KPMG

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Financial Statement Audit

For the Year Ended June 30, 2018

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

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

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STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

AGENCY OFFICIALS

Director (Acting) (07/14/18 – Present)	Mr. Harold Mays
Director (Acting) (10/24/16 – 07/13/18)	Mr. Greg Smith
Chief of Staff (04/02/18 – Present)	Mr. Scott Gillard
Chief of Staff (12/22/17 – 04/01/18)	Vacant
Chief of Staff (01/23/15 – 12/21/17)	Ms. Jayme Odom
Chief Financial Officer (09/25/17 – Present)	Ms. Carol Radwine
Chief Financial Officer (07/01/17 – 09/24/17)	Vacant
General Counsel (12/17/18 – Present)	Mr. Cornell Wilson
General Counsel (11/26/18 – 12/16/18)	Ms. Jessica White
General Counsel (11/20/18 – 11/25/18)	Vacant
General Counsel (4/17/17 – 11/19/18)	Ms. Annice Kelly
Chief Operations Officer (Acting) (08/01/18 – Present)	Mr. James Bartlett
Chief Operations Officer (01/06/13 – 07/31/18)	Mr. Harold Mays
Chief Internal Auditor	Mr. Darick Clark

LOTTERY CONTROL BOARD MEMBERS

Chair (07/28/18 – Present)	Vacant
Chair (02/26/18 – 07/27/18)	Ms. Haydee Olinger
Chair (02/01/18 – 02/25/18)	Vacant
Chair (08/30/16 – 01/31/18)	Mr. Jonathan "Blair" Garber
Member	Ms. Elba Aranda-Suh
Member (02/26/18 – Present)	Vacant
Member (06/20/16 – 02/25/18)	Ms. Haydee Olinger
Member	Mr. James Floyd
Member	Vacant

The Department's offices are located at:

122 S. Michigan Avenue, 19th Floor	101 W. Jefferson Street
Chicago, Illinois 60603	Springfield, Illinois 62702

FINANCIAL STATEMENT REPORT SUMMARY

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

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

SUMMARY OF FINDINGS

The auditors identified matters involving the Department's internal control over financial reporting that they considered to be material weaknesses and a significant deficiencies. The material weaknesses are described in the accompanying Schedule of Findings and Responses on pages 38-43 as Finding 2018-001, *Excess Transfers to the Common School Fund*, 2018-002, *Noncompliance with the Illinois Lottery Law,* and 2018-003, *Improper Classification of a Residual Value Compensation Expense*. The significant deficiencies are described in the accompanying Schedule of Findings and Responses on pages 44-48 as Finding 2018-004, *Inadequate Controls over Specialty Tickets* and 2018-005*, Financial Reporting Errors*.

EXIT CONFERENCE

On December 19, 2018, the Department waived the exit conference relating to the audit of the June 30, 2018 financial statements.

The responses to the recommendations were provided by Darick Clark, Chief Internal Auditor, in an email dated December 19, 2018.

KPMG LLP
Aon Center
Suite 5500
200 E. Randolph Street
Chicago, IL 60601-6436

Independent Auditors' Report

Honorable Frank J. Mautino
Auditor General
State of Illinois

Report on the Financial Statements

As Special Assistant Auditors for the Auditor General, we have audited the accompanying basic financial statements of the State of Illinois, Department of the Lottery as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise the State of Illinois, Department of the Lottery's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

KPMG LLP is a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the State of Illinois, Department of the Lottery as of June 30, 2018, and the respective changes in financial position and cash flows for the year then ended in accordance with U.S. generally accepted accounting principles.

Emphasis of Matters

As discussed in Note 2(b), the financial statements of the State of Illinois, Department of the Lottery are intended to present the financial position, the changes in financial position and, where applicable, cash flows of only that portion of the business-type activities of the State of Illinois that are attributable to the transactions of the State of Illinois, Department of the Lottery. They do not purport to, and do not, present fairly the financial position of the State of Illinois as of June 30, 2018, and the changes in its financial position or, where applicable, its cash flows for the year then ended in accordance with U.S. generally accepted accounting principles. Our opinion is not modified with respect to this matter.

The Department adopted GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, during the year ended June 30, 2018. Statement No. 75 established standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, expenses and expenditures. The adoption of this statement required the Department to restate net position by $(64,782) thousand at July 1, 2017.

Other Matters

Required Supplementary Information

Management has omitted management's discussion and analysis and related pension information that accounting principles generally accepted in the United States of America require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. Our opinion on the basic financial statements is not affected by this missing information.

Supplementary and Other Information

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

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

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated December 21, 2018 on our consideration of the State of Illinois, Department of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely 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 the effectiveness of the State of Illinois, Department of the Lottery's 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 State of Illinois, Department of the Lottery's internal control over financial reporting and compliance.

SIGNED ORIGINAL ON FILE

Chicago, Illinois
December 21, 2018

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY
Statement of Net Position (Deficit)
June 30, 2018
(in thousands of dollars)

Assets and Deferred Outflows of Resources		
Current assets:		
Cash and cash equivalents	$	32,564
Cash equity in State Treasury		67,863
Investments, short-term		22,692
Accounts receivable, net of allowance of $21,157		29,357
Other receivables		1
Due from other State funds		368
Total current assets		152,845
Noncurrent assets:		
Investments		244,703
Capital assets being depreciated, net		83
Total noncurrent assets		244,786
Deferred outflows of resources:		
Deferred outflows of resources - pension		17,933
Deferred outflows of resources - OPEB		1,272
Total deferred outflows of resources		19,205
Total assets and deferred outflows of resources		416,836
Liabilities and Deferred Inflows of Resources		
Current liabilities:		
Prizes payable		74,002
Accounts payable and accrued liabilities		42,376
Due to other Government – Federal		60
Due to other State funds		832
Unearned revenue		1,803
Other liabilities		1,042
Current portion of long-term annuity prizes payable		21,589
Current portion of leases payable		22
Total current liabilities		141,726
Noncurrent liabilities:		
Noncurrent portion of long-term annuity prizes payable		232,120
Noncurrent portion of leases payable		35
Due to other State funds		89,045
Net pension liability		83,979
Net OPEB liability		58,928
Noncurrent other		664
Total noncurrent liabilities		464,771
Deferred inflows of resources:		
Deferred inflows of resources - pension		5,187
Deferred inflows of resources - OPEB		9,040
Total deferred inflows of resources		14,227
Total liabilities and deferred inflows of resources		620,724
Net Position (Deficit)		
Invested in capital assets		26
Unrestricted		(203,914)
Total net position (deficit)	$	(203,888)

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

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Statement of Revenues, Expenses, and Changes in Net Position (Deficit)

Year Ended June 30, 2018

(in thousands of dollars)

Operating revenues:		
Charges for sales and services	$	2,926,375
Other		6,517
Total operating revenues		2,932,892
Operating expenses:		
Cost of sales and services		165,045
Prizes and claims		1,910,896
General and administrative		163,855
Private management contract residual value		34,375
Depreciation		17
Total operating expenses		2,274,188
Operating income		658,704
Nonoperating revenues (expenses):		
Investment income (expense)		(3,088)
Interest expense		(6,354)
Other		11
Total nonoperating revenues (expenses), net		(9,431)
Change in net position (deficit) before transfers		649,273
Transfers to other State funds		(722,525)
Change in net position (deficit)		(73,252)
Net position (deficit) at beginning of year, as restated (see Note 13)		(130,636)
Net position (deficit) at end of year	$	(203,888)

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

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Statement of Cash Flows

Year Ended June 30, 2018

(in thousands of dollars)

Cash flows from operating activities:		
Cash received from sales and services	$	2,923,272
Cash receipts from other operating activities		6,555
Cash payments for commissions and bonuses		(165,045)
Cash payments for general and administrative expenses		(136,159)
Cash payments for lottery prizes		(1,906,591)
Net cash provided by operating activities		722,032
Cash flows from noncapital financing activities:		
Cash transfers – out to other funds		(731,818)
Net cash used in noncapital financing activities		(731,818)
Cash flows from capital and related financing activities:		
Principal payments under capital lease obligation		(6)
Net cash used in capital and related financing activities		(6)
Cash flows from investing activities:		
Interest and dividends on investments		(297)
Purchase of investments		(6,820)
Proceeds from investment maturities		24,197
Cash paid for long-term annuity prizes payable		(24,494)
Net cash used in investing activities		(7,414)
Net decrease in cash and cash equivalents		(17,206)
Cash and cash equivalents at beginning of year		117,633
Cash and cash equivalents at end of year	$	100,427
Reconciliation of cash and cash equivalents to the statement of net position (deficit):		
Total cash and cash equivalents per the statement of net position (deficit)	$	32,564
Add cash equity in State Treasury		67,863
Cash and cash equivalents at end of year	$	100,427

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

(Continued)

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Statement of Cash Flows

Year Ended June 30, 2018

(in thousands of dollars)

Reconciliation of operating income to net cash provided by operating activities:		
Operating income	$	658,704
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation		17
Provision for uncollectible accounts		1,960
Changes in assets and liabilities:		
Decrease in accounts receivable		19,006
Increase in due from other funds		(367)
Decrease in deferred outflows of resources		3,787
Decrease in prizes payable		(2,515)
Increase in accounts payable and accrued liabilities		29,396
Decrease in intergovernmental payables		(1)
Increase in due to other State funds		80
Increase in unearned revenues		258
Decrease in other liabilities		(10)
Increase in long-term annuity prizes payable		6,820
Increase in deferred inflows of resources		10,939
Increase in net pension liability		1,279
Decrease in net OPEB liability		(7,321)
Net cash provided by operating activities	$	722,032

Noncash investing, capital and financing activities:		
Cost of capital asset acquisitions financed by capital leases	$	63
Increase in unrealized gains on investments		9,128
Interest accreted on investments		6,337
Interest accretion on long-term annuity prizes payable		(6,337)
Use of resources to pay long-term annuity prizes payable		5

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

(1) Organization

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

The Department is organized to provide for administering and overseeing the operations of the Illinois Lottery with the assistance of a private manager under a management agreement. The Department's mission is to maximize revenue to the State to benefit schools, capital projects and specialty causes in an ethical and responsible manner.

