

**REPORT OF THE AUDIT OF THE
KENTUCKY LOTTERY CORPORATION**

**For The Years Ended
June 30, 2016 and 2015**



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MIKE HARMON
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To the People of Kentucky
Honorable Matt Bevin, Governor
Honorable Robert Stivers, President, Kentucky Senate
Honorable Greg Stumbo, Speaker, Kentucky House of Representatives
Board of Directors, Kentucky Lottery Corporation

The enclosed report prepared by Harding, Shymanski and Company, P.S.C, presents the financial and compliance audit of the books and records of the Kentucky Lottery Corporation for the years ended June 30, 2016 and 2015, as required by KRS 154A.130.

We engaged Harding, Shymanski and Company, P.S.C to perform the audit in accordance with auditing standards generally accepted in the United States of America. We worked closely with the firm during our report review process.

Respectfully Submitted

Mike Harmon
Auditor of Public Accounts

Enclosure





Financial Report

June 30, 2016 and 2015

KENTUCKY LOTTERY CORPORATION

ANNUAL FINANCIAL REPORT

June 30, 2016 and 2015

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INDEPENDENT AUDITOR'S REPORT

To the Auditor of Public Accounts,
Commonwealth of Kentucky, and
the Board of Directors of the
Kentucky Lottery Corporation
Louisville, Kentucky

Report on the Financial Statements

We have audited the accompanying financial statements of the Kentucky Lottery Corporation (KLC), a component unit of the Commonwealth of Kentucky, as of and for the years ended June 30, 2016 and 2015, and the related notes to the financial statements, which collectively comprise the KLC'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 accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the 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.



**HARDING, SHYMANSKI
& COMPANY, P.S.C.**

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INDEPENDENT AUDITOR'S REPORT (CONTINUED)

Opinion



In our opinion, the financial statements referred to on the previous page present fairly, in all material respects, the financial position of KLC, as of June 30, 2016 and 2015, and the changes in financial position and its cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Fiscal Year 2015 Financial Statements

The financial statements of KLC, as of and for the year ended June 30, 2015, were audited by other auditors, whose report dated September 25, 2015 expressed an unmodified opinion on those statements.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis on Pages 3 through 12 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated September 20, 2016 on our consideration of KLC's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering KLC's internal control over financial reporting and compliance.

Harding, Slymanski & Company, P.S.C.

Louisville, Kentucky
September 20, 2016

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Our discussion of the Kentucky Lottery Corporation's (KLC) financial performance provides an overview of the KLC's financial activities for the fiscal years ended June 30, 2016 and 2015. Please read it in conjunction with the financial statements, which follow.

Financial Highlights for FY 2016

- Ticket sales were a record \$997.3 million compared to \$899.1 million in 2015, an increase of \$98.2 million or 10.9 percent. Instant ticket sales increased \$36.8 million or 6.6 percent to a record \$597.3 million, while draw game sales increased \$61.0 million or 18.0 percent to \$399.6 million. Keno generated sales of \$65.9 million, exceeding prior year by \$18.6 million. iLottery instant play games, which were launched in April 2016, generated sales of \$0.4 million.
- Operating revenues net of direct costs increased \$23.4 million to \$283.0 million or 28.8 percent of sales compared to \$259.6 million or 29.3 percent of sales for 2015.
- Operating expenses increased \$1.3 million to \$30.1 million or 3.1 percent of total operating revenues.
- Total payments to the Commonwealth of Kentucky were a record \$253.0 million compared to \$236.1 million in 2015, an increase of \$16.9 million or 7.2 percent. Total payments to the Commonwealth of Kentucky were 25.7 percent of total operating revenues.

The KLC is accounted for as an enterprise fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting much like a private business activity. As such, this annual financial report consists of a series of financial statements, along with explanatory notes to the financial statements and supplemental schedules.

To assess the KLC's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth on the Statements of Net Position, and in changes in operating revenues and expenses as set forth in the Statement of Revenues, Expenses, and Changes in Net Position.

Total Assets

Total assets consist primarily of cash and cash equivalents, investments, accounts receivable and capital assets. As shown in Table 1, the KLC's total assets increased \$1.3 million to \$77.1 million in 2016 from \$75.8 million in 2015. Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value. Accounts receivable represents revenue to be collected from the sale of draw and instant game tickets.

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Capital Assets

The KLC's investment in capital assets, net of accumulated depreciation in 2016 and 2015, was \$5.7 and \$6.7 million, respectively. The investment in capital assets includes buildings, game equipment, data processing equipment, automobiles, software, and furniture and fixtures. The total decrease in the KLC's investment in capital assets for 2016 was \$1.0 million or 14.9 percent compared to a decrease of \$0.4 million or 5.6 percent in 2015. Additional information on the KLC's investment in capital assets can be found in Note 6 to the financial statements.

