



A REPORT  
TO THE  
MONTANA  
LEGISLATURE

FINANCIAL AUDIT

# *Montana State Lottery*

*For the Two Fiscal Years Ended  
June 30, 2016*

MARCH 2017

LEGISLATIVE AUDIT  
DIVISION

15-30B

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§5-13-202(2), MCA,

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**FINANCIAL AUDITS**

Financial audits are conducted by the Legislative Audit Division to determine if the financial statements included in this report are presented fairly and the agency has complied with laws and regulations having a direct and material effect on the financial statements. In performing the audit work, the audit staff uses standards set forth by the American Institute of Certified Public Accountants and the United States Government Accountability Office. Financial audit staff members hold degrees with an emphasis in accounting. Most staff members hold Certified Public Accountant (CPA) licenses.

The Single Audit Act Amendments of 1996 and the Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards require the auditor to issue certain financial, internal control, and compliance reports in addition to those reports required by Government Auditing Standards. This individual agency audit report is not intended to comply with these requirements and is therefore not intended for distribution to federal grantor agencies. The Legislative Audit Division issues a statewide biennial Single Audit Report which complies with the above reporting requirements. The Single Audit Report for the two fiscal years ended June 30, 2015, was issued March 29, 2016. The Single Audit Report for the two fiscal years ended June 30, 2017, will be issued by March 31, 2018. Copies of the Single Audit Report can be obtained by contacting:

Single Audit Coordinator  
Office of Budget and Program Planning  
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P.O. Box 200802  
Helena, MT 59620-0802

Legislative Audit Division  
Room 160, State Capitol  
P.O. Box 201705  
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# LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors:  
Cindy Jorgenson  
Joe Murray

March 2017

The Legislative Audit Committee  
of the Montana State Legislature:

This is our financial audit report of the Montana State Lottery (lottery) for the two fiscal years ended June 30, 2016. This report contains one recommendation to the lottery concerning estimation of its net revenue transfers.

The lottery's response to the audit is included on C-1 of the audit report. We thank the director and her staff for their assistance and cooperation throughout the audit.

Respectfully submitted,

*/s/ Angus Maciver*

Angus Maciver  
Legislative Auditor



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## APPOINTED AND ADMINISTRATIVE OFFICIALS

|   |                                   |            | <u>Term Expires</u> |
|---|-----------------------------------|------------|---------------------|
| <b>Montana State Lottery<br/>Commission Members</b> | Wilbur Rehmann, Chair             | Helena     | 1/1/2021            |
|   | Jessika Kynett                    | Livingston | 1/1/2021            |
|   | Thomas M. Keegan, Attorney at Law | Helena     | 1/1/2018            |
|   | Cindy Hiner                       | Deer Lodge | 1/1/2018            |
|   | Leo Prigge, CPA                   | Butte      | 1/1/2019            |

### **Administrative Officials**

Angela Wong, Montana State Lottery Director

John Tarr, Montana State Lottery Director of Security  
(through December 31, 2016)

Bryan Costigan, Montana State Lottery Director of Security  
(effective January 1, 2017)

Armond Sergeant, Financial Services Director

For additional information concerning the Montana State Lottery, contact:

Armond Sergeant, Financial Services Director  
2525 N. Montana Ave.  
Helena, MT 59601  
(406) 444-5813

e-mail: [asergeant@mt.gov](mailto:asergeant@mt.gov)





# MONTANA LEGISLATIVE AUDIT DIVISION

## FINANCIAL AUDIT

### Montana State Lottery

For the Two Fiscal Years Ended June 30, 2016

MARCH 2017

15-30B

REPORT SUMMARY

Over the last five fiscal years, the Montana State Lottery sold \$260 million in lottery tickets, and transferred approximately \$61.6 million to the state's general fund. The report describes a \$400,000 error in calculating the statutory allocation of lottery net revenue between the general fund and a scholarship fund administered by the Commissioner of Higher Education.

### Context

The Montana State Lottery (lottery) currently offers both online and scratch games. Online games currently on sale include multi-state games such as Powerball, Mega Millions, and Hot Lotto, as well as state-specific games such as Montana Cash and Montana Millionaire. The lottery also markets an assortment of scratch games, as well as Treasure Play games. In fiscal year 2016, sales from these games were approximately \$59.7 million and direct costs associated with the sales were approximately \$42 million. The lottery transferred \$12,363,365 to the state's general fund in fiscal year 2016. The lottery's operating expense, funded from the net proceeds from ticket sales, totaled \$4.9 million in fiscal year 2016.

We focused our audit efforts on sales revenues, direct game costs, and the account balances associated with these activities. We specifically reviewed: scratch and online ticket revenues; direct game costs such as scratch and online ticket prize expenses, retailer commissions, and vendor fees; the estimated prize liability related to winning tickets sold but not claimed by fiscal year-end; accounts receivables associated

with ticket sales at retailer locations; and transfer activity required under state law. We also reviewed the lottery's personal services expenses. Throughout the audit, we reviewed the lottery's control systems, and determined compliance with state laws having a direct and material impact on financial statement amounts.

### Results

This report contains one recommendation related to the estimation of the net revenue transfers to the general fund and a college scholarship special revenue fund account required by state law.

| Recommendation Concurrence                                     |   |
|--|---|
| Concur   | 1 |
| Partially Concur   | 0 |
| Do Not Concur  | 0 |
| <b>Source: Agency audit response included in final report.</b> |   |

For a complete copy of the report (15-30B) or for further information, contact the Legislative Audit Division at 406-444-3122; e-mail to [lad@mt.gov](mailto:lad@mt.gov); or check the web site at <http://leg.mt.gov/audit>

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# Chapter I – Introduction

## **Introduction**

We performed a financial audit of the Montana State Lottery (lottery) for the fiscal year ended June 30, 2016, with comparative statements for the fiscal year ended June 30, 2015. The audit meets the requirements of §23-7-410, MCA, for the legislative auditor to conduct, or have conducted, an annual audit of the Montana State Lottery. The objectives of the audit were to:

1. Obtain an understanding of the lottery’s control systems to the extent necessary to support our audit of the financial statements and, if appropriate, make recommendations for improvements in management and internal controls for the lottery.
2. Determine whether the lottery’s financial statements present fairly the financial position, results of operations, and cash flows for the fiscal year ended June 30, 2016, with comparative financial amounts for the fiscal year ended June 30, 2015.

We addressed these objectives by focusing our audit efforts on the review of revenues, expenses, and account balances resulting from ticket sales. We specifically reviewed: scratch and online ticket revenues; direct game costs such as scratch and online ticket prize expenses, retailer commissions, and vendor fees; the estimated prize liability related to winning tickets sold but not claimed by fiscal year-end; accounts receivables associated with ticket sales at retailer locations; cash and cash equivalents; and transfer activity required under state law. We also reviewed the lottery’s personal services expenses. Throughout the audit, we reviewed the lottery’s control systems, and determined compliance with state laws having a direct and material impact on financial statement amounts.

## **Background**

The lottery is established in state law, and governed by a five-member Lottery Commission (commission). Members of the commission are appointed by the governor to serve four-year staggered terms. The director of the lottery is also appointed by the governor. The commission is responsible for overseeing lottery operations and maximizing the net revenue earned by the lottery and paid to the state. The commission also sets the price of tickets and the number and size of prizes awarded for Montana-specific lottery games.

The lottery is a member of the Multi-State Lottery Association (MUSL), a nonprofit, government-benefit association. MUSL is owned and operated by member lotteries, and each state member lottery has a representative on the MUSL board of directors.

The MUSL Board develops rules and regulations for all member state lotteries regarding games operated by MUSL. The lottery must comply with these regulations as a condition of offering MUSL games such as Powerball.

During fiscal year 2016, the lottery offered scratch tickets, Powerball, Mega Millions, Lucky for Life, Montana Millionaire, Montana Cash, Wild Card, Hot Lotto, 10 Spot, Treasure Play, Fantasy Football, and Fantasy Racing. State law requires a minimum of 45 percent of money paid for tickets and chances on lottery games be used for prizes. Games sold in fiscal year 2016 had a composite prize payout of 56.45 percent.

The lottery accounts for its operations in an enterprise fund, which means that the operations are financed and operated similar to a private business enterprise where the intent is to finance or recover all costs through user charges. Funding for lottery operations comes from sales of lottery games.

The commission is allocated to the Department of Administration (department) for administrative purposes. The financial activity of the lottery is also included in the states' Comprehensive Annual Financial Report and the department's audited financial schedules.

### **Transfer Determination**

Section 23-7-402(4), MCA, specifies the transfers of lottery net revenue. Generally accepted accounting principles for financial reporting purposes requires the lottery to record the allocated share of other post employment benefit (OPEB) and pension expenses, as well as the associated liabilities resulting from benefits associated with their employees. As a result of combined pension and OPEB liability, the lottery has a negative net position. However, these items do not result in cash outflows from the lottery fund. The lottery and the Department of Administration's State Financial Services Division determined the annual OPEB and pension expenses should not be included in the calculation of the net revenue transfer amounts. The financial statements included in this report reflect this methodology in calculation of the transfer amount.

## Chapter II - Findings and Recommendations

### Net Revenue Transfer

**Montana State Lottery personnel did not apply provisions of state law correctly in its estimates of net revenue transfers for the year ended June 30, 2016.**

In 2015, the legislature enacted laws to establish a scholarship program to provide an incentive for Montana high school students to prepare for and complete degrees in science, technology, engineering, mathematics and healthcare (STEM) and provide funding from Montana State Lottery (lottery) net revenue. For fiscal year 2016 only, §23-7-402(4), MCA, required \$400,000 of net revenue to be transferred from the lottery enterprise fund to the Montana STEM scholarship special revenue account before any net revenue would be transferred to the general fund. The law also stated that the amount of net revenue transferred to the general fund during a fiscal year cannot exceed the amount transferred to the general fund in fiscal year 2015, which was \$12,363,385. Once the General Fund cap is transferred, any net revenue in excess of the cap is transferred to STEM.

As part of our audit, we tested compliance with the net revenue transfer requirements in state law. Lottery made an initial transfer of \$400,000 to the STEM account. State law required the lottery to transfer \$12,363,365, the fiscal year 2015 net revenue amount, to the general fund, before transferring the residual net revenue to the STEM account. In estimating the year-end transfer to the STEM account, lottery personnel subtracted the general fund limit from the total estimated net revenue without considering the \$400,000 STEM transfer made earlier in the fiscal year as shown in the figure below. The error in interpreting the statute caused the projected general fund transfer to be understated and the STEM transfer to be overstated by \$400,000 on the state's accounting records at fiscal year-end 2016.