(2) Summary of Significant Accounting Policies

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

(a) Financial Reporting Entity

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

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

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

(b) Basis of Accounting and Presentation

The financial statements of the State of Illinois, Department of the Lottery, are intended to present the financial position, changes in financial position, and cash flows of only that portion of the activities of the State of Illinois that are attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of the State as of June 30, 2018, the changes in financial position and the cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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

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

(c) Cash and Cash Equivalents

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

(d) Investments

Investments are reported at fair value based on quoted market prices. The Department holds investments pursuant to statutory authority for locally held funds.

(e) Fair Value of Financial Instruments

The Department follows guidance for fair value measurements that defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability on the measurement date. The guidance establishes a hierarchy of inputs used to measure fair value that prioritizes the inputs into three categories that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available.

Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from independent sources. Unobservable inputs reflect assumptions that market participants would use in pricing the asset or liability based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the transparency of inputs as follows:

Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the measurement date.

Level 2 – Observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data. These inputs are either directly or indirectly observable as of the measurement date.

Level 3 – Unobservable inputs for the asset or liability as of the measurement date. These securities are measured using management's best estimate of fair value, where the inputs into the determination of fair value are not observable and require significant management judgment or estimation.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. The following describes the valuation methodologies used to measure the Department's financial instruments at fair value. There have been no changes in the methodologies used at June 30, 2018 when compared to June 30, 2017.

U.S. Treasury bonds—U.S. Treasury bonds are valued using prices quoted in active markets for those securities. These assets are classified as Level 1 assets.

Annuities—Annuities are valued at fair value and are comprised of insurance policies not traded on the open market. These assets are classified as Level 3 assets.

(f) Allowances and Provisions

The allowance for doubtful accounts at June 30, 2018 is based on an analysis of the historical collection experience for accounts receivable, which considers the age of the receivable and current economic conditions.

(g) Interfund Transactions

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

Services provided and used—Sales and purchases of goods and services between funds for a price approximating their external exchange value. Interfund services provided and used are reported as revenues in seller funds and expenditures or expenses in purchaser funds. Unpaid amounts are reported as interfund receivables and payables in the Statement of Net Position (Deficit).

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

(h) Capital Assets

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

(i) Compensated Absences

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

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

(j) Net Position (Deficit)

In the Statement of Net Position (Deficit), equity is displayed in three components as applicable:

Invested in Capital Assets – This consists of capital assets, net of accumulated depreciation, reduced by the outstanding balances of borrowings attributable to the acquisition of those assets.

Restricted – This consists of net position (deficit) that is legally restricted by outside parties or by law through constitutional provisions or enabling legislation. When both restricted and unrestricted resources are available for use, generally it is the State's policy to use restricted resources first, then unrestricted resources when they are needed. There is no restricted net position (deficit) as of June 30, 2018.

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

(k) Classification of Revenues and Expenses

The Department classifies its revenues and expenses as either operating or nonoperating in the Statement of Revenues, Expenses, and Changes in Net Position (Deficit) according to the following criteria:

Revenue

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

Expenses

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

(l) Lottery Revenue

Draw Games

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

Instant Games

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

(m) Prizes and Claims – Instant Ticket Expense

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

(n) Estimates

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

(o) Pension

For purposes of measuring the net pension liability, deferred outflows of resources, deferred inflows of resources, pension expense and expenditures associated with the Department's contribution requirements, information about the fiduciary net position of the State Employees Retirement System (SERS) and additions to/deductions from the SERS' fiduciary net position have been determined on the same basis as they are reported within the separately issued SERS financial statements. For this purpose, benefit payments (including refunds of employee contributions) are recognized when due and payable in accordance with terms of the plan. Investments are reported at fair value.

The net pension liability is calculated as the difference between the actuarially calculated value of the projected benefit payments attributed to past periods of service and the plans' fiduciary net position. The total pension expense is comprised of the service cost or actuarial present value of projected benefit payments attributed to the valuation year, interest on the total pension liability, plan administrative expenses, current year benefit changes, and other changes in plan fiduciary net position less employee contributions and projected earnings on plan investments. Additionally, the total pension expense includes the annual recognition of outflows and inflows of resources due to pension assets and liabilities.

(p) Post-Employment Benefits Other Than Pensions (OPEB)

The Department provides health, dental, vision and life insurance benefits for certain retirees and their dependents through the State Employees Group Insurance Program (SEGIP). The total OPEB liability, deferred outflows of resources, deferred inflows of resources, expense, and expenditures associated with the program have been determined through an actuarial valuation using certain actuarial assumptions as applicable to the current measurement period.

For purposes of measuring the net OPEB liability, deferred outflows of resources, deferred inflows of resources, expense and expenditures associated with the Department's contribution requirements, information about fiduciary net position of the SEGIP OPEB plan and additions to/deductions from the plan's fiduciary net position have been determined on the same basis as they are reported within the separately issued plan financial statements. For this purpose, benefit payments are recognized when due and payable in accordance with the terms of the plan. Investments are reported at fair value.

(q) New Accounting Pronouncements

Effective for the year ended June 30, 2018, the Department adopted GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, which establishes standards for measuring and recognizing liabilities, deferred outflows of resources, deferred inflows of resources, expenses, and expenditures and identifies the note disclosure requirements. The statement requires the Department to report a liability on the face of the financial statements for the other postemployment benefits (OPEB) it provides and identifies the methods and assumptions that are required to be used to project benefit payments, discount projected benefit payments to their actuarial present value and attribute that present value to periods of employee service. The implementation of this statement significantly impacted the Department's financial statements and footnote disclosures with the recognition of an OPEB liability, deferred outflows of resources, and deferred inflows of resources on the Statement of Net Position (Deficit) and general and administrative expenses on the Statement of Revenues, Expenses, and Changes in Net Position (Deficit). Information regarding the Department's OPEB plans is disclosed in Note 9. Additionally, the requirements of this statement resulted in the restatement of beginning net deficit, as detailed in Note 13.

Effective for the year ended June 30, 2018, the Department adopted GASB Statement No. 81, *Irrevocable Split-Interest Agreements*, which improves accounting and financial reporting for irrevocable split-interest agreements by providing recognition and measurement guidance for situations in which a government is a beneficiary of the agreement. The implementation of this statement had no impact on the Department's financial statements.

Effective for the year ended June 30, 2018, the Department adopted GASB Statement No. 85, *Omnibus 2017*, which addresses practice issues that have been identified during implementation and application of certain GASB statements. This statement addresses a variety of topics including issues related to blending component units, goodwill, fair value measurement and application and postemployment benefits (pensions and other postemployment benefits). The implementation of this statement had no impact on the Department's financial statements.

Effective for the year ended June 30, 2018, the Department adopted GASB Statement No. 86, *Certain Debt Extinguishment Issues,* which improves consistency in accounting and financial reporting for in-substance defeasance of debt by providing guidance for transactions in which cash and other monetary assets acquired with only existing resources – resources other than the proceeds of refunding debt – are placed in an irrevocable trust for the sole purpose of extinguishing debt. This statement also improves accounting and financial reporting for prepaid insurance on debt that is extinguished and notes to financial statements for debt that is defeased in substance. The implementation of this statement had no impact on the Department's financial statements.

(r) Future Adoption of GASB Statements

Effective for the year ending June 30, 2019, the Department will adopt GASB Statement No. 83, *Certain Asset Retirement Obligations*, which establishes criteria for determining the timing and pattern of recognition of a liability and a corresponding deferred outflow of resources for asset retirement obligations. The Department currently has no asset retirement obligations.

Effective for the year ending June 30, 2020, the Department will adopt GASB Statement No. 84, *Fiduciary Activities*, which improves guidance regarding the identification of fiduciary activities for accounting and financial reporting purposes and how those activities should be reported.

Effective for the year ending June 30, 2021, the Department will adopt GASB Statement No. 87, *Leases,* which was established to better meet the information needs of financial statement users by improving accounting and financial reporting for leases by governments.

Effective for the year ending June 30, 2019, the Department will adopt GASB Statement No. 88, *Certain Disclosures Related to Debt, Including Direct Borrowings and Direct Placements*, which improves the information that is disclosed in notes to government financial statements related to debt, including direct borrowings and direct placements. The Department currently has no debt.

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

(3) Deposits and Investments

The State Treasurer is the custodian of the Department's deposits and investments for funds maintained in the State Treasury. These amounts are classified as "Cash equity in State Treasury" on the Statement of Net Position (Deficit). The Department independently manages deposits and investments maintained outside the State Treasury.

(a) Deposits

Deposits in the custody of the State Treasurer of approximately $68 million as of June 30, 2018, are pooled and invested with other State funds in accordance with the Deposit of State Moneys Act of the Illinois Compiled Statutes (15 ILCS 520/11). Funds held by the State Treasurer have not been categorized as to credit risk because the Department does not own individual securities. Details on the nature of these deposits and investments are available within the State's CAFR.

Bank deposits for the enterprise funds held outside of the State Treasury of approximately $33 million as of June 30, 2018, are held in Federal Deposit Insurance Corporation (FDIC) insured depository institutions. The Department has an agreement under which one of these institutions insures balances in excess of FDIC insurance limits from loss by pledging securities as collateral. The collateral amount exceeded the deposited amount of $8 million at June 30, 2018. The Department has not incurred any losses on deposits exceeding the value of pledged securities and considers the risk minimal.

