STATEMENTS**

Note 8 – Pensions and Other Postemployment Benefits (continued)

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:

	<u>1% Decrease (7% Discount Rate)</u>	<u>Current (8% Discount Rate)</u>	<u>1% Increase (9% Discount Rate)</u>
Lottery's proportionate share of the net pension liability	\$ 8,568,080	\$ 6,538,813	\$ 5,148,101

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, 2016, the Lottery reported a liability of \$6,538,813 for its proportionate share of the ASRS' net pension liability.

Note 9 – Major Vendors

The Lottery has three vendors that represent approximately 82% of its purchases for the years ended June 30, 2016, 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	
	2016 (2015)	2015 through 2017
Lottery's proportion of the net pension liability	0.041980%	Information
Lottery's proportionate share of the net pension liability	\$ 6,538,813	not available
Lottery's covered-employee payroll	\$ 3,039,467	
Lottery's proportionate share of the net pension liability as a percentage of its covered employees payroll	215.13%	
Plan fiduciary net position as a percentage of the total pension liability	68.35%	

ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
SCHEDULE OF PENSION CONTRIBUTIONS

	Fiscal Year		2014 through 2017
	2016	2015	
Statutorily required contribution	\$ 382,689	\$ 444,044	Information not available
Lottery's contributions in relation to the statutorily required contribution	<u>382,689</u>	<u>444,044</u>	
Lottery's contribution deficiency (excess)	<u>\$ -</u>	<u>\$ -</u>	
Lottery's covered-employee payroll	<u>\$ 3,039,467</u>	<u>\$ 3,962,274</u>	
Lottery's contribution as a percentage of covered-employee payroll	12.59%	11.21%	

**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, 2015 report is available at <https://www.azasrs.gov/sites/default/files/pdf/2015%20CAFR.pdf>.

For details about actuarial assumptions, see section IV. Actuarial Section.

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, 2016, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements, and have issued our report thereon dated January 24, 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.

This report is intended solely for the information and use of management, Commissioners of the Arizona State Lottery, and others within the entity and is not intended to be, and should not be, used by anyone other than these specified parties.

Moss Adams LLP

Scottsdale, Arizona

January 24, 2017

**ARIZONA STATE LOTTERY
A PROPRIETARY FUND OF THE STATE OF ARIZONA
SCHEDULE OF PRIOR YEAR AUDIT FINDINGS
YEAR ENDED JUNE 30, 2016**

2015-001 – Accounting and Reporting Components of Net Position (Significant Deficiency)

Status at June 30, 2016 – This finding was cleared in the current year.

2015-002 – Regularly Review Third-Party Service Reports (Significant Deficiency)

Status at June 30, 2016 – This finding was cleared in the current year.