Figure 1  
**Lottery Net Revenue Transfers in Fiscal Year 2016**

|   |                          |                                     |                                      |
|---|--------------------------|-------------------------------------|--------------------------------------|
| <b>Transfers Required by §23-7-402(4), MCA</b>              | <b>STEM</b><br>\$400,000 | <b>General Fund</b><br>\$12,363,365 | <b>STEM</b><br>\$81,317 (Remainder)  |
| <b>Lottery Transfers per Accounting Records at FYE 2016</b> | <b>STEM</b><br>\$400,000 | <b>General Fund</b><br>\$11,963,365 | <b>STEM</b><br>\$481,317 (Remainder) |

Source: Compiled by the Legislative Audit Division.

We communicated the estimate error to the lottery. As a result, the commission approved transfers at its September 2016 meeting, based on corrected amounts, so the proper cash transfers were made. However, lottery procedures did not detect or prevent the accounting error resulting from improper interpretation of the change in the transfer statute. We reported this situation as a significant deficiency in internal control in our report on internal control over financial reporting on page B-1.

Since the allocation of the transfer for fiscal year 2016 was defined by a change in statute, the lottery may have been able to avoid the error by obtaining guidance from an attorney on how to interpret the law. To prevent errors in complying with changes in transfer provisions set by law, the lottery should consider obtaining legal advice regarding changes in statutory provisions affecting distribution of its net revenue.

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***RECOMMENDATION #1***

*We recommend the Montana State Lottery seek legal review of changes in statutory requirements regarding transfers of its net revenue.*

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# Independent Auditor's Report and Lottery Financial Statements



## LEGISLATIVE AUDIT DIVISION

Angus Maciver, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors:  
Cindy Jorgenson  
Joe Murray

## INDEPENDENT AUDITOR'S REPORT

The Legislative Audit Committee  
of the Montana State Legislature:

### *Introduction*

We have audited the accompanying Statement of Net Position of the Montana State Lottery as of June 30, 2016, and 2015, the related Statement of Revenues, Expenses and Changes in Net Position, and the Statement of Cash Flows for each of the fiscal years then ended, and the related notes to the financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this responsibility includes designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free 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 controls relevant to the Montana State Lottery'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 Montana State Lottery's internal control, and 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 the overall presentation of the financial statements.

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

*Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Montana State Lottery as of June 30, 2016, and 2015, and the changes in net position and cash flows for the fiscal years then ended in conformity with accounting principles generally accepted in the United States of America.

*Emphasis of Matter*

As discussed in Note 1 to the financial statements, the financial statements present only the enterprise fund of the Montana State Lottery and do not purport to, and do not, present fairly the financial position of the State of Montana, as of June 30, 2016, and 2015, the changes in its financial position, or its cash flows for each of the two fiscal years then ended in conformity with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

*Other Reporting Required by Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated February 14, 2017, on our consideration of the Montana State 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.

Respectfully submitted,

*/s/ Cindy Jorgenson*

Cindy Jorgenson, CPA  
Deputy Legislative Auditor  
Helena, MT

February 14, 2017

**MONTANA LOTTERY  
STATEMENT OF NET POSITION  
JUNE 30, 2016 AND 2015**

A-3

|  | 2016                         | 2015                         |
|--|------------------------------|------------------------------|
| <b>ASSETS</b>  |                              |                              |
| <b>CURRENT ASSETS</b>  |                              |                              |
| Cash and Cash Equivalents  | \$ 2,308,534                 | \$ 3,288,630                 |
| Receivables (Net)  | 2,140,199                    | 1,846,723                    |
| Multi-State Reserve Fund   | 65,000                       | 65,000                       |
| Inventories  | 435,336                      | 361,790                      |
| Securities Lending Collateral                                    | 6,020                        | 5,594                        |
| Prepaid Expenses   | <u>36,395</u>                | <u>17,122</u>                |
| <b>TOTAL CURRENT ASSETS</b>                                      | <b>4,991,484</b>             | <b>5,584,859</b>             |
| <b>NONCURRENT ASSETS</b>   |                              |                              |
| Computer, Furniture & Equipment                                  | 538,153                      | 2,981,645                    |
| Leasehold Improvements   | 59,781                       | 59,781                       |
| Accumulated Depreciation   | (461,917)                    | (2,549,526)                  |
| Investments  | 0                            | 20,773                       |
| Multi-State Reserve Fund   | <u>1,121,635</u>             | <u>1,302,470</u>             |
| <b>TOTAL NONCURRENT ASSETS</b>                                   | <b>1,257,652</b>             | <b>1,815,143</b>             |
| <b>DEFERRED OUTFLOW OF RESOURCES</b>                             |                              |                              |
| Pension Deferred Outflows  | <u>218,447</u>               | <u>127,377</u>               |
| <b>COMBINED ASSETS AND DEFERRED OUTFLOWS<br/>OF RESOURCES</b>    | <b>\$ <u>6,467,583</u></b>   | <b>\$ <u>7,527,379</u></b>   |
| <b>LIABILITIES</b>   |                              |                              |
| <b>CURRENT LIABILITIES</b>                                       |                              |                              |
| Accounts Payable   | \$ 835,894                   | \$ 394,166                   |
| Estimated Prize Liability  | 2,522,426                    | 2,133,757                    |
| Transfer Obligations   | 1,527,596                    | 3,064,720                    |
| Liability under Security Lending                                 | 6,020                        | 5,594                        |
| Unearned Revenue   | 104,297                      | 103,010                      |
| Accrued Compensated Absences                                     | 133,730                      | 157,935                      |
| Current Portion Long-Term Obligations                            | <u>0</u>                     | <u>54,126</u>                |
| <b>TOTAL CURRENT LIABILITIES</b>                                 | <b>5,129,963</b>             | <b>5,913,308</b>             |
| <b>NONCURRENT LIABILITIES</b>                                    |                              |                              |
| Multi-State Prize Liability                                      | 1,016,794                    | 1,148,771                    |
| Accrued Compensated Absences                                     | 102,379                      | 73,553                       |
| Net Pension Liability  | 1,651,762                    | 1,370,034                    |
| Other Post Employment Benefits                                   | <u>663,958</u>               | <u>597,244</u>               |
| <b>TOTAL NONCURRENT LIABILITIES</b>                              | <b>3,434,893</b>             | <b>3,189,602</b>             |
| <b>DEFERRED INFLOWS OF RESOURCES</b>                             |                              |                              |
| Pension Deferred Inflows   | <u>142,273</u>               | <u>353,994</u>               |
| <b>COMBINED LIABILITIES AND DEFERRED INFLOW OF<br/>RESOURCES</b> | <b>8,707,129</b>             | <b>9,456,904</b>             |
| <b>NET POSITION</b>  |                              |                              |
| Net Investment in Capital Assets                                 | 136,017                      | 437,774                      |
| Unrestricted   | <u>(2,375,563)</u>           | <u>(2,367,299)</u>           |
| <b>TOTAL NET POSITION</b>  | <b>\$ <u>(2,239,546)</u></b> | <b>\$ <u>(1,929,525)</u></b> |

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

|   |
|---|
| <b>MONTANA LOTTERY</b><br><b>STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET POSITION</b><br><b>FOR THE YEARS ENDED JUNE 30, 2016 AND 2015</b> |
|---|

|   | 2016                  | 2015                  |
|---|-----------------------|-----------------------|
| <b>OPERATING REVENUES:</b>                                |                       |                       |
| Scratch Ticket Revenue                                    | \$ 17,813,988         | \$ 17,531,453         |
| On Line Ticket Revenue                                    | 41,886,531            | 34,792,457            |
| License, Permits, and Misc                                | <u>26,571</u>         | <u>17,724</u>         |
| Total Operating Revenues                                  | 59,727,090            | 52,341,634            |
| <b>DIRECT GAME COSTS:</b>                                 |                       |                       |
| Scratch Ticket Prize Expense                              | 10,722,806            | 10,475,269            |
| On Line Ticket Prize Expense                              | 22,955,042            | 18,781,202            |
| Retailer Commissions                                      | 3,499,035             | 3,109,971             |
| Cost of Tickets Sold                                      | 981,044               | 928,071               |
| Vendor fees   | <u>3,861,429</u>      | <u>3,082,984</u>      |
| Total Direct Game Costs                                   | 42,019,356            | 36,377,497            |
| Income Before Operating Expenses                          | 17,707,734            | 15,964,137            |
| <b>OPERATING EXPENSES:</b>                                |                       |                       |
| Advertising   | 583,065               | 448,486               |
| Advertising Production                                    | 248,819               | 187,481               |
| Audit Fees  | 79,282                | 30,115                |
| Bad Debts Expense   | 4,652                 | 0                     |
| Communications  | 136,346               | 145,439               |
| Contractual Services                                      | 263,549               | 120,459               |
| Depreciation and Amortization                             | 167,157               | 492,205               |
| Interest  | 1,297                 | 5,360                 |
| Administrative Service Fee                                | 76,538                | 64,819                |
| Multi-State Dues  | 96,001                | 39,470                |
| Public Relations  | 53,748                | 59,698                |
| Other Post Employment Benefits                            | 88,769                | 90,075                |
| Other Expenses  | 36,640                | 31,138                |
| Pension Expense   | 141,852               | 104,639               |
| Personal Services   | 2,092,101             | 1,999,318             |
| Repairs and Maintenance                                   | 31,634                | 21,984                |
| Supplies and Materials                                    | 273,045               | 194,034               |
| Travel  | 53,300                | 44,386                |
| Utilities and Rent  | <u>519,797</u>        | <u>629,293</u>        |
| Total Operating Expense                                   | 4,947,592             | 4,708,399             |
| Operating Income  | 12,760,142            | 11,255,738            |
| <b>NONOPERATING REVENUES (EXPENSES):</b>                  |                       |                       |
| Interest Earnings   | 10,625                | 3,898                 |
| Security Lending Income                                   | 340                   | 11                    |
| Security Lending Expense                                  | (17)                  | (1)                   |
| Non Employer Pension Revenue                              | 40,722                | 37,027                |
| Gain/Loss on Sale of Assets                               | <u>(234,961)</u>      | <u>(1,778)</u>        |
| Total Nonoperating Revenues(Expenses)                     | <u>(183,291)</u>      | <u>39,157</u>         |
| Income Before Operating Transfers                         | 12,576,851            | 11,294,895            |
| Operating Transfers Out - General Fund                    | (12,363,365)          | (12,363,365)          |
| Operating Transfers Out - Other Agencies                  | (523,506)             | (3,780)               |
| CHANGE IN NET POSITION                                    | (310,020)             | (1,072,250)           |
| Total Net Position, Beginning of Period                   | (1,929,526)           | 99,498                |
| Prior Period Adjustment Included in Transfers (Note6)     | 0                     | 698,819               |
| Net Position Restatement For Implementation<br>of GASB 68 | <u>0</u>              | <u>(1,655,592)</u>    |
| TOTAL NET POSITION, END OF PERIOD                         | <u>\$ (2,239,546)</u> | <u>\$ (1,929,525)</u> |