(b) Investments

As of June 30, 2018, the Department had the following investments outside of the State Treasury:

		Fair value (thousands)	Weighted average maturity (years)
Annuities	$	222	2.393
U.S. Treasury bonds		267,173	7.143
Total	$	267,395	

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

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

(4) Fair Value Measurements

The following table presents assets (amounts expressed in thousands) measured at fair value on a recurring basis at June 30, 2018:

		Level 1	Level 2	Level 3	Total
Annuities	$	—	—	222	222
U.S. Treasury bonds		267,173	—	—	267,173
Total assets at fair value	$	267,173	—	222	267,395

The change in assets measured at fair value using Level 3 inputs for the year ended June 30, 2018 is as follows:

		2018
Balance, beginning of the year	$	276
Change in value of annuities		(54)
Balance, end of the year	$	222

(5) Interfund Balance and Activity

(a) Balance Due from/to Other Funds

The following balance (amounts expressed in thousands) at June 30, 2018, represents amounts due from other State funds.

	Due from			
Fund	Other State funds		2018	Description/Purpose
Lottery	SERS	$	367	Refund for recertification of FY 2018 employer contribution rate and Problem Gambler services.
	Other State Funds		1	
		$	368	

The following balance (amounts expressed in thousands) at June 30, 2018, represents amounts due to other State funds.

	Due to			
Fund	Other State funds		2018	Description/Purpose
Lottery	Capital Projects	$	89,045	Due to other State funds for allocation of lottery proceeds and for administrative expenses.
	Other State funds		832	
		$	89,877	

The $89.045 million due to the Capital Projects Fund as of June 30, 2018, is not expected to be repaid within one year.

(Continued)

(b) Transfers to Other Funds

The Department reports transfers out in the Statement of Revenues, Expenses, and Changes in Net Position (Deficit), for the amounts required by statute to be transferred to the Common School Fund, Capital Projects Fund, and other State funds for lottery games designated for special purposes. The following balances (amounts expressed in thousands) for the year ended June 30, 2018 represent amounts transferred to other State funds:

Fund	Transfers out to Other State funds	2018	Description/Purpose
Lottery	Common School	$ 718,750	Transfers to Common School
	Other State funds	3,713	fund and other State funds
Deferred Prize Winners	Other State funds	62	pursuant to statutory requirements.
		$ 722,525	

(6) Capital Assets

Capital asset activity (amounts expressed in thousands) for the year ended June 30, 2018 was as follows:

	Balance June 30, 2017	Additions	Deletions	Net transfers	Balance June 30, 2018
Capital assets being depreciated:					
Equipment	$ 1,018	63	334	—	747
Less accumulated depreciation	(981)	(17)	(334)	—	(664)
Total capital assets, net	$ 37	46	—	—	83

(7) Long-Term Obligations

(a) Changes in Long-Term Obligations

Changes in long-term obligations (amounts expressed in thousands) for the year ended June 30, 2018 were as follows:

	Balance June 30, 2017	Additions	Deletions	Balance June 30, 2018	Amounts Due within one year
Leases payable	$ —	57	—	57	22
Compensated absences	834	1,169	1,217	786	122
Obligations to Lottery prize winners – group contracts	276	—	54	222	60
Obligations to Lottery prize winners – annuities	264,473	6,820	17,806	253,487	21,529
Net pension liability	82,700	1,279	—	83,979	—
Net OPEB liability	66,249	—	7,321	58,928	—
Total long-term obligations	$ 414,532	9,325	26,398	397,459	21,733

(b) Obligations to Lottery Prize Winners

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

For certain prize winners, annuities (group contracts) were purchased in the name of the Department for which the Department has retained the rights of ownership. The present value of these annuities and the related liability installments owed to prize winners were as follows at June 30, 2018:

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

Fiscal year	Current	Long-term	Total
2019	$ 62	—	62
2020	—	62	62
2021	—	62	62
2022	—	50	50
Total future prize payments	62	174	236
Less present value adjustments	(2)	(12)	(14)
Present value at June 30, 2018	$ 60	162	222

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

The fair value of the investments approximated $267 million at June 30, 2018. Interest rates range from 1.3% to 7.7% and prizes payable are scheduled annually through 2044 as follows (amounts expressed in thousands):

Fiscal year	Current	Long-term	Total
2019	$ 23,117	—	23,117
2020	—	22,890	22,890
2021	—	24,981	24,981
2022	—	22,340	22,340
2023	—	23,478	23,478
2024-2044	—	217,030	217,030
Total future prizes	23,117	310,719	333,836
Adjustments to present value	(1,588)	(78,761)	(80,349)
Present value of future prizes	21,529	231,958	253,487
Adjustments to fair value	1,103	12,583	13,686
Fair value of future prizes at June 30, 2018	$ 22,632	244,541	267,173

The amortized discount on the prizes payable reflects the interest rates earned by the investments held to fund the related liabilities. The amortization of discount is recorded as interest expense in the Statement of Revenues, Expenses, and Changes in Net Position (Deficit) and amounted to approximately $6 million for the year ended June 30, 2018.

(c) Leases Payable

The Department has entered into a lease agreement as lessee for financing the acquisition of office equipment. The lease agreement qualifies as a capital lease for accounting purposes, and therefore, has been recorded at the present value of the future minimum lease payments as of the inception date in the capital assets account. Information regarding operating leases is included in Note 12(a).

Assets under the capital lease amounted to $63 thousand, and the related accumulated depreciation amounted to $9 thousand as of June 30, 2018.

Future minimum lease payments for the capital lease recorded in the Department's Statement of Net Position (Deficit) as of June 30, 2018, are as follows (amounts expressed in thousands):

Year ending June 30,	Principal	Interest
2019	$ 22	$ 2
2020	21	1
2021	14	-
Total minimum lease payments	$ 57	$ 3

(8) Pension Plan

***Plan Description*.** Substantially all of the Department's full-time employees who are not eligible for participation in another state-sponsored retirement plan participate in the State Employees' Retirement System (SERS), which is a single-employer defined benefit pension trust fund in the State of Illinois reporting entity. SERS is governed by article 14 of the Illinois Pension Code (40 ILCS 5/1, et al.). The plan consists of two tiers of contribution requirements and benefit levels based on when an employee was hired. Members who first become an employee and participate under any of the State's retirement plans on or after January 1, 2011 are members of Tier 2, while Tier 1 consists of employees hired before January 1, 2011 or those who have service credit prior to January 1, 2011. The provisions below apply to both Tier 1 and 2 members, except where noted. The SERS issues a separate CAFR available at www.srs.illinois.gov or that may be obtained by writing to the SERS, 2101 South Veterans Parkway, PO Box 19255, Springfield, Illinois, 62794-9255.

***Benefit Provisions*.** SERS provides retirement benefits based on the member's final average compensation and the number of years of service credit that have been established. The retirement benefit formula available to general State employees that are covered under the Federal Social Security Act is 1.67% for each year of service and for noncovered employees it is 2.2% for each year of service. The maximum retirement annuity payable is 75% of final average compensation for regular employees and 80% for alternative formula employees. The minimum monthly retirement annuity payable is $15 for each year of covered service and $25 for each year of noncovered service.

Members in SERS under the Tier 1 and Tier 2 receive the following levels of benefits based on the respective age and years of service credits.

Regular Formula Tier 1	**Regular Formula Tier 2**
A member must have a minimum of eight years of service credit and may retire at: • Age 60, with 8 years of service credit. • Any age, when the member's age (years & whole months) plus years of service credit (years & whole months) equal 85 years (1,020 months) (Rule of 85) with eight years of credited service.	A member must have a minimum of 10 years of credited service and may retire at: • Age 67, with 10 years of credited service. • Between ages 62-67 with 10 years of credited service (reduced 1/2 of 1% for each month under age 67). The retirement benefit is based on final average compensation and credited service. For regular formula employees, final average

• Between ages 55-60 with 25-30 years of service credit (reduced 1/2 of 1% for each month under age 60). The retirement benefit is based on final average compensation and credited service. Final average compensation is the 48 highest consecutive months of service within the last 120 months of service. Under the Rule of 85, a member is eligible for the first 3% increase on January 1 following the first full year of retirement, even if the member is not age 60. If the member retires at age 60 or older, he/she will receive a 3% pension increase every year on January 1, following the first full year of retirement. If the member retires before age 60 with a reduced retirement benefit, he/she will receive a 3% pension increase every January 1 after the member turns age 60 and has been retired at least one full year. These pension increases are not limited by the 75% maximum.	compensation is the average of the 96 highest consecutive months of service within the last 120 months of service. The retirement benefit is calculated on a maximum salary of $106,800. This amount increases annually by 3% or one-half of the Consumer Price Index, whichever is less. If the member retires at age 67 or older, he/she will receive a pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, every year on January 1, following the first full year of retirement. The calendar year 2017 rate is $112,408. If the member retires before age 67 with a reduced retirement benefit, he/she will receive a pension increase of 3% or one-half of the Consumer Price Index for the preceding calendar year, whichever is less, every January 1 after the member turns age 67 and has been retired at least one full year. These pension increases are not limited by the 75% maximum.

Additionally, the Plan provides an alternative retirement formula for State employees in high-risk jobs, such as State policemen, fire fighters, and security employees. Employees qualifying for benefits under the alternative formula may retire at an earlier age depending on membership in Tier 1 or Tier 2. The retirement formula is 2.5% for each year of covered service and 3.0% for each year of non-covered service. The maximum retirement annuity payable is 80% of final average compensation as calculated under the alternative formula.

SERS also provides occupational and nonoccupational (including temporary) disability benefits. To be eligible for nonoccupational (including temporary) disability benefits, an employee must have at least 18 months of credited service with the System. The nonoccupational (including temporary) disability benefit is equal to 50% of the monthly rate of compensation of the employee on the date of removal from the payroll. Occupational disability benefits are provided when the member becomes disabled as a direct result of injuries or diseases arising out of and in the course of State employment. The monthly benefit is equal to 75% of the monthly rate of compensation on the date of removal from the payroll. This benefit amount is reduced by Workers' Compensation or payments under the Occupational Diseases Act.

Occupational and nonoccupational death benefits are also available through the System. Certain nonoccupational death benefits vest after 18 months of credited service. Occupational death benefits are provided from the date of employment.

Contributions. Contribution requirements of active employees and the State are established in accordance with Chapter 40, section 5/14-133 of the Illinois Compiled Statutes. Member contributions are based on fixed percentages of covered payroll ranging between 4.00% and 12.50%. Employee contributions are fully refundable, without interest, upon withdrawal from State employment. Tier 1 members contribute based on total annual compensation. Tier 2 members contribute based on an annual compensation rate not to exceed $106,800 with limitations for future years increased by the lessor of 3% or one-half of the annual percentage increase in the Consumer Price Index. For 2018, this amount was $113,645.

The State is required to make payment for the required departmental employer contributions, all allowances, annuities, any benefits granted under Chapter 40, Article 5/14 of the ILCS and all administrative expenses of the System to the extent specified in the ILCS. State law provides that the employer contribution rate be determined based upon the results of each annual actuarial valuation.

For fiscal year 2018, the required employer contributions were computed in accordance with the State's funding plan. This funding legislation provides for a systematic 50-year funding plan with an ultimate goal to achieve 90% funding of the plan's liabilities. In addition, the funding plan provided for a 15-year phase-in period to allow the State to adapt to the increased financial commitment. Since the 15-year phase-in period ended June 30, 2010, the State's contribution will remain at a level percentage of payroll for the next 35 years until the 90% funded level is achieved. For fiscal year 2018, the employer contribution rate was 47.342%. The Department's contribution amount for fiscal year 2018 was $4.782 million.

Pension liability, deferred outflows of resources, deferred inflows of resources and expense related to pensions. At June 30, 2018, the Department reported a liability of $83.979 million for its proportionate share of the State's net pension liability for SERS on the Department's Statement of Net Position (Deficit). The net pension liability was measured as of June 30, 2017 (current year measurement date), and the total pension liability used to calculate the net pension liability was determined by an actuarial valuation as of that date. The Department's portion of the net pension liability was based on the Department's proportion of employer contributions relative to all employer contributions made to SERS during the year ended June 30, 2017. As of the current year measurement date of June 30, 2017, the Department's proportion was 0.2552%, which was an increase of 0.013% from its proportion measured as of the prior year measurement date of June 30, 2016.

For the year ended June 30, 2018, the Department recognized pension expense of $11.552 million. At June 30, 2018, the Department reported deferred outflows and deferred inflows of resources related to the pension liability, as of the measurement date of June 30, 2017, from the following sources (amounts expressed in thousands):

	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	$ 50	$ 2,660
Changes of assumptions	8,662	1,751
Net difference between projected and actual investment earnings on pension plan investments	73	-
Changes in proportion	4,366	776
Department contributions subsequent to the measurement date	4,782	-
Total	$ 17,933	$ 5,187

The Department reported $4.782 million of deferred outflows of resources related to pensions resulting from Department contributions subsequent to the measurement date. These will be recognized as a reduction of the net pension liability in the year ending June 30, 2019. Other amounts reported as deferred outflows and deferred inflows of resources related to pensions will be recognized as pension expense (credit) as follows (amounts expressed in thousands):

Year ended June 30,		
2019	$	3,384
2020		2,956
2021		2,020
2022		(396)
Total	$	7,964

Actuarial Methods and Assumptions. The total pension liability was determined by an actuarial valuation as of June 30, 2017, using the following actuarial assumptions, applied to all periods included in the measurement:

Mortality: 105 percent of the RP 2014 Healthy Annuitant mortality table, sex distinct, with rates projected to 2015; generational mortality improvement factors were added.

Inflation: 2.75%

Investment Rate of Return: 7.00%, net of pension plan investment expense, including inflation.

Salary increases: Salary increase rates based on age related productivity and merit rates plus inflation.

Post-retirement benefit increases of 3.00%, compounded, for Tier 1 and the lessor of 3.00% or one-half of the annual increase in the Consumer Price Index for Tier 2

Retirement Age: Experience-based table of rates specific to the type of eligibility condition. Table was last updated for the June 30, 2014, valuation pursuant to an experience study of the period July 1, 2009 to June 30, 2013.

The long-term expected real rate of return on pension plan investments is determined using the best estimates of geometric real rates of return for each major asset class. These returns are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. For each major asset class that is included in SERS' target asset allocation, calculated as of the measurement date of June 30, 2017, the best estimates of geometric real rates of return are summarized in the following table:

Asset Class	Target Allocation	Long-Term Expected Real Rate of Return
U.S. Equity	23%	5.50%
Developed Foreign Equity	13%	5.30%
Emerging Market Equity	8%	7.80%
Private Equity	7%	7.60%
Intermediate Investment Grade Bonds	14%	1.50%
Long-term Government Bonds	4%	1.80%
TIPS	4%	1.50%
High Yield and Bank Loans	5%	3.80%
Opportunistic Debt	8%	5.00%
Emerging Market Debt	2%	3.70%
Core Real Estate	5.5%	3.70%
Non-core Real Estate	4.5%	5.90%
Infrastructure	2%	5.80%
Total	100%	

Discount Rate. A discount rate of 6.78% was used to measure the total pension liability as of the measurement date of June 30, 2017 as compared to a discount rate of 6.64% used to measure the total pension liability as of the prior year measurement date. The June 30, 2017 single blended discount rate was based on the expected rate of return on pension plan investments of 7.00% and a municipal bond rate of 3.56%, based on an index of 20 year general obligation bonds with an average AA credit rating as published by the Federal Reserve. The projection of cash flows used to determine this single discount rate assumed that plan member contributions will be made at the current contribution rate and that contributions will be made based on the statutorily required rates under Illinois law. Based on these assumptions, the pension plan's fiduciary net position and future contributions will be sufficient to finance the benefit payments through the year 2073. As a result, the long-term expected rate of return on pension plan investments was applied to projected benefit payments through the year 2073, and the municipal bond rate was applied to all benefit payments after that date.

Sensitivity of the Net Pension Liability to Changes in the Discount Rate. The Department's proportionate share of net pension liability for the plan was calculated using the stated discount rate, as well as what the net pension liability would be if it were calculated using a discount rate that is one-percentage point lower or one-percentage point higher than the current rate as shown below (amounts expressed in thousands):

	1% Decrease 5.78%	Discount Rate 6.78%	1% Increase 7.78%
Department's proportionate share of the net pension liability	$ 101,616	$ 83,979	$ 69,544

Payables to the pension plan. At June 30, 2018, the Department reported a payable of $247 thousand to SERS for the outstanding amount of contributions to the pension plan required for the year ended June 30, 2018.

Due from other state funds. At June 30, 2018, the Department reported a due from other state funds of $368 thousand from SERS for the overpayment of contributions to the pension plan for the rate change in January 2018 from 54.013 to 47.342 per Public Act 100-0023, that was retroactive to July 1, 2017. See Note 5(a).

(9) Post-Employment Benefits Other Than Pensions (OPEB)

***Plan description*.** The State Employees Group Insurance Act of 1971 (Act), as amended, authorizes the Illinois State Employees Group Insurance Program (SEGIP) to provide health, dental, vision, and life insurance benefits for certain retirees and their dependents. Substantially all of the Department's full-time employees are members of SEGIP. Members receiving monthly benefits from the General Assembly Retirement System (GARS), Judges Retirement System (JRS), State Employees' Retirement System of Illinois (SERS), Teachers' Retirement System (TRS), and State Universities Retirement System of Illinois (SURS) are eligible for these other post-employment benefits (OPEB). The eligibility provisions for each of the retirement systems are defined within the State's CAFR.

The Department of Central Management Services administers these benefits for annuitants with the assistance of the public retirement systems sponsored by the State (GARS, JRS, SERS, TRS and SURS). The State recognizes SEGIP OPEB benefits as a single-employer defined benefit plan. The plan does not issue a stand-alone financial report.

***Benefits provided*.** The health, dental, and vision benefits provided to and contribution amounts required from annuitants are the result of collective bargaining between the State and the various unions representing the State's and the university component units' employees in accordance with limitations established in the Act. Therefore, the benefits provided and contribution amounts are subject to periodic change. Coverage through SEGIP becomes secondary to Medicare after Medicare eligibility has been reached. Members must enroll in Medicare Parts A and B to receive the subsidized SEGIP premium available to Medicare eligible participants. The Act requires the State to provide life insurance benefits for annuitants equal to their annual salary as of the last day of employment until age 60, at which time, the benefit amount becomes $5,000.

***Funding policy and annual other postemployment benefit cost*.** OPEB offered through SEGIP are financed through a combination of retiree premiums, State contributions and Federal government subsidies from the Medicare Part D program. Contributions are deposited in the Health Insurance Reserve Fund, which covers both active State employees and retirement members. Annuitants may be required to contribute towards health and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed health care plan. Annuitants who retired prior to January 1, 1998, and who are vested in the State Employee's Retirement System do not contribute toward health and vision benefits. For annuitants who retired on or after January 1, 1998, the annuitant's contribution amount is reduced five percent for each year of credited service with the State allowing those annuitants with twenty or more years of credited service to not have to contribute towards health and vision benefits. All annuitants are required to pay for dental benefits regardless of retirement date. The Director of Central Management Services shall, on an annual basis, determine the amount the State shall contribute toward the basic program of group health benefits. State contributions are made primarily from the General Revenue Fund on a pay-as-you-go basis. No assets are accumulated or dedicated to funding the retiree health insurance benefit and a separate trust has not been established for the funding of OPEB.

For fiscal year 2018, the annual cost of the basic program of group health, dental, and vision benefits before the State's contribution was $10,926.24 ($6,145.92 if Medicare eligible) if the annuitant chose benefits provided by a health maintenance organization and $14,939.04 ($5,165.04 if Medicare eligible) if the annuitant chose other benefits. The State is not required to fund the plan other than the pay-as-you-go amount necessary to provide the current benefits to retirees.