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

**MONTANA LOTTERY  
STATEMENTS OF CASH FLOWS  
FOR THE YEARS ENDED JUNE 30, 2016 AND 2015**

A-5

|  | 2016                 | 2015                 |
|--|----------------------|----------------------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                      |                      |
| Receipts for Sales & Services  | \$ 59,430,249        | \$ 52,171,076        |
| Payments for Goods & Services  | (10,444,363)         | (9,233,756)          |
| Payments to Employees  | (2,231,728)          | (2,135,986)          |
| Payments for Prizes  | <u>(33,421,156)</u>  | <u>(29,660,929)</u>  |
| Net Cash Provided by Operating Activities  | 13,333,002           | 11,140,405           |
| <b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>                                     |                      |                      |
| Transfer to Other Funds  | <u>(14,423,995)</u>  | <u>(11,913,411)</u>  |
| Net Cash Used For Noncapital Financing   | (14,423,995)         | (11,913,411)         |
| <b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>                            |                      |                      |
| Acquisition of Fixed Assets  | (46,236)             | (32,568)             |
| Proceeds from Sale of Fixed Assets   | 0                    | 2,481                |
| Principal & Interest Payment on Leases   | <u>(55,423)</u>      | <u>(77,528)</u>      |
| Net Cash Used For Capital Financing  | (101,659)            | (107,615)            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                      |                      |
| Interest and Dividends on Investments  | 10,948               | 3,908                |
| Received from (Paid to) MUSL Prize Reserve Fund  | 180,835              | 146,234              |
| Sale (Purchase) of long term investments   | <u>20,773</u>        | <u>11,191</u>        |
| Net Cash Provided by Investing Activities  | 212,556              | 161,333              |
| <b>NET DECREASE IN CASH AND CASH EQUIVALENTS</b>   | (980,096)            | (719,288)            |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR</b>  | <u>3,288,630</u>     | <u>4,007,918</u>     |
| <b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>  | \$ <u>2,308,534</u>  | \$ <u>3,288,630</u>  |
| <br><b>Reconciliation of Operating Income to Net Cash Provided by Operating Activities</b> |                      |                      |
| Operating Income   | \$ 12,760,142        | \$ 11,255,738        |
| Adjustments to Reconcile Operating Income<br>to Net Cash Provided by Operating Activities  |                      |                      |
| Depreciation   | 167,157              | 492,205              |
| Interest Expense   | 1,297                | 5,360                |
| Change in Assets and Liabilities:  |                      |                      |
| Decr (Incr) in Account Receivable  | (293,476)            | (147,247)            |
| Decr (Incr) in Inventories   | (73,546)             | 28,236               |
| Decr (Incr) in Collateral securities on loan   | (426)                | (3,432)              |
| Decr (Incr) in Prepaid expenses  | (19,273)             | (3,479)              |
| Incr (Decr) in Accounts Payable  | 441,728              | (120,685)            |
| Incr (Decr) in Lottery Prizes Payable  | 256,692              | (404,458)            |
| Incr (Decr) in Liability for securities on loan  | 426                  | 3,432                |
| Incr (Decr) in Unearned Income   | 1,287                | (23,311)             |
| Incr (Decr) in Other Post Employment Benefits  | 66,714               | 64,682               |
| Incr (Decr) in Pension Liability   | 19,659               | (21,914)             |
| Incr (Decr) in Compensated Absences Payable  | <u>4,621</u>         | <u>15,278</u>        |
| Total Adjustments  | <u>572,860</u>       | <u>(115,333)</u>     |
| Net Cash Provided by Operating Activities  | \$ <u>13,333,002</u> | \$ <u>11,140,405</u> |

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



**MONTANA LOTTERY**  
Notes to the Financial Statements  
June 30, 2016 and 2015

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Reporting Entity.

The Montana Lottery, established under the provisions of Section 23-7-101, Montana Code Annotated (MCA), was approved by the Montana electorate through Legislative Referendum No. 100 on November 4, 1986.

Montana's first lottery tickets went on sale June 24, 1987.

The Montana Lottery is operated by a five-member commission consisting of Montana residents appointed by the Governor. The Commission, by law, has the power to operate a state lottery, determine the types and forms of lottery games, set the ticket price, number and size of prizes, conduct lottery drawings, enter into agreements to offer lottery games in conjunction with other lottery states and countries, and prepare financial reports. The Montana Lottery is attached to the Montana Department of Administration for administrative purposes.

The Montana Lottery is included as an enterprise fund in the State of Montana's Comprehensive Annual Financial Report. In accordance with governmental accounting and financial reporting standards, there are no component units to be included within the Montana Lottery's financial statements as a reporting entity.

Basis of Presentation. The Montana Lottery reports its financial activity in accordance with generally accepted accounting principles (GAAP) as prescribed in pronouncements of the Governmental Accounting Standards Board (GASB).

Enterprise Fund. The Montana Lottery is classified as an Enterprise Fund of the Proprietary Fund Type. Enterprise Funds account for operations: a) financed and operated similar to private business enterprises, where the intent of the Legislature is that costs are to be financed or recovered primarily through user charges, or b) where the Legislature has decided that periodic determination of revenue earned, expenses incurred, or net income is appropriate.

Basis of Accounting. The Montana Lottery's financial statements are prepared using the accrual basis of accounting. Revenues are recognized in the accounting period in which they are earned and become measurable; expenses are recognized in the period incurred, if measurable.

Property and equipment. Property and equipment are recorded at cost. Donated property and equipment are recorded at their estimated fair market value at the date of donation. Ordinary maintenance and repairs are charged to operations as incurred; major renewals and betterments are capitalized. Upon disposition or retirement of property and equipment, the cost and related accumulated depreciation or amortization are removed from the accounts. Gain or loss on disposal is reflected in non-operating revenues and expenses. Depreciation and amortization are calculated on a straight-line basis over estimated useful lives of three to ten years. The Lottery conforms to the State of Montana capitalization threshold for capitalizing property and equipment as well as buildings and building/land improvements. The threshold for capitalizing property and equipment is \$5,000 and the threshold for capitalizing buildings/land improvements is \$25,000.

Revenue Recognition. Lottery scratch ticket sales are recorded as revenue based on the time the retailer activates the pack of tickets for sale. In accordance with an established policy, retailers may return unsold tickets to the Lottery for credit. Sales are decreased by an allowance for estimated ticket returns.

Ticket sales for lotto games Powerball, Wild Card, Montana Cash, Hot Lotto, Montana Millionaire, Mega Millions, Lucky for Life, Big Sky Bonus, and 10 Spot are recorded as revenue based on drawings. Tickets sold in advance for future drawings are recorded as unearned income until such time as the tickets become valid for the most current drawing.

Treasure Play revenue is recorded on a daily basis as games are played. Treasure Play games are instant chances for wins, so when these games are played the revenue from these games are earned as played.

Ticket sales for Fantasy Sports games are based upon MCA 23-4-302 and an interagency agreement between the Lottery and the Board of Horse Racing. The Lottery is only a facilitator of these games and charges an administrative fee for this service. The actual sales of these games are not reflected on the Lottery's financial statements as they are not income to the Lottery.

Classification of Revenues. The Lottery has classified its revenues as either operating or non-operating according to the following criteria:

Operating revenues – include activities that have characteristics of exchange transactions, including (1) ticket sales, net of returns, and (2) retailer license fees and administrative fees in relation to selling lottery tickets.

Non-Operating revenues – include activities that have the characteristics of non-exchange transactions, such as gifts and other revenue sources that are defined as non-operating revenues by GASB No. 9, “Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting,” and GASB No. 34, “Basic Financial Statements and Management Discussion and Analysis for State and Local Governments.” Types of revenue sources that fall into this classification are investment income, and gain or loss on disposition of assets.

Free Tickets. Some Montana Lottery scratch games award free tickets as prizes. Net lottery ticket revenue does not include the value of free tickets given away and free plays won. The face value of these free ticket prizes distributed for the year ended June 30, 2016, and 2015 was \$450,120, and \$481,032, respectively.

Promotional Credits. The Lottery issues promotional credits to retailers to be used to distribute free tickets to players. The tickets are distributed as part of a promotion run by the retailer, e.g., “Ask for the Sale” or second chance drawings. The Lottery also directly distributes scratch tickets for promotional purposes at trade shows, for media give-aways, and during new game introductions. The tickets distributed as a result of promotional credits are reflected as a reduction in revenue. The related prize expense and ticket cost for all promotions are reclassified as an advertising expense. For the year ended June 30, 2016, promotional credits resulted in a revenue reduction of approximately \$23,236 and an expense reclassification of approximately \$17,460. For the year ended June 30, 2015, promotional credits resulted in a revenue reduction of approximately \$18,996 and an expense reclassification of approximately \$14,723.

Prizes. Expenses for scratch prizes are recorded based on the predetermined prize structure for each game. Expenses for lotto prizes are recorded based on the predetermined prize structure for each individual game. No prize expense is recorded for free tickets distributed.

Unclaimed Prizes. Prizes for the lotto games must be claimed within six months after the appropriate draw date. Prizes for scratch games must be claimed within six months of the announced end of each game. The unclaimed prize amounts for these games are taken as a reduction in the Lottery Prizes Payable liability and the Prize Expense and are transferred to the State of Montana General Fund as a portion of the quarterly transfer. The amount of unclaimed prizes for all Montana Lottery games is represented in the table below.

|               | Quarter Ended<br>6/30/16 | Quarter Ended<br>6/30/15 | Year To Date<br>6/30/16 | Year To Date<br>6/30/15 |
|---------------|--------------------------|--------------------------|-------------------------|-------------------------|
| Lotto         | \$139,205                | \$137,366                | \$ 540,754              | \$ 485,243              |
| Scratch       | \$375,354                | \$475,118                | \$ 914,062              | \$ 934,467              |
| <b>TOTALS</b> | \$514,559                | \$612,484                | \$1,454,816             | \$1,419,710             |

## 2. OTHER ACCOUNTING ISSUES

New Accounting Guidance. Beginning in fiscal year ended June 30, 2015, the Montana State Lottery has included, in the financials and the notes, the pension information required by GASB 68 for the PERS Multi-Employer, Cost Sharing Plan. The total pension liability is calculated by the Public Employees' Retirement Board's actuary. The Plan's fiduciary net position is reported in the PERB's *Comprehensive Annual Financial Report's* financial statements and in the GASB 67 & 68 Report which are both available on the Montana Public Employee Retirement Administration (MPERA) website. The Lottery has prepared its statements and financial notes using their information to report the Lottery's proportionate share of each of the pension components.