***Total OPEB liability, deferred outflows of resources, deferred inflows of resources and expense related to OPEB*.** The total OPEB liability, as reported at June 30, 2018, was measured as of June 30, 2017, with an actuarial valuation as of June 30, 2016. At June 30, 2018, the Department recorded a liability of $58.928 million for its proportionate share of the State's total OPEB liability. The Department's portion of the OPEB liability was based on the Department's proportion of employer contributions relative to all employer contributions made to the plan during the year ended June 30, 2017. As of the current year measurement date of June 30, 2017, the Department's proportion was 0.1426%, which was a decrease of 0.0097% from its proportion measured as of the prior year measurement date of June 30, 2016.

The Department recognized OPEB expense for the year ended June 30, 2018, of $3.167 million. At June 30, 2018, the Department reported deferred outflows and deferred inflows of resources, as of the measurement date of June 30, 2017, from the following sources (amounts expressed in thousands):

	Deferred Outflows of Resources	Deferred Inflows of Resources
Differences between expected and actual experience	$ 19	$ -
Changes of assumptions	-	5,595
Changes in proportion and differences between employer contributions and proportionate share of contributions	-	3,445
Department contributions subsequent to the measurement date	1,253	-
Total	$ 1,272	$ 9,040

The $1.253 million reported as deferred outflows of resources related to OPEB resulting from Department contributions subsequent to the measurement date will be recognized as a reduction to the OPEB liability in the year ended June 30, 2019. Other amounts reported as deferred outflows and deferred inflows of resources related to OPEB will be recognized in OPEB expense (credit) as follows (amounts expressed in thousands):

(Continued)

Year ended June 30,		
2019	$	(2,028)
2020		(2,028)
2021		(2,028)
2022		(2,028)
2023		(909)
Total	$	(9,021)

***Actuarial methods and assumptions*.** The total OPEB liability was determined by an actuarial valuation using the following actuarial assumptions, applied to all periods included in the measurement unless otherwise specified. The actuarial valuation for the SEGIP was based on GARS, JRS, SERS, TRS, and SURS active, inactive, and retiree data as of June 30, 2016, for eligible SEGIP employees, and SEGIP retiree data as of June 30, 2016.

Valuation Date	June 30, 2016
Measurement Date	June 30, 2017
Actuarial Cost Method	Entry Age Normal
Inflation Rate	2.75%
Projected Salary Increases*	3.00% - 15.00%
Discount Rate	3.56%
Healthcare Cost Trend Rate:	
Medical (Pre-Medicare)	8.0 % grading down 0.5% in the first year to 7.5%, then grading down 0.01% in the second year to 7.49%, followed by grading down of 0.5% per year over 5 years to 4.99% in year 7
Medical (Post-Medicare)	9.0% grading down 0.5% per year over 9 years to 4.5%
Dental	7.5% grading down 0.5% per year over 6 years to 4.5%
Vision	3.00%
Retirees' share of benefit-related costs	Healthcare premium rates for members depend on the date of retirement and the years of service earned at retirement. Members who retired before January 1, 1998, are eligible for single coverage at no cost to the member. Members who retire after January 1, 1998, are eligible for single coverage provided they pay a portion of the premium equal to 5 percent for each year of service under 20 years. Eligible dependents receive coverage provided they pay 100 percent of the required dependent premium. Premiums for plan year 2017 and 2018 are based on actual premiums. Premiums after 2018 were projected based on the same healthcare cost trend rates applied to per capita claim costs but excluding the additional trend rate that estimates the impact of the Excise Tax.

* Dependent upon service and participation in the respective retirement systems. Includes inflation rate listed.

Additionally, the demographic assumptions used in the this OPEB valuation are identical to those used in the June 30, 2016 valuations for GARS, JRS, SERS, TRS, and SURS as follows:

	Retirement age experience study^	Mortality^^
GARS	July 2012 - June 2015	RP-2014 White Collar Total Healthy Annuitant mortality table, sex distinct, set forward 1 year for males and set back 1 year for females and generational mortality improvements using MP-2014 two-dimensional mortality improvement scales
JRS	July 2012 - June 2015	RP-2014 White Collar Total Healthy Annuitant mortality table, sex distinct, set forward 1 year for males and set back 1 year for females and generational mortality improvements using MP-2014 two-dimensional mortality improvement scales
SERS	July 2009 - June 2013	105 percent of the RP 2014 Healthy Annuitant mortality table, sex distinct, with rates projected to 2015; generational mortality improvement factors were added
TRS	July 2011 - June 2014	RP-2014 with future mortality improvements on a fully generational basis using projection table MP-2014
SURS	July 2010 - June 2014	RP-2014 White Collar, gender distinct, projected using MP-2014 two dimensional mortality improvement scale, set forward one year for male and female annuitants

^ The actuarial assumptions used in the respective actuarial valuations are based on the results of actuarial experience studies for the periods defined. A modified experience review was completed for SERS for the 3-year period ending June 30, 2015. Changes were made to the assumptions regarding investment rate of return, projected salary increases, inflation rate, and mortality based on this review. All other assumptions remained unchanged.

^^ Mortality rates are based on mortality tables published by the Society of Actuaries' Retirement Plans Experience Committee.

Discount rate. Retirees contribute a percentage of the premium rate based on service at retirement. The State contributes additional amounts to cover claims and expenses in excess of retiree contributions. Because plan benefits are financed on a pay-as-you-go basis, the single discount rate is based on a tax-exempt municipal bond rate index of 20-year general obligation bonds with an average AA credit rating as of the measurement date. A single discount rate of 2.85% at June 30, 2016, and 3.56% at June 30, 2017, was used to measure the total OPEB liability.

Sensitivity of total OPEB liability to changes in the single discount rate. The following presents the Department's total OPEB liability, calculated using a Single Discount Rate of 3.56%, as well as what the plan's total OPEB liability would be if it were calculated using a Single Discount rate that is one percentage point higher (4.56%) or lower (2.56%) than the current rate (amounts expressed in thousands):

	1% Decrease (2.56%)	Current Single Discount Rate Assumption (3.56%)	1% Increase (4.56%)
Department's proportionate share of total OPEB liability	$ 66,853	$ 58,928	$ 51,047

Sensitivity of the total OPEB liability to changes in the healthcare cost trend rate. The following presents the Department's total OPEB liability, calculated using the healthcare cost trend rates as well as what the plan's total OPEB liability would be if it were calculated using a healthcare cost trend rate that is one percentage point higher or lower, than the current healthcare cost trend rates (amounts in table expressed in thousands). The key trend rates are 8.0% in 2018 decreasing to an ultimate trend rate of 4.99% in 2025, for non-Medicare coverage, and 9.0% decreasing to an ultimate trend rate of 4.5% in 2027 for Medicare coverage.

	1% Decrease (a)	Current Healthcare Cost Trend Rates Assumption	1% Increase (b)
Department's proportionate share of total OPEB liability	$ 50,353	$ 58,928	$ 66,007

(a) One percentage point decrease in healthcare trend rates are 7.00% in 2018 decreasing to an ultimate trend rate of 3.99% in 2025, for non-Medicare coverage, and 8.00% in 2018 decreasing to an ultimate trend rate of 3.50% in 2027 for Medicare coverage.
(b) One percentage point increase in healthcare trend rates are 9.00% in 2018 decreasing to an ultimate trend rate of 5.99% in 2025, for non-Medicare coverage, and 10.00% in 2018 decreasing to an ultimate trend rate of 5.50% in 2027 for Medicare coverage.

(10) Risk Management

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

The Department's risk management activities are financed through appropriations to the Illinois Department of Central Management Services and are accounted for in the general fund of the State. The claims are not considered to be a liability of the Department; and accordingly, have not been reported in the Department's financial statements for the year ended June 30, 2018.

(11) Private Management Agreement

(a) Northstar Lottery Group, LLC

The State (acting through the Department) and in compliance with the Illinois Lottery Law 20 ILCS 1605/ entered into a 10-year private management agreement (PMA) with Northstar Lottery Group, LLC (Private Manager) effective January 18, 2011, for the purpose of providing all equipment, services, and functions necessary to operate the Lottery for the State, except for those specifically retained by the State as defined within the PMA. Under the terms of the PMA, the compensation to be paid is comprised of the reimbursement of operating expenses and incentive compensation payments. Incentive compensation is subject to annual adjustments in accordance with the PMA. For the year ended June 30, 2018, total compensation for reimbursement of operating expenses to Northstar under the PMA was $63.8 million and is included in general and administrative expenses. Of this amount, $6.8 million was outstanding at June 30, 2018, and is included in accounts payable and accrued liabilities.

On September 18, 2015, the State (acting through the Department) executed a Letter Agreement of Termination (Letter Agreement), which resolved certain outstanding disputes between Northstar and the Department. The Letter Agreement contains provisions regarding Northstar paying the Department for not meeting net income goals pursuant to the PMA, a retroactive supply agreement reduction, and Northstar's reimbursement of legal fees related to prior disputes. Under the terms of the Third Amendment to the Letter Agreement, Northstar continued in its role as private manager until January 1, 2018.

Additionally, the State (acting through the Department) executed an Amendment to the Northstar Letter Agreement of Termination, extending the supply agreements with IGT and Scientific Games through April 1, 2019, or earlier in accordance with the terms of such Supply Agreements. These agreements were assumed by Camelot Illinois, LLC. Under the Letter Agreement, if the new private manager did not continue services with IGT, the State is required to pay the technology vendor a residual value, which is to be prorated through the end of this amended agreement. The Department recorded a payable and expense at June 30, 2018, in the amount of $34.375 million for this residual value. In early 2019, the State will transition to a new technology vendor under the agreement with Camelot Illinois, LLC.

(b) Camelot Illinois, LLC

On October 13, 2017, the State (acting through the Department) and in compliance with the Illinois Lottery Law 20 ILCS 1605/ entered into a 10-year private management agreement (Camelot PMA) with Camelot Illinois, LLC (Camelot), for the purpose of providing specified lottery management services to the State. The effective date of the contract is October 13, 2017, and the term includes a period for transitioning from Northstar Lottery Group, LLC to Camelot. The contract with Northstar ended on January 1, 2018, and Camelot commenced its management contract obligations on January 2, 2018.