For the fiscal year ended June 30, 2016, the Montana Lottery implemented GASB Statement 72, *Fair Value Measurement and Application*. In accordance with this statement, certain assets have been presented at fair value and the appropriate disclosures are included.

Change in Accounting Method It was determined that state statutes did not intend to include any pension expense or revenue when determining the amount of transfers for any year. This expense is now disregarded and added or subtracted to the change in net position on the Statement of Revenues, Expenses, and Changes in Net Position. As a result of this change, the transfer amounts were decreased by net pension revenue during fiscal year ended June 30, 2016. The amount of the decreases were \$58,941 from FY2015 and \$21,063 from FY2016.

### 3. SUMMARY OF ACCOUNTS

Cash and Cash Equivalents. Cash and cash equivalents consist of interest-bearing deposits with the Montana Board of Investments short-term investment pool; cash on deposit in a revolving account with a non-state financial institution; and cash on deposit with the Montana State Treasurer that is part of the State's pooled cash and is not separately identifiable as to specific types of securities. These funds are highly liquid and may be drawn on daily.

Cash and cash equivalents consist of the following:

|                                      | June 30,           |                    |
|--------------------------------------|--------------------|--------------------|
|                                      | <u>2016</u>        | <u>2015</u>        |
| Short-term investment pool           | \$1,428,495        | \$2,398,370        |
| Cash on deposit with State Treasurer | 869,839            | 880,060            |
| Cash in revolving deposit account    | 10,000             | 10,000             |
| Petty Cash & Cash on Hand            | 200                | 200                |
| <b>TOTALS</b>                        | <u>\$2,308,534</u> | <u>\$3,288,630</u> |

The bank balance of the revolving deposit account, not including outstanding deposits or checks, was \$17,400, and \$34,156 as of June 30, 2016 and 2015, respectively, and was covered by federal depository insurance. The carrying amount reported in the balance sheet for cash and cash equivalents approximates the fair market value.

Receivables. For the year ended June 30, 2016, receivables include \$2,367,610, representing amounts due the Lottery for tickets purchased by retailers. Receivables also include \$980 for interest income due from the Montana Board of Investments short-term investment pool. An allowance for ticket returns is included in the receivables amount. This allowance represents a reduction in receivables as of June 30, 2016, for estimated ticket returns. This is an estimate based on returns received to date, as well as an estimate of tickets unsold by retailers for games that have a public sale end date prior to July 1, 2016. The allowance for ticket returns is \$249,580 as of June 30, 2016. The return of vendor fees related to the allowance for returns is \$21,189.

For the year ended June 30, 2015, receivables included \$2,060,479, representing amounts due the Lottery for tickets purchased by retailers. Receivables also include \$391 for interest income due from the Montana Board of Investments short-term investment pool. An allowance for ticket returns is included in the receivables amount. This allowance represents a reduction in receivables as of June 30, 2015, for estimated ticket returns. This is an estimate based on returns received to date, as well as an estimate of tickets unsold by retailers for games that have a public sale end date prior to July 1, 2015. The allowance for ticket returns is \$227,332 as of June 30, 2015. The return of vendor fees related to the allowance for returns is \$13,185.

Inventories. Inventories consist of merchandise and supplies inventories. Merchandise inventory for years ended June 30, 2016 and 2015 include scratch tickets valued at \$337,628, and \$301,085, respectively, that are stored in the warehouse, at retailers prior to being activated by the retailer, and with the marketing representatives. These ticket inventories are recorded at cost using the specific identification method and maintained on a perpetual inventory system. Tickets are charged to cost of tickets sold upon activation or after game end.

Supplies inventories include ticket dispensers, premiums and point-of-sale materials. For the years ended June 30, 2016, and 2015, supplies inventories totaled \$97,708, and \$60,705, respectively. These inventories are also recorded at cost using the specific identification method.

Other Current Assets. Other current assets include the following:

|                  | <u>June 30,</u> |                 |
|------------------|-----------------|-----------------|
|                  | <u>2016</u>     | <u>2015</u>     |
| Prepaid Expenses | <u>\$36,395</u> | <u>\$17,122</u> |

The prepaid expenses for the year ended June 30, 2016 consisted of \$6,325 for booth fees for upcoming events, \$16,000 in annual lottery industry dues, and \$14,070 for prepaid commissions and vendor fees related to unearned income. The prepaid expenses for the year ended June 30, 2015 consisted of \$6,000 for booth fees for upcoming events, and \$11,122 for prepaid commissions and vendor fees related to unearned income.

Property and Equipment. A summary of property and equipment for the Lottery is as follows:

|                          | <u>June 30,</u> |                  |                  | <u>June 30,</u> |
|--------------------------|-----------------|------------------|------------------|-----------------|
|                          | <u>2015</u>     | <u>Additions</u> | <u>Deletions</u> | <u>2016</u>     |
| Leasehold Improvements   | \$ 59,781       | \$ -             | \$ -             | \$ 59,781       |
| Furniture & Equipment    | \$ 2,981,645    | \$ 46,236        | \$ (2,489,728)   | \$ 538,153      |
| Accumulated Depreciation | \$(2,549,526)   | \$ (167,157)     | \$ 2,254,766     | \$ (461,917)    |

During the year ended June 30, 2016, the contract with the Lottery’s on-line services vendor ended (See note 9). This contract ended on March 30, 2016 and included the lease arrangements for various terminal machines. The leases and ownership of all terminal equipment ceased as of this date and were disposed of by the Lottery. The cost of this equipment disposed was \$2,463,200 with a related accumulated depreciation of \$2,231,669. There were no proceeds received for these machines as they were mostly obsolete and were physically disposed of by the vendor at their own cost. The transaction created a net loss of \$231,531 which consisted primarily of salvage value kept on the books as required by State policy.

Estimated Prize Liability. The estimated prize liability represents the Lottery’s estimate of prizes payable related to games in process at year-end based on the predetermined prize structure of each outstanding game.

Obligation to Transfer Funds. The Lottery is required to transfer its net revenue to the Montana State General Fund. This change was enacted through the passage of SB83 by the 1995 Legislature and signed into law by Governor Racicot in April 1995. The 2015 Legislature passed HB617 which changed the transfer requirements. Any year forward, the Lottery is to transfer an amount to the General Fund that equals the transfer made by the Lottery for FY2015. Any amount over and above this threshold will then be transferred to the Office of Commissioner for Higher Education (OCHE) for the Montana STEM scholarship program. The transfer obligations outstanding at June 30, 2016 were \$1,404,090 to the General Fund and \$123,506 to OCHE. For the year ending June 30, 2015, the obligation outstanding at year end was \$3,064,720 due to the General Fund only.

Compensated Absences. State employees earn vacation leave ranging from 15 to 24 days per year depending on the individual’s years of service. Vacation leave may be accumulated not to exceed two times the maximum number of days earned annually. With no limit on accumulation, sick leave is earned at 12 days per year. Upon retirement or termination, an employee is paid 100% for unused vacation and 25% for unused sick leave. The Lottery’s liability for compensated absences is detailed below.

|  |  |  |
|--|--|--|
| <u>Balance</u><br><u>June 30, 2015</u> | <u>Net Leave</u><br><u>Earned/(Used)</u> | <u>Balance</u><br><u>June 30, 2016</u> |
| \$231,488                              | \$4,621                                  | \$236,109                              |

Commissions. Section 23-7-301(10), MCA, provides retailers a commission on scratch and lotto tickets or chances sold. The Lottery Commission established this commission at 5% of the face value of scratch tickets activated by the retailers and the face value of lotto tickets sold. Section 23-4-302 (5)(b)(i), MCA, establishes a 3.99% commission for the face value of Fantasy Sports tickets sold. In addition retailers can earn bonus commissions on tickets sold based on incremental sales of scratch tickets. For the years ended June 30, 2016 and 2015, retailers earned bonus commissions of \$479,473 and \$451,031, respectively. For the years ended June 30, 2016 and 2015, total commissions were \$3,499,035 and \$3,109,971, respectively.

#### 4. PAYMENTS TO OTHER STATE AGENCIES

The Lottery receives a variety of services, supplies, and materials from other state agencies. These services and materials are detailed below for the fiscal years ended June 30, 2016 and 2015:

| <u>Year ended June 30</u>       | <u>2016</u>       | <u>2015</u>       |
|---------------------------------|-------------------|-------------------|
| Administrative Service Fees     | \$ 76,536         | \$ 64,819         |
| Audit Fees                      | 79,282            | 30,115            |
| Computer Fees                   | 65,766            | 74,534            |
| Insurance                       | 13,518            | 10,976            |
| Mail Processing Fees            | 9,705             | 9,775             |
| Other Expenses                  | 2,430             | 1,223             |
| Payroll Services                | 7,009             | 7,364             |
| Printing                        | 5,372             | -                 |
| Record Retention                | 1,018             | 425               |
| State Accounting System Support | 4,158             | 3,061             |
| Supplies & Materials            | 59                | -                 |
| Telecommunications              | 11,437            | 13,630            |
| Warrant Writing Services        | 280               | 472               |
|                                 | <u>\$ 276,570</u> | <u>\$ 216,394</u> |

## 5. PRIZES

Paid Prizes. Section 23-7-402, MCA states, “A minimum of 45% of the money paid for tickets or chances must be paid as prize money”. Prize expense is recorded based on the predetermined prize structure percentage for each game less unclaimed prizes. For the year ended June 30, 2016, the prize expense of \$33,677,848 is 56.41% of net Lottery ticket revenue of \$59,700,519. For the year ended June 30, 2015, the prize expense of \$29,256,471 was 55.91% of net Lottery ticket revenue of \$52,323,910.

## 6. TRANSFERS OF NET REVENUE

Section 23-7-402(3), MCA, states “That part of all gross revenue not used for payment of prizes, commissions, and operating expenses, together with the interest earned on the gross revenue while the gross revenue is in the enterprise fund, is net revenue. Net revenue must be transferred quarterly from the enterprise fund established by 23-7-401 to the state general fund. Once the amount of revenue transferred to the general fund during a fiscal year equals the amount transferred to the general fund in fiscal year 2015, any additional net revenue must be transferred to the Montana STEM scholarship program special revenue account established in 20-26-617.” For the years ended June 30, 2016 and 2015, the net revenue payable to the State General Fund totaled \$12,363,365, and \$12,363,365, respectively. The amount payable to the General Fund for FY2015 included an amount for prior period adjustments of \$698,819 which was related to a recalculation of Other Post-Employment Benefits in FY2014. For the years ended June 30, 2016 and 2015, the net revenue payable to the Montana STEM scholarship totaled \$523,506, and \$0, respectively.