Under the terms of the agreement, the compensation to be paid under the Camelot PMA is comprised of the reimbursement of operating expenses and incentive compensation payments. Incentive compensation is subject to annual adjustments and is only earned if net income meets statutorily required transfers in accordance with the agreement. For the year ended June 30, 2018, total compensation for reimbursement of operating expenses to Camelot under the Camelot PMA was $70.9 million, including one-time expenses relating directly to transition, and is included in general and administrative expenses. Of this amount, $233 thousand was outstanding at June 30, 2018, and is included in accounts payable and accrued liabilities.

The Department has recorded a receivable from Camelot at June 30, 2018, in the amount of $4.5 million. This amount is comprised solely of excess advance for expense reimbursements from fiscal year 2018.

(12) Commitments and Contingencies

(a) Lease Commitments

The Department leases certain facilities and equipment necessary for operations, primarily from other State agencies. The majority of the Department's leases are month-to-month operating leases. Total operating lease costs for the year ended June 30, 2018 amounted to $246 thousand. Information regarding the Department's capital lease is included in Note 7(c).

(b) Litigation

As discussed in Note 11(a), the Letter Agreement resolved outstanding disputes in connection with Northstar and its suppliers. The Department is routinely involved in a number of legal proceedings and claims that cover a wide range of matters.

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

(13) Restatement

In accordance with the Department's adoption of GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, the net OPEB liability, deferred outflows of resources, deferred inflows of resources and OPEB expense have been recognized in the financial statements. See Note 9. As part of the adoption, the financial statements have been restated as of July 1, 2017, as follows (amounts expressed in thousands):

Net Deficit, June 30, 2017, as previously reported	$	(65,854)
Restatement – deferred outflow of resources – OPEB		1,467
Restatement – net OPEB liability		(66,249)
Net Deficit, July 1, 2017, as restated	$	(130,636)

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Combining Schedule of Net Position (Deficit)

June 30, 2018

(in thousands of dollars)

Assets and Deferred Outflows of Resources		State Lottery (0711)	Deferred Prize Winners (0978)	Lottery Security Deposits (1309)	Eliminations	Total
Current assets:						
Cash and cash equivalents	$	31,716	—	848	—	32,564
Cash equity in State Treasury		65,972	1,891	—	—	67,863
Investments, short-term		60	22,632	—	—	22,692
Accounts receivable, net of allowance of $21,157		29,357	—	—	—	29,357
Other receivables		1	—	—	—	1
Due from other Department funds		1,830	—	—	(1,830)	—
Due from other State funds		368	—	—	—	368
Total current assets		129,304	24,523	848	(1,830)	152,845
Noncurrent assets:						
Investments		162	244,541	—	—	244,703
Capital assets being depreciated, net		83	—	—	—	83
Total noncurrent assets		245	244,541	—	—	244,786
Deferred outflows of resources:						
Deferred outflows of resources - pension		17,933	—	—	—	17,933
Deferred outflows of resources - OPEB		1,272	—	—	—	1,272
Total deferred outflows of resources		19,205	—	—	—	19,205
Total assets and deferred outflows of resources		148,754	269,064	848	(1,830)	416,836
Liabilities and Deferred Inflows of Resources						
Current liabilities:						
Prizes payable		74,002	—	—	—	74,002
Accounts payable and accrued liabilities		42,376	—	—	—	42,376
Due to other Government – Federal		60	—	—	—	60
Due to other Department funds		—	1,830	—	(1,830)	—
Due to other State funds		832				832
Unearned revenue		1,803	—	—	—	1,803
Other liabilities		122	72	848	—	1,042
Current portion of long-term annuity prizes payable		60	21,529	—	—	21,589
Current portion of leases payable		22	—	—	—	22
Total current liabilities		119,277	23,431	848	(1,830)	141,726
Noncurrent liabilities:						
Noncurrent portion of long-term annuity prizes payable		162	231,958	—	—	232,120
Noncurrent portion of leases payable		35	—	—	—	35
Due to other State funds		89,045	—	—	—	89,045
Net pension liability		83,979	—	—	—	83,979
Net OPEB liability		58,928	—	—	—	58,928
Noncurrent other		664	—	—	—	664
Total noncurrent liabilities		232,813	231,958	—	—	464,771
Deferred inflows of resources:						
Deferred inflows of resources - pension		5,187	—	—	—	5,187
Deferred inflows of resources - OPEB		9,040	—	—	—	9,040
Total deferred inflows of resources		14,227	—	—	—	14,227
Total liabilities and deferred inflows of resources		366,317	255,389	848	(1,830)	620,724
Net Position (Deficit)						
Invested in capital assets		26	—	—	—	26
Unrestricted		(217,589)	13,675	—	—	(203,914)
Total net position (deficit)	$	(217,563)	13,675	—	—	(203,888)

See accompanying independent auditors' report.

STATE OF ILLINOIS
DEPARTMENT OF THE LOTTERY

Combining Schedule of Revenues, Expenses, and Changes in Net Position (Deficit)

Year Ended June 30, 2018

(in thousands of dollars)

	State Lottery (0711)	Deferred Prize Winners (0978)	Eliminations	Total
Operating revenues:				
Charges for sales and services	$ 2,926,375	—	—	2,926,375
Other	6,517	—	—	6,517
Total operating revenues	2,932,892	—	—	2,932,892
Operating expenses:				
Cost of sales and services	165,045	—	—	165,045
Prizes and claims	1,910,896	—	—	1,910,896
General and administrative	163,855	—	—	163,855
Private management contract residual value	34,375	—	—	34,375
Depreciation	17	—	—	17
Total operating expenses	2,274,188	—	—	2,274,188
Operating income	658,704	—	—	658,704
Nonoperating revenues (expenses):				
Investment income (expense)	(297)	(2,791)	—	(3,088)
Interest expense	(17)	(6,337)	—	(6,354)
Other	(18)	29	—	11
Total nonoperating revenues (expenses), net	(332)	(9,099)	—	(9,431)
Change in net position (deficit) before transfers	658,372	(9,099)	—	649,273
Transfers from other State funds	(33)	—	33	—
Transfers to other State funds	(722,463)	(29)	(33)	(722,525)
Change in net position (deficit)	(64,124)	(9,128)	—	(73,252)
Net position (deficit), July 1, 2017 (as restated)	(153,439)	22,803	—	(130,636)
Net position (deficit), June 30, 2018	$ (217,563)	13,675	—	(203,888)

See accompanying independent auditors' report.

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Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

Honorable Frank J. Mautino
Auditor General
State of Illinois

As Special Assistant Auditors for the Auditor General, we have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the financial statements of the State of Illinois, Department of the Lottery, which comprise the statement of net position (deficit) as of June 30, 2018, and the related statements of revenues, expenses, and changes in net position (deficit) and cash flows for the year then ended, and the related notes to the financial statements, which collectively comprise the State of Illinois, Department of the Lottery's basic financial statements, and have issued our report thereon dated December 21, 2018. That report contained the following emphasis of matters:

As discussed in Note 2(b), the financial statements of the State of Illinois, Department of the Lottery are intended to present the financial position, the changes in financial position and, where applicable, cash flows of only that portion of the business-type activities of the State of Illinois that are attributable to the transactions of the State of Illinois, Department of the Lottery. They do not purport to, and do not, present fairly the financial position of the State of Illinois as of June 30, 2018, and the changes in its financial position or, where applicable, its cash flows for the year then ended in accordance with U.S. generally accepted accounting principles. Our opinion is not modified with respect to this matter.

The Department adopted GASB Statement No. 75, *Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions*, during the year ended June 30, 2018. Statement No. 75 established standards for recognizing and measuring liabilities, deferred outflows of resources, deferred inflows of resources, expenses and expenditures. The adoption of this statement required the Department to restate net position by $(64,782) thousand at July 1, 2017.

Internal Control Over Financial Reporting

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

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been

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identified. However, as described in the accompanying Schedule of Findings and Responses, we identified certain deficiencies in internal control that we consider to be material weaknesses and significant deficiencies.

A *deficiency in internal* control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying Schedule of Findings and Responses as Findings 2018-001 through 2018-003 to be material weaknesses.

A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiencies described in the accompanying Schedule of Findings and Responses as Findings 2018-004 and 2018-005 to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the State of Illinois, Department of 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 of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that is required to be reported under *Government Auditing Standards*, and which is described in the accompanying Schedule of Findings and Responses as Findings 2018-001, 2018-002, and 2018-004.

State of Illinois, Department of the Lottery's Responses to Findings

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

Purpose of this Report

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

SIGNED ORIGINAL ON FILE

Chicago, Illinois
December 21, 2018

Finding 2018-001 Excess Transfers to the Common School Fund

The Department of the Lottery (Department) transferred $73.054 million more in cash from the State Lottery Fund (Fund 711) than was available under the priority order for distributing proceeds under the Illinois Lottery Law (Law).

The Law (20 ILCS 1605/9.1(o)) requires the Department distribute the proceeds of lottery tickets and shares sold in the following priority order and manner:

1) to pay prizes and retailer bonuses;
2) to pay costs related to administering the Lottery (including all amounts due under the Management Agreement to the Private Manager);
3) to distribute the net revenue from specialty tickets into specific State funds, as provided by § 21.5, § 21.6, § 21.7, § 21.8, § 21.9, and § 21.10 of the Law;
4) to transfer into the Common School Fund (Fund 412) an amount equal to the proceeds transferred into Fund 412 from Fund 711 in Fiscal Year 2009, adjusted for inflation, on the last day of each month or as soon thereafter as possible; and,
5) to annually deposit, on or before September 30, any estimated remaining proceeds from the prior fiscal year into the Capital Projects Fund (Fund 694), with an adjustment in the subsequent annual transfer for any difference between the estimated amount and actual audited amount reported in the Department's annual financial report.