## 7. MULTI-STATE LOTTERY

In November 1989 the Montana State Lottery joined the Multi-State Lottery Association (MUSL). MUSL was created in September 1987 to operate a multi-state lottery game for the benefit of party lotteries. Powerball, Wild Card, Hot Lotto, and Mega Millions are the games jointly operated by the members, in which Montana presently participates. Each lottery participating in MUSL is represented on the Board of Directors.

The Multi-State Lottery Reserve Fund with a balance of \$1,186,635 and \$1,367,470 as of June 30, 2016, and 2015, respectively, is comprised of several reserve accounts, which are maintained by the Multi-State Lottery Association (MUSL). A portion of the Powerball Unreserved Account is classified as a current asset which represents an amount expected to be converted into cash and collected from MUSL within the next fiscal year. The balance of these reserve accounts and investment category is as follows:

June 30, 2016

|                                     | US<br><u>Treasury</u> | Federal<br><u>Agencies</u> | <u>Total</u>               |
|-------------------------------------|-----------------------|----------------------------|----------------------------|
| Powerball Prize Reserve Account     | \$ 329,685            | \$ 93,313                  | \$ 422,998                 |
| Powerball Set Prize Reserve Account | 50,870                | 133,042                    | 183,912                    |
| Powerball Unreserved Account        | 13,570                | 156,270                    | 169,840                    |
| Hot Lotto Set Prize Reserve Account | -                     | 264,764                    | 264,764                    |
| Mega Millions Prize Reserve Account | <u>113,107</u>        | <u>32,014</u>              | <u>145,121</u>             |
| Total Reserves                      | <u>\$ 507,232</u>     | <u>\$ 679,403</u>          | \$ 1,186,635               |
| Less Current Portion                |                       |                            | <u>(65,000)</u>            |
| <b>Non Current Reserves</b>         |                       |                            | <b>\$ <u>1,121,635</u></b> |

June 30, 2015

|                                     | US<br><u>Treasury</u> | Federal<br><u>Agencies</u> | <u>Total</u>               |
|-------------------------------------|-----------------------|----------------------------|----------------------------|
| Powerball Prize Reserve Account     | \$ 215,925            | \$ 233,825                 | \$ 449,750                 |
| Powerball Set Prize Reserve Account | 78,394                | 117,150                    | 195,544                    |
| Powerball Unreserved Account        | 42,406                | 176,292                    | 218,698                    |
| Wild Card Prize Reserved Account    | -                     | 48,626                     | 48,626                     |
| Hot Lotto Set Prize Reserve Account | -                     | 297,464                    | 297,464                    |
| Mega Millions Prize Reserve Account | <u>\$ 75,562</u>      | <u>\$ 81,826</u>           | <u>\$ 157,388</u>          |
| Total Reserves                      | <u>\$ 412,287</u>     | <u>\$ 955,183</u>          | \$ 1,367,470               |
| Less Current Portion                |                       |                            | <u>(65,000)</u>            |
| <b>Non Current Reserves</b>         |                       |                            | <b>\$ <u>1,302,470</u></b> |

The Powerball Prize Reserve Account is to be used only in the event of an unanticipated prize claim. It is an insurance fund intended to protect the member lotteries against the liability that could result from a system failure at one of the member lotteries. All money paid to this fund would be returned to the Lottery one year after the Lottery leaves the Powerball game, assuming that no unanticipated prize claims have been paid.

The Powerball Set Prize Reserve Account is used to fund prize payments for current drawings. Since the Powerball game has fixed prizes, it is often necessary to draw from this reserve to fund payment of prizes at the fixed amount. This account would be returned to the Lottery upon withdrawal from the Powerball game.

The Lottery contributes to these reserve funds through the 50% set aside for prizes. In addition the Lottery was required to contribute for its portion of the reserve funds accumulated since the start of the Powerball game. Payments made to this fund are considered a portion of prize expense associated with the game.

The Powerball Unreserved Account is a separate account used by a participating Lottery to have MUSL hold funds due to the Lottery. Balances in this account are created when any MUSL jackpot expires and goes unclaimed. Each Lottery is then refunded its pro rata share of the jackpot based on sales during the accumulation of that specific jackpot. This money is then invested in U.S. Treasury securities until withdrawn. Interest earned on the Lottery's share of the fund is added to the Unreserved Account on a quarterly basis. The amount in the Unreserved Account has limited uses and are set and approved by the Board with the stipulation that requests to use the funds are accompanied by certification from the requesting Board Member that the payment is made in conformance with state or jurisdiction law and is related to a MUSL activity.

During fiscal year ended 2016, the Lottery received \$1,006 in interest plus received \$44,307 distributions from the Wild Card Reserve, \$4,646 from the Powerball Unreserved account, \$1,223 from the Mega Millions Reserve, and had \$100,040 withdrawn for annual MUSL dues and assessments. During the fiscal year ended 2015, the Lottery received \$606 in interest plus received \$57,188 in distributions from the Wild Card Reserve, and had \$43,162 withdrawn for annual MUSL dues and assessments.

The Wild Card Reserve Account was to be used in the event of an unanticipated prize claim on the Wild Card game. This account was also administered by MUSL and would be returned to the Lottery one year after the Wild Card Product Group of Idaho, Montana, South Dakota, and North Dakota is disbanded. The Lottery contributed to this account through the 57% set aside for prizes. Payments made to this fund were considered a portion of prize expense related to the Wild Card game. The Wild Card game ended February 24, 2016.

The Hot Lotto Set Prize Reserve Account is administered by MUSL and is to be used only in the event of unanticipated prize claims. Like other MUSL games the reserve amount would be returned to the Lottery one year after withdrawal from the Hot Lotto game. The Lottery contributes to the reserve through the 50% set aside for prizes. Payments made to the reserve are considered a portion of the prize expense related to the game.

The Mega Millions Prize Reserve Account is to be used only in the event of an unanticipated prize claim. It is an insurance fund intended to protect the member lotteries against the liability that could result from a system failure at one of the member lotteries. All money paid to this fund would be returned to the Lottery one year after the Lottery leaves the Mega Millions game, assuming that no unanticipated prize claims have been paid. The Lottery contributes to the reserve through the 50% set aside for prizes for Mega Millions plays and 50% for Megaplier plays. Payments made to the reserve are considered a portion of the prize expense related to the game.

## 8. GAMES

Currently, Montana Lottery games are scratch ticket games and ten lotto games referred to as Powerball, Montana Cash, Wild Card, Hot Lotto, Mega Millions, Lucky for Life, Big Sky Bonus, and 10 Spot. The lottery also offers Treasure Play, a line of instant terminal-issued games with pre-determined odds, and Montana Millionaire, a limited-edition lottery game. The lottery is facilitating Fantasy Sports games on behalf of the Board of Horse Racing. Currently the lottery is selling Montana Sports Action Fantasy Football and Fantasy Racing games.

Scratch ticket games provide players the opportunity to win instantly by scratching the latex covering to reveal a prize. The lottery sells tickets for \$1, \$2, \$3, \$5, \$10, and \$20. Top prizes range from \$500 to \$500,000.

The Powerball game allows players a chance to win a minimum parimutuel jackpot of \$40 million. A player must match all six numbers to win the jackpot. Players also win prizes ranging from \$4 to \$1 million for matching fewer than all six numbers. Drawings are held twice weekly on Wednesday and Saturday nights. Powerball is offered in 45 lottery jurisdictions including Montana. For any drawing, if no ticket matches 6 out of 6 numbers, the jackpot rolls over to the next drawing, creating a progressive jackpot. In March 2001, the Lottery added Power Play to the Powerball game. For an additional \$1 per play, Power Play doubles the Match 5 prize from \$1 million to \$2 million and increases other prizes as well. Each Powerball prize (except for the jackpot and the Match 5 prize) increases by 2x, 3x, 4x, 5x, or 10x with Power Play.

The Montana Cash game allows players the chance to win a minimum parimutuel jackpot of \$40,000. Players select five numbers from a field of 45 and must match at least two out of five to win a prize. Matching 2 of 5 wins \$1, 3 of 5 wins \$5, and 4 of 5 wins \$200. The drawings are conducted twice weekly on Wednesday and Saturday nights. If no ticket matches all five numbers, the jackpot rolls over to the next drawing to create a progressive jackpot.

Wild Card is played in four lottery jurisdictions and allows players the chance to win a parimutuel jackpot with a guaranteed minimum of \$200,000. In January 2013, the game was improved by increasing the minimum jackpot from \$100,000 and increasing other prizes as well. Players select five numbers from a field of 33 plus one of 16 face cards (the Wild Card) and must match all five numbers and the Wild Card to win the jackpot. Players win prizes from \$1 to \$6,000 for matching fewer than all five numbers and/or the Wild Card. Drawings are held twice weekly on Wednesday and Saturday nights. If no ticket matches all five numbers and the Wild Card, the jackpot rolls over to the next drawing to create a progressive jackpot. This game ended on February 24, 2016.

Hot Lotto allows players in the 16 participating lotteries a chance to win an all-cash parimutuel jackpot with a guaranteed minimum of \$1 million, plus tax withholdings paid. This change was implemented in May 2013. Each time the jackpot is not won, it grows, thus creating a progressive jackpot. Players choose five numbers from one to 47, and one Hot Ball number from 1 to 19. To win the parimutuel jackpot, a player must match all six numbers drawn. Players can also win prizes from \$2 to \$30,000 by matching fewer than all six numbers. If a player chooses, for an additional bet amount, to add Sizzler to their ticket, any prize except the jackpot is multiplied by three. Drawings are held twice weekly on Wednesday and Saturday nights.

Mega Millions is a multi-state game that allows players to win a minimum parimutuel jackpot starting at \$15 million. If no one wins the jackpot, the jackpot continues to grow. Mega Millions went on sale March 1, 2010, in Montana. To win the jackpot, players must match all six numbers drawn; other prizes range from \$2 to \$1,000,000. For an additional \$1 per play, Mega Millions has a Megaplier option which multiplies non-jackpot prizes by two, three, or four. Drawings are held each Tuesday and Friday night.

10 Spot, which went on sale February 1, 2010, is a Montana-only, twice-daily game. Players select 10 numbers from one through 80. The lottery draws 20 numbers, and players win by matching 10, nine, eight, seven, six, five, or none of the numbers drawn. Prizes range from \$2 to \$25,000. This game ended on April 2, 2016.

Lucky for Life debuted January 2015. Lucky for Life is a multi-state game that allows players to win a top prize of \$1,000 a day for life. The second prize is \$25,000 a year for life. This pari-mutuel game has a set top prize and tickets cost \$2 each. Players select five numbers from a field of 48 and must match at least the Lucky Ball to win a prize. The drawings are conducted twice weekly on Monday and Friday nights.