During testing, we noted the Department's draft financial statement provided to us in October 2018 reflected $649.273 million was available after satisfying its obligations to (1) prizewinners and retailers for bonuses and (2) administering the Lottery. From this amount, $3.577 million was transferred as net revenue from specialty tickets, which left $645.696 million for transfer into Fund 412. Instead of transferring the $645.696 million into Fund 412 related to Fiscal Year 2018 proceeds, we noted the Department actually transferred $718.750 million in cash into Fund 412. As such, Fund 412 was transferred $73.054 million more in cash from Fund 711 during Fiscal Year 2018 than was available under the priority order for distributing proceeds within the Law.

Department officials indicated the Law's current language lacks clarity and specificity on how to address the conflict between the Department's monthly obligation to transfer the statutorily pre-determined amount to Fund 412 with the transfer of actual final sales proceeds that are both not fully realized nor audited until, at least, three months after the end of the fiscal year. Therefore, the Department's current process is to make the monthly transfers based on the availability of cumulative cash proceeds from the ticket sales, as the Law does not have a provision for adjusting the deposits and transfers made during the fiscal year after the actual final sales proceeds in a given fiscal year have been realized and audited in accordance with the priority order established by the Law.

Due to the significance of the issue noted, we concluded this condition represents noncompliance with the priority order for the distribution and use of proceeds established by law, which could have a direct and material effect on the determination of financial statement amounts. Further, this condition represents material noncompliance with the priority order for the distribution and use of proceeds established by applicable laws and regulations in the Department's financial and fiscal operations and a material weakness in the Department's internal control over compliance for not preventing, or detecting and correcting, these conditions.

Failure to make transfers into Fund 412 in conformity with the priority order for the distribution and use of proceeds established by the Law created a cash deficit within Fund 711. (Finding Code No. 2018-001)

(Continued)

Recommendation:

We recommend the Department implement controls to provide assurance it has the resources available on an accrual basis to properly allocate proceeds in accordance with the Law, or seek a legislative remedy. Further, the Department should take action to correct the overpayment of $73.054 million.

Department Response:

The Department agrees with the finding and recommendation. The Law as written does not address when or how sales proceed amounts are determined to comply with the distribution requirements as described in 20 ILCS 1605/9.1(o). It does not make the distinction that proceeds are expected to be defined as final audited proceeds for the entire year. The Department is required to make prescribed monthly contributions to Fund 412 without having final audited proceed amounts to calculate the monthly transfer amounts. The final audited proceed amounts are not determined until three months after the fiscal year ends.

As a consequence of this ambiguity in the Law, the Department is exposed to the potential risk of overpayment in years when final audited proceeds are not enough to cover the prescribed amount for Fund 412. This risk also exists conversely in years where a discrepancy between the prescribed amount and available final audited proceeds indicates an underpayment is necessary. The Law also doesn't allow for this occurrence and doesn't define how overpayments or underpayments can be reconciled.

The Department understands the need for expediency in making monthly transfers to Fund 412. However, this expediency can only be supported with estimated transfer amounts since it is impossible to know with certainty what sales and year-end final audited proceeds will be in advance. The Department is researching possible solutions to resolve this issue. We will seek an opinion from the Attorney General on interpreting the Law and will propose an amendment that allows the Department to address this concern.

(Continued)

Finding 2018-002 Noncompliance with the Illinois Lottery Law

The Department of the Lottery (Department) has not performed all of the transfers to the Capital Projects Fund (Fund 694) required by the Illinois Lottery Law (Law). All of the unperformed transfers relate to periods prior to Fiscal Year 2018.

During our testing of transfers to other funds, we noted the State Lottery Fund (Fund 711) owed $89.045 million to Fund 694 at June 30, 2018. This balance has accumulated since 2009 because the actual amount of cash transferred by the Department into Fund 694 has been less than required by the Law.

The Law (20 ILCS 1605/9.1(o)) requires the Department distribute the proceeds of lottery tickets and shares sold in the following priority order and manner:

1) to pay prizes and retailer bonuses;
2) to pay costs related to administering the Lottery (including all amounts due under the Management Agreement to the Private Manager);
3) to distribute the net revenue from specialty tickets into specific State funds, as provided by § 21.5, § 21.6, § 21.7, § 21.8, § 21.9, and § 21.10 of the Law;
4) to transfer into the Common School Fund (Fund 412) an amount equal to the proceeds transferred into Fund 412 from Fund 711 in Fiscal Year 2009, adjusted for inflation, on the last day of each month or as soon thereafter as possible; and,
5) to annually deposit, on or before September 30, any estimated remaining proceeds from the prior fiscal year into Fund 694, with an adjustment in the subsequent annual transfer for any difference between the estimated amount and actual audited amount reported in the Department's annual financial report.

During our discussions with Department officials concerning this balance, they indicated this balance has accumulated due to the following reasons:

1) Fund 711 annually transferred more cash into Fund 412 than required on an accrual basis during fiscal years prior to June 30, 2009. In order to account for this excess transfer, the Department's predecessor agency booked a due from Fund 412 (accounts receivable) for the amount of excess cash transferred in Fund 711 of $69.842 million at June 30, 2009. During the Department's Fiscal Year 2012 financial audit, it was determined this due from did not meet criteria established by the Governmental Accounting Standards Board to be reported and Department management posted an adjustment to reclassify the $69.842 million as a transfer out to Fund 412. This created a cash deficit of $69.842 million within Fund 711, as Fund 412 now had the cash that otherwise should have been deposited into Fund 694 in accordance with the Law.

2) Prior to Public Act 100-0023, the Department was required to annually transfer cash from Fund 711 into Fund 694 on June 30. Due to difficulties determining the exact amount to transfer and timing issues arising from the conversion of accounts receivable into cash, the Department was not able to timely transfer the remaining $19.203 million from Fund 711 into Fund 694.

Due to the significance of the issue noted, we concluded these conditions represent noncompliance with the law, which could have a direct and material effect on the determination of financial statement amounts. Further, these conditions represent material noncompliance with applicable laws and regulations in the Department's financial and fiscal operations and a material weakness in the Department's internal control over compliance for not preventing, or detecting and correcting, these conditions.

(Continued)

Failure to make transfers into Fund 694 in conformity with the Law delays Fund 694's receipt of cash and represents noncompliance with State law. (Finding Code No. 2018-002, 2017-001)

Recommendation:

We recommend the Department work with the General Assembly to address the permanent cash deficit of $69.842 million within Fund 711 arising from the excess transfers before June 30, 2009. Further, the Department should transfer the other $19.203 million due to Fund 694 from Fund 711.

Department Response:

The Department accepts the recommendation. As noted in the finding, excess transfers to the Common School Fund in the amount of $69.842 million did occur prior to 2009 and have never been recouped. The write-off of this amount, previously categorized as a due from Fund 412, resulted in a cash shortage which affects our prior and future transfers.

The balance owed to the Capital Projects Fund is a result of transfer activity prior to Fiscal Year 2017. In Fiscal Year 2018, the Department implemented all of the recommendation points made by the auditors from the previous audit. The Department worked with the General Assembly to get legislation passed to address the timing of the transfer, properly reported the current and non-current portion of the amount due and transferred the current portion due of $9.337 million.

The Department will remain committed to correct the remaining balance owed to the Capital Projects Fund by working with the General Assembly to address the excess transfers to the Common School Fund.

(Continued)

Finding 2018-003 Improper Classification of a Residual Value Compensation Expense

The Department of the Lottery (Department) improperly classified an expense within its financial statements.

During our audit of the financial statements as of June 30, 2018, we noted the Department classified its residual value compensation expense to a subcontractor of the prior private manager as part of the termination process of its prior Private Manager Agreement, totaling $34.375 million, as a special item as opposed to an ordinary operating expense. Department management corrected this classification error in the Department's final financial statements.

Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, (Paragraph 56) states that special items are unusual or infrequent significant transactions within the control of management. Further, Governmental Accounting Standards Board Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* , (Paragraph 46) defines unusual nature as "the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the government, taking into account the environment in which the government operates" and infrequency of occurrence as "the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the government operates."

Additionally, Governmental Accounting Standards Board Statement No. 62 (Paragraph 45) states a transaction is considered an ordinary and usual activity of a government, unless evidence clearly supports classification as a special item.

In addition to the foregoing, the Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the Department ensure revenues, expenses, and funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over the State's resources.

Department officials indicated the classification of this item within the financial statements was made only after careful consideration and was based upon the infrequency of the occurrence of termination agreements at the Department. First, it was originally expected the prior private manager would fulfill its entire contractual term for operating the Lottery. Second, under the disentanglement terms entered into by the Department with the Department's prior private manager in 2015, a residual value compensation payment would only have been required if the new private manager did not retain the subcontractor who provided services that only two known vendors worldwide could provide to the Lottery. Third, the new Private Manager Agreement entered into between the Department and the new private manager addresses this disentanglement scenario by giving the State the right to assign any subcontract to a successor private manager or the State itself.

We evaluated the Department's position and considered whether this transaction has a high degree of abnormality within the State. As contract renegotiations and terminations are common occurrences within the governmental environment, we concluded termination payments are neither unusual in nature nor infrequent in occurrence.

Subsequently, the Auditor General's Office obtained guidance on the proper classification of this transaction from a staff member of the Governmental Accounting Standards Board, who advised we would need to consider the State's environment as a whole for the classification of a special item, since the Department is (1) not legally separate from the State and (2) a part of the State's primary government. In this context, the question becomes whether, when looking at the State as a whole, contractual terminations are either unusual

(Continued)

in nature or infrequent in occurrence by entities within the primary government of the State. When viewed in this context, contracts are renegotiated and terminated on a routine basis. Therefore, the termination payment does not meet the criteria to be presented as a special item.

Due to the significance of the issue noted, we concluded this condition represents material noncompliance with applicable laws and regulations in the Department's financial and fiscal operations and a material weakness in the Department's internal control over compliance for not preventing, or detecting and correcting, these conditions.

Failure to properly report the Department's residual value compensation payment transaction could have, if not detected and corrected, resulted in a material misstatement of the Department's financial statements, reducing the overall reliability of financial reporting. (Finding Code No. 2018-003)

Recommendation:

We recommend the Department, when applying the Governmental Accounting Standards Board's special item guidance, consider whether the transaction is either unusual in nature or infrequent in occurrence by entities within the primary government of the State.

Department Response:

The Department agrees with the finding. During preparation of the Fiscal Year 2018 financial statements, the Department reviewed the Governmental Accounting Standards Board's special item guidance and applied the guidance at the Department level as opposed to the Statewide level. The Department will consider itself as an entity within the primary government of the State as it relates to future guidance from the Governmental Accounting Standards Board.

(Continued)

Finding 2018-004 Inadequate Controls over Specialty Tickets

The Department of the Lottery (Department) used an unallowable allocation of overhead costs as opposed to direct costs incurred to specialty scratch-off tickets and had not performed a "true up" of estimated prize liabilities to prizes paid.

As of June 30, 2018, the Illinois Lottery Law (Law) requires the Department offer specialty scratch-off games to fund:

- breast cancer research grants appropriated by the General Assembly to the Department of Public Health from the Carolyn Adams Ticket For The Cure Grant Fund (Fund 208) (20 ILCS 1605/21.5);
- assistance for veterans appropriated by the General Assembly to the Department of Veterans' Affairs for grants from the Illinois Veterans Assistance Fund (Fund 236) (20 ILCS 1605/21.6);
- multiple sclerosis research grants appropriated by the General Assembly to the Department of Public Health from the Multiple Sclerosis Research Fund (Fund 429) (20 ILCS 1605/21.7);
- HIV/AIDS prevention grants appropriated by the General Assembly to the Department of Public Health from the Quality of Life Endowment Fund (Fund 437) (20 ILCS 1605/21.8); and,
- Special Olympics grants appropriated by the General Assembly to the Department of Human Services from the Special Olympics Illinois and Special Children's Charities Fund (Fund 073) (20 ILCS 1605/21.9).

During testing, we noted the following:

- The Department's calculation of net proceeds for its specialty scratch-off games incorrectly included certain overhead charges as opposed to actual and identifiable direct administrative costs. The allocated overhead charge has varied over time, beginning at 3% through October 2008, falling to 2.7% from November 2008 through December 2012, increasing to 2.77% from January 2012 through June 2014, and increasing to the current rate of 3.05% in July 2015. In addition, in certain years, actual direct administrative costs exceeded amounts allocated in the calculation of net proceeds. The following chart, which has been adjusted to reflect known and quantifiable direct costs, shows the amount of overhead allocated since inception for each game as of June 30, 2018:

Inception	Fund	Amount
2006	Veterans' Assistance Fund (236)	$ 1,532,045
2006	Breast Cancer (208)	1,052,755
2008	HIV/AIDS Prevention (437)	724,517
2009	Multiple Sclerosis (429)	703,399
2015	Special Olympics (073)	250,784
	Total	$ 4,263,500

  As actual overhead charges were unable to be identified by the Department, we were unable to quantify the impact of this error.

- The Department's estimate for its prize liabilities associated with its specialty scratch-off games had not been adjusted to reflect actual amounts paid for games ending on or before June 30, 2017, as of June 30, 2018. We were unable to quantify the impact of this error.

  The Law (20 ILCS 1605/21.5(b), 20 ILCS 1605/21.6(b), 20 ILCS 1605/21.7(b), 20 ILCS 1605/21.8(b), and 20 ILCS 1605/21.9(b)) requires the transfer of net revenue from each game to its respective fund within the State Treasury pursuant to the following statutory formula: Net Revenue = Tickets Sold – Amounts Paid Out in Prizes – Actual Administrative Expenses of the Department solely-related to each specific specially scratch-off game.

- The Department did not report accurate "accrual only" information to the Department of Public Health, the Department of Veterans' Affairs, and the Department of Human Services during the State's annual financial reporting process as it had not properly calculated "net revenues" or performed a "true up" for its prize liabilities associated with its specialty scratch-off games.

  The Statewide Accounting Management System (SAMS) (Procedure 27.50.10) requires the Department prepare a complete set of manual forms to report "accrual only" entries to the Department of Public Health, the Department of Veterans' Affairs, and the Department of Human Services who serve as the "administering agency" for financial reporting purposes of the five State Treasury-held funds receiving "net revenues" from the Department's specialty scratch-off games. Good internal controls include ensuring accurate and timely information is reported to each "administering agency" to ensure its transactions are properly recorded and accounted for to enable the "administering agency" to prepare accurate financial reports for the Office of the State Comptroller to use in preparing the State's Comprehensive Annual Financial Report.

In addition, the Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the Department ensure revenues, transfers, and funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over the State's resources.

Due to the significance of the issue noted, we concluded these conditions represent noncompliance with the law, which could have a direct and material effect on the determination of financial statement amounts. Further, these conditions represent noncompliance with applicable laws and regulations in the Department's financial and fiscal operations and a significant deficiency in the Department's internal control over compliance for not preventing, or detecting and correcting, these conditions.

Department officials indicated they have used an allocated overhead rate to estimate administrative costs because it is nearly impossible to track all actual costs with the current systems and processes in place. In addition, the verifiable historical records have not been found that would enable determination of the actual costs of the specialty games which occurred earlier than Fiscal Year 2016, as the Department's records retention schedule has a two-year retention period for these types of records. Finally, the prize estimates were not "trued up" due to an administrative oversight.

Failure to accurately calculate "net revenue" pursuant to the statutory formula represents noncompliance with the Law and could reduce or overstate the amount of ticket proceeds remitted to various appropriated State funds to support grants. (Finding Code No. 2018-004, 2017-003)

Recommendation:

We recommend the Department implement controls to calculate "net revenues" in accordance with the Law and correct its prior errors, or seek a legislative remedy. Further, the Department should implement controls to perform a "true up" process in a timely manner for its prior period prize liability estimates to reflect actual prizes paid. Finally, the Department should communicate with each "administering agency" receiving its "accrual only" information to correct any prior period errors.

Department Response:

The Department accepts the recommendation. The vast majority of our actual administrative expenses for these games are incurred during the course of performing other administrative duties related to all of our games and aren't specifically separated. Work occurs through our instant ticket processes, marketing processes, and financial processes. We are able to identify vendor charges for specific products or services attributed to the development and marketing of specialty games, but the hourly efforts of the Lottery staff and of the Private Manager staff requires manual tracking and have been difficult and costly to isolate.

In Fiscal Year 2019, the Department has implemented additional procedures to capture direct administrative costs and performed a reconciliation to “true-up” estimated prize liabilities to prizes paid and will complete any necessary transfer during the year. Furthermore, the Department will communicate directly with those agencies impacted on the matter and work towards a legislative remedy to better allocate and account for the administrative costs associated with specialty tickets.

Finding 2018-005 Financial Reporting Errors

The Department of the Lottery (Department) did not correct existing errors within its annuity prizes payable.

During our audit of the financial statements as of June 30, 2018, we noted the following:

- The Department incorrectly calculated the present value of future prize payments by recording certain annuities with payments within one year, when payments were scheduled to be paid out in future periods. As a result, the current portion of long-term annuity prizes payable was overstated by $190,699. This amount was deemed immaterial by Department management and was not corrected in the Department's final financial statements; however, we determined this exception represented a significant deficiency in the Department's internal control over financial reporting.

  Governmental Accounting Standards Board Statement No. 34 (Paragraph 31), *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, notes liabilities whose average maturities are greater than one year should be split into the current amount due within one year and the long-term amount due beyond one year.

- The Department incorrectly calculated the accrued interest for the future value of securities purchased for future payments for 58 annuitants. As a result, the noncurrent portion of long-term annuity prizes payable was understated by $1,489,441. This amount was deemed immaterial by Department management and was not corrected in the Department's final financial statements; however, we determined this exception represented a significant deficiency in the Department's internal control over financial reporting.

  Governmental Accounting Standards Board Statement No. 63 (Paragraph 8), *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, notes the Department's Statement of Net Position (Deficit) should report all assets, deferred outflows of resources, liabilities, deferred inflows of resources, and net position.

In addition, the Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires the Department ensure revenues, expenses, and funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial reports and to maintain accountability over the State's resources.

Department officials indicated they had identified other certain errors within its annuity prizes payable and had corrected those errors during Fiscal Year 2018; however, the Department lacked sufficient resources to complete a full examination of its annuity prizes payable prior to presenting the Department's financial statements to us for this audit.

Due to the significance of the issues noted, we concluded this condition represents noncompliance with applicable laws and regulations in the Department's financial and fiscal operations and a significant deficiency in the Department's internal control over compliance for not preventing, or detecting and correcting, these conditions.

Failure to ensure the ensure interest is properly accrued and the liability is properly allocated into its current and noncurrent portion for prizes payable reduces the overall reliability of Statewide financial information. (Finding Code No. 2018-005)

(Continued)

Recommendation:

We recommend the Department review its process for accounting for prizes payable to (1) ensure interest is properly accrued and (2) the liability is properly allocated into its current and noncurrent portion.

Department Response:

During Fiscal Year 2018, the Department noted an error in annuity prizes payable and properly corrected. However, the Department is in the process of completing a full examination over annuity prizes payable to consider any additional prior year errors requiring correction. The Department will make the review over annuity prizes payable a top priority in Fiscal Year 2019 and correct any known errors at that time.

PRIOR FINDING NOT REPEATED

A. FINDING Inadequate Control over Online Games Prize Liabilities

During the prior engagement, the Department did not exercise adequate internal control over reporting its online games prize liabilities.

During the current engagement, our testing did not identify any similar errors related to the reporting of its online games prize liabilities. (Finding Code No. 2017-002)