Big Sky Bonus is the newest Montana Lottery game. Big Sky Bonus is a Montana-only game that allows players to win a progressive jackpot. Players select 4 numbers from a field of 28 and must match at least 2 out of 4 to win a prize unless they hit the bonus number which is a 5<sup>th</sup> number picked out of a field of 17. Matching the bonus number at any time wins \$10. Matching 2 of 4 wins \$2, 3 of 4 wins \$20, and 4 of 4 wins the jackpot. The drawing is held every day at 7:30 p.m. If not ticket matches all 4 numbers, the jackpot rolls over to the next day to create a progressive jackpot.

The Treasure Play games are offered on self-serve terminals in taverns and casinos that are licensed to sell Montana Lottery products. Introduced in November 2011, they are a suite of games with a pre-determined prize structure like a scratch game. Players can tell instantly if they have won a prize. The tickets sell for \$1, \$2, \$3, \$5, and \$10.

Montana Millionaire is a seasonal raffle-type game offering a \$1 million top prize. The first offering went on sale October 1, 2007. The lottery has sold the game every winter since. Tickets are sold sequentially and are sold for \$20 each. Early bird drawings for \$25,000 and \$15,000, respectively, will be offered on Thanksgiving weekend and the second week of December to stimulate early sales. There will also be 400 \$100 instant winners and 625 \$500 instant winners. On January 1, 2016, one \$1 million prize was awarded, along with two \$100,000 prizes and three \$10,000 prizes. Montana Millionaire is scheduled to sell from November 1 through December 31, 2016, with a drawing on New Year's Day 2017 or earlier is sold out.

The Montana Lottery offers a product line called Montana Sports Action on behalf of the Montana Board of Horse Racing. The product line began in August 2008 with a game called Fantasy Football. To play the game, players choose five offensive players and a defensive unit from the official roster of professional football players and teams. The players can also select a bet amount (\$5, \$10, \$20, \$50, or \$100) which determines the shares of the prize pool players are eligible to win should their team have one of the three highest point totals for the week. Tickets are sold weekly through the professional playoffs, excluding the championship game. A second game called Fantasy Racing was introduced in February 2009 and follows the NASCAR® Sprint Cup Series. Teams are created by selecting a driver from the top nine ranked drivers for the week, three drivers ranked from 10 through 34, and one driver ranked 35 or above. The sixth element in a player's Fantasy Racing team is the number of yellow-flag cautions the player believes might occur in that week's race. Like Fantasy Football, players may also choose to purchase a higher-cost ticket to increase the share of the prize pool in the event their team has one of the three highest point totals for that race.

## **9. COMMITMENTS - GAMING SUPPLIER CONTRACTS**

Scratch Tickets. On July 30, 2015 the Montana Lottery Commission approved the award of a five-year contract with Scientific Games International (SGI) for the provision of scratch tickets. The contract is for five years with the option for two additional one-year renewals. The contract contains specifications regarding ticket design, printing, game ownership, inspection, and prize structure.

SGI, as the vendor, provided a performance bond covering the contract term and an errors and omissions policy covering an ultimate net loss of \$5,000,000. The Lottery may terminate this contract by providing proper notification to Scientific Games.

On-line Services. On October 11, 2005, the Lottery signed a seven-year contract with Intralot, Inc. of Duluth, GA to provide an on-line gaming system and the associated services beginning March 31, 2006. The contract requires Intralot to provide new terminals to all retailers with the associated software and communications. Payment under the contract is based on 5.8% of net weekly Lottery sales of lotto and scratch games. On August 18, 2008 an addendum was signed to provide services for the Fantasy Sports games at 3% of net weekly Lottery sales up to \$2,999,999 of Montana Sports Action games. The contract currently has a termination date of March 30, 2016.

On February 13, 2015, the Lottery signed a seven-year contract with Intralot, Inc. of Duluth, GA to provide an on-line gaming system and the associated services beginning March 31, 2016. The contract requires Intralot to provide new terminals to all retailers with the associated software and communications. Payment under the contract is based on 8.49% of net weekly Lottery sales of lotto and scratch games. The contract currently has a termination date of March 30, 2023.

#### **10. LEASES/INSTALLMENT PURCHASES PAYABLE**

Rent. The Montana Lottery leases its office, administrative and warehouse facilities under a lease agreement that is effective September 2007 through August 2017. The monthly lease payment is \$12,867 through August 2016. The base rate will increase 3% annually.

#### **11. INVESTMENTS**

Effective June 30, 2005, the State of Montana implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures*. The Lottery participates in two investment pools: the Multi-State Lottery Association (MUSL) reserve accounts and the State of Montana's Short Term Investment Pool (STIP). The applicable investment disclosures are described in the following paragraphs.

Multi-State Lottery Association The MUSL investment policy for prize reserve and unreserved funds states that permitted investments "include direct obligations of the United States government, perfected repurchase agreements, and obligations issued or guaranteed as to payment of principal and interest by agencies or instrumentalities of the United States government, and mutual funds of approved investments".

Short-term Investment Pool The State's Short Term Investment Pool (STIP) is an external investment pool managed and administered under the direction of the Montana Board of Investments as statutorily authorized by the Unified Investment Program. It is a commingled external investment pool and participants may request for redemption on a daily basis. The fair values of the investments in this category have been determined using the NAV per share (or its equivalent) of the investment.

**Credit risk** is defined as the risk that an issuer of an investment will not fulfill its obligation, i.e., not make timely principal and interest payments. The STIP securities have credit risk as measured by major credit rating services, however, the pool is not rated. The Lottery does not have a policy regarding credit risk

Per MUSL, for 2016 the prize reserves held on behalf of the Montana Lottery are invested in the Montana Winners Trust which has an AA+ credit quality rating. In this trust, 62% was invested in Federal Agencies; another 10% was invested in the First American Government Obligation Fund which is used for overnight investing and does not have a rating from S&P or Moodys, etc. However, it is a very conservatively managed vehicle, investing exclusively in short-term U.S. government securities. The other 28% of the prize reserves are invested in Federal Agency repurchase agreements secured by U.S. government securities. The Lottery does not have any authority or a policy regarding the investment portfolios.

**Custodial credit risk** is the risk that the Lottery would not be able to recover the value of the investment or collateral securities that are in the possession of an outside party in the event of the failure of that party. The Lottery does not have any authority or a policy regarding the investment portfolios.

The MUSL prize reserves are held in the Montana Winners Trust using policies set forth by the MUSL board regarding policies for the type of securities, as well as the custody, trading and the use of proceeds of the securities. The Lottery does not have any authority or a policy regarding the investment portfolios.

**Concentration of credit** is the risk of loss attributed to the magnitude of a government's investment in a single issuer. Because STIP is a pooled investment, this risk does not apply. Because the MUSL reserves are also a pooled investment, this risk does not apply to them either.

**Interest rate risk** is the risk that changes in interest rates will adversely affect the fair value of an investment. The Lottery does not have any authority or a policy regarding the investment portfolios.

The MUSL prize reserves are invested through the Montana Winners Trust with daily liquidity, and therefore, has no interest rate risk. The MUSL board's investment policy limits the individual security and the portfolio's maturity. As of June 30, 2016, the duration for the U.S. Government Treasury securities was a blended rate of 1.00 years.

The STIP securities are invested in various bond pools and investment portfolios which are liquid on a daily basis. Therefore, STIP, itself does not have this risk. The duration for this pool as of June 30, 2016 is 0.11 years.

## 12. FAIR VALUE MEASUREMENT

The Lottery categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles as follows:

- Level 1 – Quoted prices for identical assets or liabilities in active markets.
- Level 2 – Prices determined using inputs, other than quoted prices included within Level 1, that are observable for an asset or liability, either directly or indirectly.
- Level 3 – Prices are determined using unobservable inputs.

### Investments Measured at Fair Value

|                                       | June 30, 2016   | Fair Value Measurements Using  |   |  |
|---------------------------------------|-----------------|--|---|--|
|                                       |                 | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>(Level 3) |
| <u>Investments by Fair Value</u>      |                 |  |   |  |
| Short Term Investment Pool (STIP)     | \$ 1,428,495.00 | \$ 1,428,495.00  |   |  |
| Total Investments by fair value level | \$ 1,428,495.00 | \$ 1,428,495.00  | \$ -  | \$ -                                     |

The Short Term Investment Pool (STIP) has a daily redemption frequency and a daily redemption notice period. The fair value of this pool has been determined using the Net Asset Value (or its equivalent). For the year ended June 30, 2015, STIP was reported on an amortized cost basis and no fair value disclosure was needed.

### 13. OTHER POST EMPLOYMENT BENEFITS

*General.* The State of Montana and the Montana Lottery provide optional postemployment healthcare benefits in accordance with Montana Code Annotated, Title 2, Chapter 18, Section 704 to the following employees and dependents who elect to continue coverage and pay administratively established contributions: (1) employees and dependents who retire under applicable retirement provisions, and (2) surviving dependents of deceased employees. Medical, dental, and vision benefits are available through this plan.

*Plan Description.* The State OPEB plans are agent multiple employer plans. There are a number of State agencies who are participating employers under this plan. Each participating employer is required by GASB Statement No. 43 to disclose additional information regarding funding policy, the employer's annual OPEB cost and contributions made, the funded status and funding progress of the employer's individual plan, and actuarial methods and assumptions used.

The healthcare OPEB plans allow retirees to participate, as a group, at a rate that does not cover all of the related costs. This results in the reporting of an "implied rate" subsidy in the related financial statements and footnotes. While this liability is disclosed for financial statement purposes, it does not represent a legal liability of the State or any of its component units. Accordingly, reported contributions are not a result of direct funding to the plans or for associated liabilities, but are a measure of the difference in retiree payments into the plans and actual medical costs associated with those individuals paid for by the plans. The healthcare OPEB plans are reported as agency funds. There are no assets or liabilities as only contributions collected and distributions made are reflected in these funds. See the funding policy that follows.

*Bases of Accounting.* OPEB is recorded on an accrual basis for all enterprise and internal service funds as well as component units. OPEB is recorded on a modified accrual basis for the governmental funds. Plan member contributions are recognized in the period in which the contributions are made. Benefits and refunds are recognized when due and payable in accordance with the terms of each plan.

*Funding Policy.* The State of Montana pays for postemployment healthcare benefits on a pay-as-you-go basis. Montana Code Annotated, Title 2, Chapter 18, Part 8 gives authority for establishing and amending the funding policy to the Department of Administration. As of June 2016, the State plan's administratively established retiree medical premiums vary between \$371 and \$1,345 per month depending on the medical plan selected, family coverage, and Medicare eligibility. Administratively established dental premiums vary between \$22 and \$68.50 and vision hardware premiums vary between \$5.76 and \$16.76 depending on the coverage selected.

*Annual Other Postemployment Benefit Cost and Contributions.* The annual

required contribution (ARC), an actuarially determined rate in accordance with the parameters of GASB Statement No. 45, represents a level of funding that, if paid on an ongoing basis, is projected to cover the normal cost each year and amortize any unfunded actuarial liabilities over a period not to exceed 30 years.

The following table presents the OPEB cost for the year, the amount contributed, and changes in the OPEB plans for fiscal year 2016 and 2015:

| <b>Year ended June 30,</b>              |    | <b>2016</b>     | <b>2015</b>       |
|---|----|-----------------|-------------------|
| Annual Required Contribution/OPEB cost  | \$ | 83,228          | \$ 85,212         |
| Interest on net OPEB obligation         |    | 25,690          | 22,545            |
| Amortization Factor                     |    | <u>(20,149)</u> | <u>(17,682)</u>   |
| Annual OPEB cost                        |    | 88,769          | 90,075            |
| Retiree Claims Paid                     |    | (22,055)        | (25,393)          |
| Increase in net OPEB obligation         |    | 66,714          | 64,682            |
| Net OPEB obligation – beginning of year |    | <u>597,244</u>  | <u>532,562</u>    |
| Net OPEB obligation – end of year       | \$ | <u>663,958</u>  | \$ <u>597,244</u> |

Since the plan pays other postemployment benefits on a pay-as-you-go basis, the funded ratio of the OPEB obligation is 0%.

The Lottery's annual healthcare OPEB cost, the percentage of annual implicit contributions toward the OPEB cost through retiree claims paid on their behalf, and the net OPEB obligation for the fiscal years 2016 through 2014 was as follows:

| <b>Fiscal Year Ended</b> | <b>Annual OPEB Cost</b> | <b>Percentage of Annual OPEB Cost Contributed</b> | <b>Net OPEB Obligation</b> |
|--------------------------|-------------------------|---|----------------------------|
| 6/30/2016                | \$ 88,769               | 24.8%   | \$ 663,958                 |
| 6/30/2015                | \$ 90,075               | 28.2%   | \$ 597,244                 |
| 6/30/2014                | \$ 88,325               | 19.1%   | \$ 532,562                 |

*Actuarial Methods and Assumptions.* The State is required by GASB Statement No. 45 to obtain an actuarial evaluation every other year. An actuarial report was prepared for December 31, 2015. Therefore, an actuarial evaluation was not prepared for December 31, 2014.

As of December 31, 2015, the Lottery's actuarially accrued liability (AAL) for benefits was \$924,958, with no actuarial value of assets, resulting in an unfunded actuarial liability (UAAL) of \$924,958, and the ratio of the UAAL to the covered payroll was 57.32%. The UAAL is being amortized as a level dollar amount over an open basis for 30 years.

In the December 31, 2015 actuarial valuation, the projected unit cost funding method was used for the State. The actuarial assumptions included a 4.25% discount rate and a 2.50% payroll growth rate. The projected annual healthcare cost trend rate is initially 3.4% for medical and 10.8% for prescription drugs. The decrease to the medical costs trend rate in plan year 2015 is based on actual trend data instead of estimated trend rates. The medical rate increases to an actuarially determined 9.5% in 2016. Both medical costs and prescription drugs are reduced by decrements to a rate of 5.0%, medical costs after eleven years and prescription drugs after six years.

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Actuarially determined amounts are subject to continual revisions being actual results are compared with past expectations and new estimates are made about the future. Actuarial calculations reflect a long-term perspective.

The following schedule of funding progress is designed to present multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial liabilities for benefits.

| <u>Date</u> | <b>Actuarial Value of Assets (A)</b> | <b>Actuarial Accrued Liability (AAL) (B)</b> | <b>Unfunded AAL (UAAL) (B-A)</b> | <b>Funded Ration (A/B)</b> | <b>Covered Payroll (C)</b> | <b>UAAL as a Percentage of Covered Payroll (B-A)/C</b> |
|-------------|--------------------------------------|--|----------------------------------|----------------------------|----------------------------|--|
| 1/1/2009    | \$ -                                 | \$ 839,608                                   | \$ 839,608                       | 0.00%                      | \$ 1,373,902               | 61.11%   |
| 1/1/2011    | \$ -                                 | \$ 789,880                                   | \$ 789,880                       | 0.00%                      | \$ 1,370,886               | 57.62%   |
| 1/1/2013    | \$ -                                 | \$ 881,458                                   | \$ 881,458                       | 0.00%                      | \$ 1,402,639               | 62.84%   |
| 1/1/2015    | \$ -                                 | \$ 924,958                                   | \$ 924,958                       | 0.00%                      | \$ 1,613,698               | 57.32%   |

Projections of benefits for financial reporting progress are based on the substantive plan (*the plan as understood by the employer and the plan members*). This includes the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point.

The projection of benefits for financial reporting purposes does not explicitly incorporate the potential effects of legal or contractual funding limitations on the pattern of cost sharing between the employer and plan members in the future.

## 14. EMPLOYEE RETIREMENT PLAN

*Plan Description.* The PERS-Defined Benefit Retirement Plan (DBRP) and Defined Contribution Retirement Plan (DCRP) are administered by the Montana Public Employee Retirement Administration (MPERA), and are a multiple-employer, cost-sharing plans established July 1, 1945, and governed by Title 19, chapters 2 & 3, Montana Code Annotated (MCA). These plans cover the State, local governments, certain employees of the Montana University System, and school districts.

All new members are initially members of the PERS-DBRP and have a 12-month window during which they may choose to remain in the PERS-DBRP or join the PERS-DCRP by filing an irrevocable election. Members may not be members of both the *defined contribution* and *defined benefit* retirement plans.

The PERS-DBRP provides retirement, disability, and death benefits to plan members and their beneficiaries. Benefits are established by state law and can only be amended by the Legislature. Benefits are based on eligibility, years of service, and highest average compensation. Member rights are vested after five years of service.

*Summary of Benefits.* **Member's highest average compensation (HAC)**

Hired prior to July 1, 2011 - highest average compensation during any consecutive 36 months;

Hired on or after July 1, 2011 – highest average compensation during any consecutive 60 months;

Hired on or after July 1, 2013 – 110% annual cap on compensation considered as part of a member's highest average compensation.

**Eligibility for benefit**

Service retirement:

Hired prior to July 1, 2011: Age 60, 5 years of membership service;  
Age 65, regardless of membership service; or  
Any age, 30 years of membership service.

Hired on or after July 1, 2011: Age 65, 5 years of membership service;  
Age 70, regardless of membership service.

Early retirement, actuarially reduced:

Hired prior to July 1, 2011: Age 50, 5 years of membership service; or  
Any age, 25 years of membership service.

Hired on or after July 1, 2011: Age 55, 5 years of membership service.

**Vesting;** 5 years of membership service

#### **Monthly benefit formula**

Members hired prior to July 1, 2011:

- Less than 25 years of membership service: 1.785% of HAC per year of service credit;
- 25 years of membership service or more: 2% of HAC per year of service credit.

Members hired on or after July 1, 2011:

- Less than 10 years of membership service: 1.5% of HAC per year of service credit;
- 10 years or more, but less than 30 years of membership service: 1.785% of HAC per year of service credit;
- 30 years or more of membership service: 2% of HAC per year of service credit.

#### **Guaranteed Annual Benefit Adjustment (GABA)**

- 3% for members hired **prior to** July 1, 2007
- 1.5% for members hired **on or after** July 1, 2007
- Members hired on or after July 1, 2013:
  - (a) 1.5% for each year PERS is funded at or above 90%;
  - (b) 1.5% is reduced by 0.1% for each 2% PERS is funded below 90%; and
  - (c) 0% whenever the amortization period for PERS is 40 years or more.

After the member has completed 12 full months of retirement, the member's benefit increases by the applicable percentage each January, **inclusive** of other adjustments to the member's benefit.

#### *Overview of Contributions.*

Rates are specified by state law for periodic employer and employee contributions and are a percentage of the member's compensation. Contributions are deducted from each member's salary and remitted by participating employers. The State legislature has the authority to establish and amend contribution rates to the plan.

Member contributions to the system: a. Plan members are required to contribute 7.90% of member's compensation. Contributions are deducted from each member's salary and remitted by participating employers.

The 7.90% member contributions is temporary and will be decreased to 6.9% on January 1 following actuary valuation results that show the amortization period has dropped below 25 years and would remain below 25 years following the reduction of both the additional employer and additional member contribution rates.

Employer contributions to the system: State and University System employers are required to contribute 8.27% of members' compensation. Following the 2013 Legislative Session, PERS-employer contributions were temporarily increased. Effective July 1, 2013, employer contributions increased 1.0%. Beginning July 1, 2014, employer contributions increased an additional 0.1% a year over 10 years, through 2024. The employer additional contributions including the 0.27% added in 2007 and 2009, terminates on January 1 following actuary valuation results that show the amortization period of the PERS-DBRP has dropped below 25 years and would remain below 25 years following the reductions of both the additional employer and member contributions rates. Effective July 1, 2013, employers are required to make contributions on working retirees' compensation. Member contributions for working retirees are not required.

*Stand-Alone Statements.* The PERS financial information is reported in the Public Employees' Retirement Board's *Comprehensive Annual Financial Report* for the fiscal year ended. It is available from the PERB at 100 North Park, PO Box 200131, Helena MT 59620-0131, 406-444-3154.

CAFR information including the stand alone financial statements can be found at the MPERA's website, <http://mpera.mt.gov/annualReports.shtml>. The latest actuarial valuation and experience study can be found at the MPERA's website, <http://mpera.mt.gov/actuarialValuations.asp>.

*Actuarial Assumptions.* The Total Pension Liability as of June 30, 2016, is based on the results of an actuarial valuation date of June 30, 2014 with update procedures to roll forward the Total Pension Liability to June 30, 2015. There were several significant assumptions and other inputs used to measure the Total Pension Liability. The actuarial assumptions used in the June 30, 2015 valuation were based on the results of the last actuarial experience study, dated May 2010 for the six year period July 1, 2003 to June 30, 2009. Among those assumptions were the following:

- General Wage Growth 4.00% (includes Inflation at 3.00%)
- Merit Increases 0% to 6%
- Investment Return 7.75%
- Postretirement Benefit Increases; 3% for members hired **prior to** July 1, 2007, 1.5% for members hired **on or after** July 1, 2007, and for members hired **on or after** July 1, 2013;
  - (a) 1.5% for each year PERS is funded at or above 90%;
  - (b) 1.5% is reduced by 0.1% for each 2% PERS is funded below 90%; and
  - (c) 0% whenever the amortization period for PERS is 40 years or more.

Mortality assumptions among contributing members, terminated vested members, service retired members and beneficiaries based on RP 2000 Combined Employee and Annuitant Mortality Tables projected to 2015 with scale AA. Mortality assumptions among Disabled Retirees are based on RP 2000 Combined Employee and Annuitant Mortality Tables with no projections. No future mortality improvement is assumed.

*Discount Rate.* The discount rate used to measure the Total Pension Liability was 7.75%. The projection of cash flows used to determine the discount rate assumed that contributions from participating plan members, employers, and non-employer contributing entities will be made based on the Board's funding policy, which establishes the contractually required rates under Montana Code Annotated. The State contributes 0.1% of salaries for local governments and 0.37% for school districts. In addition, the State contributes coal severance tax and interest money from the general fund. The interest is contributed monthly and the severance tax is contributed quarterly. Based on those assumptions, the System's fiduciary net position was projected to be adequate to make all the projected future benefit payments of current plan members through the year 2122. 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. No municipal bond rate was incorporated in the discount rate.

*Target Allocations.*

| <b>Asset Class</b> | <b>Target Asset Allocation</b> | <b>Long-Term Expected Real Rate of Return</b> |
|--------------------|--------------------------------|---|
| Cash Equivalents   | 2.00%                          | -0.25%  |
| Domestic Equity    | 36.00%                         | 4.55%   |
| Foreign Equity     | 18.00%                         | 6.10%   |
| Fixed Income       | 24.00%                         | 1.25%   |
| Private Equity     | 12.00%                         | 8.00%   |
| Real Estate        | 8.00%                          | 4.25%   |

The long-term expected return on pension plan assets is reviewed as part of the regular experience studies prepared for the System. The most recent analysis, performed for the period covering fiscal years 2003 through 2009, is outlined in a report dated May 2010, which is located on the MPERA website. Several factors are considered in evaluating the long-term rate of return assumption including rates of return adopted by similar public sector systems, and by 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 by the investment consultant for each major asset class. These ranges were 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 then adding expected inflation. The assumption is intended to be a long term assumption and is not expected to change absent a significant change in the asset allocation, a change in the inflation assumption, or a fundamental change in the market that alters expected returns in future years. Best estimates are presented as the arithmetic real rates of return for each major asset class included in the System’s target asset allocation as of June 30, 2015, is summarized in the above table.

*Sensitivity Analysis.*

|   | 1.0% Decrease<br>(6.75%) | Current Discount<br>Rate | 1.0% Increase<br>(8.75%) |
|---|--------------------------|--------------------------|--------------------------|
| <u>Employer Net<br/>Pension Liability</u> |                          |                          |                          |
| June 30, 2016                             | \$2,546,659              | \$1,651,762              | \$896,042                |
| June 30, 2015                             | \$2,179,582              | \$1,370,034              | \$687,259                |

In accordance with GASB 68 regarding the disclosure of the sensitivity of the Net Pension Liability to changes in the discount rate, the above table presents the Net Pension Liability calculated using the discount rate that is 1.00% lower (6.75%) or 1.00% higher (8.75%) than the current rate.

*Summary of Significant Accounting Policies.* The Montana Public Employee Retirement Administration (MPERA) prepares its financial statements using the accrual basis of accounting. For the purposes of measuring the Net Pension Liability, deferred inflows of resources and deferred outflows of resources related to pensions, Pension Expense, information about the fiduciary net position and additions to/deductions from fiduciary net position have been determined on the same accrual basis as they are reported by MPERA. For this purpose, member contributions are recognized in the period in which contributions are due. Employer contributions are recognized when due and the employer has made a formal commitment to provide the contributions. Revenues are recognized in the accounting period they are earned and become measurable. Benefit payments

and refunds are recognized in the accounting period when due and payable in accordance with the benefit terms. Expenses are recognized in the period incurred. Investments are reported at fair value. MPERA adheres to all applicable Governmental Accounting Standards Board (GASB) statements.

*Net Pension Liability.* In accordance with GASB Statement 68, Accounting and Financial Reporting for Pensions, employers are required to recognize and report certain amounts associated with their participation in the Public Employees' Retirement System (PERS). Statement 68 became effective for fiscal year ended June 30, 2015 and includes requirements to record and report their proportionate share of the collective Net Pension Liability, Pension Expense, Deferred Inflows and Deferred Outflows of resources associated with pensions.

In accordance with Statement 68, PERS has a special funding situation in which the State of Montana is legally responsible for making contributions directly to PERS on behalf of the employers. Due to the existence of this special funding situation, local governments and school districts are required to report the portion of the State of Montana's proportionate share of the collective Net Pension Liability that is associated with the non-State employer. The State of Montana also has a funding situation that is not Special Funding whereby the State General Fund provides contributions from the Coal Severance Tax and interest. All employers are required to report the portion of Coal Tax Severance Tax and interest attributable to the employer.

Lottery Proportionate Share of Net Pension Liability:

| Net Pension Liability as of 6/30/16 | Net Pension Liability as of 6/30/15 | Percent of Collective NPL as of 6/30/16 | Percent of Collective NPL as of 6/30/15 | Change in Percent of Collective NPL |
|-------------------------------------|-------------------------------------|---|---|-------------------------------------|
| \$2,546,659                         | \$1,651,762                         | 0.118163%                               | 0.109954%                               | 0.008209%                           |

At June 30, 2016, the Lottery recorded a liability of \$1,651,762 for its proportionate share of the Net Pension Liability. The Net Pension Liability was measured as of June 30, 2015, and the Total Pension Liability used to calculate the Net Pension Liability was determined by an actuarial valuation as of July 1, 2014, with roll forward provisions to the June 30, 2015 measurement date. For the fiscal years ended June 30, 2016, and 2015, the employer's proportion of the Net Pension Liability was based on the employer's contributions received by PERS during the measurement periods July 1, 2014 to June 30, 2015, and July 1, 2013 to June 30, 2014, respectively. Relative to the total employer contributions received from all of PERS' participating employers, at June 30, 2015, the Lottery's proportion was 0.118163%.

**Changes in actuarial assumptions and methods:** There were no changes in assumptions or other inputs that affected the measurement of the Total Pension Liability.

**Changes in benefit terms:** There have been no changes in benefit terms since the previous measurement date.

**Changes in proportionate share:** There were no changes between the measurement date of the collective Net Pension Liability and the employer's reporting date that are expected to have a significant effect on the employer's proportionate share of the collective NPL.

**Pension Expense.** The Lottery's proportionate share of the pension expense as of 6/30/15 was \$141,852 while the State of Montana's proportionate share associated with the Lottery was \$0.00, for a total pension expense of \$141,852.

At June 30, 2016, the Lottery recognized a Pension Expense of \$141,852 for its proportionate share of the PERS' Pension Expense. The Lottery also recognized grant revenue of \$40,722 for the support provided by the State of Montana, through the Coal Tax Severance Fund, for its proportionate share of the Pension Expense that is associated with the Lottery.

**Recognition of Deferred Inflows and Outflows.** At June 30, 2016, the Lottery reported its proportionate share of PERS' deferred outflows of resources and deferred inflows of resources related to PERS from the following sources:

|  | Deferred Outflows<br>of Resources | Deferred Inflows<br>of Resources |
|--|-----------------------------------|----------------------------------|
| Actual vs. Expected Experience   | \$ -                              | \$ 9,489                         |
| Changes in Assumptions   | \$ -                              | \$ -                             |
| Actual vs. Expected Investment Earnings  | \$ -                              | \$ 132,784                       |
| Changes in Proportion Share and<br>Differences between Employer<br>Contributions and Proportionate Share<br>of Contributions | \$ 95,212                         | \$ -                             |
| Employer contributions subsequent to<br>the measurement date - FY 2016<br>contributions                                      | \$ 123,235                        | \$ -                             |
| Total  | \$ 218,447                        | \$ 142,273                       |

Amounts reported as deferred outflows of resources related to pensions resulting from the Lottery's contributions subsequent to the measurement date will be recognized as a reduction of the Net Pension Liability in the year ended June 30, 2016. Other amounts reported as deferred outflows and inflows of resources related to pensions will be recognized in Pension Expense as follows:

| Year ended June 30, | Amount recognized in<br>Pension Expense as an<br>Increase or (decrease)<br>to Pension Expense |
|---------------------|---|
| 2017                | \$(31,934)  |
| 2018                | \$(31,934)  |
| 2019                | \$(32,210)  |
| 2020                | \$ 36,370   |
| 2021                | \$ 0  |
| Thereafter          | \$ 0  |

# Report on Internal Control and Compliance



# LEGISLATIVE AUDIT DIVISION

B-1

Angus Maciver, Legislative Auditor  
Deborah F. Butler, Legal Counsel



Deputy Legislative Auditors:  
Cindy Jorgenson  
Joe Murray

## REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

The Legislative Audit Committee  
of the Montana State Legislature:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the Montana State Lottery, as of and for the years ended June 30, 2016, and 2015, and the related notes to the financial statements, which collectively comprise the Lottery's basic financial statements, and have issued our report thereon dated February 14, 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 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 controls 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 and therefore, material weaknesses or significant deficiencies may exist that were not identified. 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. We did identify a deficiency in internal control, described below, that we consider to be a significant deficiency. Lottery internal controls did not detect an error in its application of state statute in preparing its accrual estimates of net income transfers for the year ended June 30, 2016.

*Compliance and Other Matters*

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination on 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*.

*Montana State Lottery's Response to Findings*

Montana State Lottery's response to the findings identified in our audit are described on page C-1 of this report. The Montana State Lottery's response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

*Purpose of this Report*

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

Respectfully submitted,

*/s/ Cindy Jorgenson*

Cindy Jorgenson, CPA  
Deputy Legislative Auditor  
Helena, MT

February 14, 2017

MONTANA STATE LOTTERY

LOTTERY RESPONSE





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LEGISLATIVE AUDIT DIV.

March 3, 2017

Mr. Angus Maciver, Legislative Auditor  
Legislative Audit Division  
Room 135, State Capitol  
Helena, MT 45620

Dear Mr. Maciver:

I would like to thank the Legislative Audit staff for their work performed on the Montana Lottery Financial Audit for the two fiscal years ending June 30, 2016. The services your staff provides in reviewing the Lottery's control systems and their impacts on our financial statement amounts are appreciated. We feel this audit was productive in improving the financial reporting for the agency. There was one recommendation made in the audit regarding the Lottery's estimation of net revenue transfers.

Below are the recommendation and our response:

Recommendation 1:

We recommend the Montana State Lottery seek legal review of changes in statutory requirements regarding transfers of its net revenue.

Response:

The Lottery concurs with this recommendation.

Sincerely,

A handwritten signature in cursive script that reads "Angella Wong".

Angela Wong  
Director  
Montana Lottery