TABLE 1
NET POSITION
(In millions)

	<u>2016</u>	Increase (Decrease)	<u>2015</u>	Increase (Decrease)	<u>2014</u>
Current and other assets	\$ 52.4	\$ 3.8	\$ 48.6	\$ (8.5)	\$ 57.1
Investments (noncurrent)	14.1	(1.0)	15.1	(5.9)	21.0
Capital assets, net	5.7	(1.0)	6.7	(0.4)	7.1
Prepaid license	0.2	(0.1)	0.3	0.0	0.3
Deposits with MUSL	<u>4.7</u>	<u>(0.4)</u>	<u>5.1</u>	<u>(0.5)</u>	<u>5.6</u>
Total assets	<u>77.1</u>	<u>1.3</u>	<u>75.8</u>	<u>(15.3)</u>	<u>91.1</u>
Current liabilities	40.2	2.0	38.2	(2.3)	40.5
Long-term liabilities	<u>16.1</u>	<u>(0.6)</u>	<u>16.7</u>	<u>(7.1)</u>	<u>23.8</u>
Total liabilities	<u>56.3</u>	<u>1.4</u>	<u>54.9</u>	<u>(9.4)</u>	<u>64.3</u>
Net position					
Net investment in capital assets	5.7	(1.0)	6.7	(0.4)	7.1
Unrestricted – accumulated unrealized gains on investments	2.8	(0.1)	2.9	(0.9)	3.8
Unrestricted	<u>12.3</u>	<u>1.0</u>	<u>11.3</u>	<u>(4.6)</u>	<u>15.9</u>
Total net position	<u>\$ 20.8</u>	<u>\$ (0.1)</u>	<u>\$ 20.9</u>	<u>\$ (5.9)</u>	<u>\$ 26.8</u>

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Liabilities

TABLE 2
LIABILITIES
(In millions)

	Current			Long-Term		
	2016	2015	2014	2016	2015	2014
Prize liabilities	\$ 26.1	\$ 27.8	\$ 35.2	\$ 15.1	\$ 15.7	22.8
Due to Commonwealth	5.6	3.3	0.2	0.0	0.0	0.0
Accounts payable and other liabilities	<u>8.5</u>	<u>7.1</u>	<u>5.1</u>	<u>1.0</u>	<u>1.0</u>	<u>1.0</u>
Total liabilities	<u>\$ 40.2</u>	<u>\$ 38.2</u>	<u>\$ 40.5</u>	<u>\$ 16.1</u>	<u>\$ 16.7</u>	<u>\$ 23.8</u>

Total current liabilities increased \$2.0 million or 5.2 percent in 2016 and decreased \$2.3 million or 5.7 percent in 2015. The account titled "Due to Commonwealth" increased \$2.3 million in 2016 and \$3.1 million in 2015. This is a timing issue and represents payments due to the General Fund and the KEES Reserve Fund after the fiscal year-end.

Long-term liabilities consist principally of prize liability for prizes paid in installments over several years and the noncurrent portion of accrued compensated absences. Long-term liabilities decreased \$0.6 million or 3.6 percent in 2016 and \$7.1 million or 29.8 percent in 2015. The decrease is attributable to the maturing of long-term prize liabilities. More detailed information can be obtained in Note 8 to the financial statements.

Net Position

As shown in Table 1 on page 4, the KLC's net position in 2016 decreased \$0.1 million to \$20.8 million. The decrease was attributable to decline in market value of investments the KLC holds to fund future payments due on annuitized lottery prizes. Accounting principles dictate the KLC record the unrealized gain or loss related to the change in market value of these investments. Zero-coupon U.S. Government bonds have been purchased for the payment of installment prize awards and are generally held to maturity. The change in the market value of these investments (i.e. the unrealized losses on investments) was recorded as a decrease in unrestricted net position. The accumulated unrealized gain on investments included in unrestricted net position at June 30, 2016 is not available for transfer to the Commonwealth's general fund. The KLC's net investment in capital assets of \$5.7 million is also not available for transfer to the Commonwealth's general fund. The remaining net position of \$12.3 million is unrestricted, but provides working capital and cash flow and is utilized in the KLC's day-to-day operations. In 2015, the KLC's net position decreased \$5.9 million to \$20.9 million due to dividend transfers from prior year earnings and the decrease in market value of investments the KLC held to fund future payments due on annuitized lottery prizes.

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Changes in Net Position

TABLE 3
CHANGES IN NET POSITION
(In millions)

	<u>2016</u>	<u>Increase (Decrease)</u>	<u>2015</u>	<u>Increase (Decrease)</u>	<u>2014</u>
Operating revenues					
Instant games	\$ 597.3	\$ 36.8	\$ 560.5	\$ 39.0	\$ 521.5
Draw games	399.6	61.0	338.6	1.3	337.3
iLottery instant play games	0.4	0.4	0.0	0.0	0.0
Less tickets provided as prizes	<u>(13.5)</u>	<u>(1.3)</u>	<u>(12.2)</u>	<u>3.4</u>	<u>(15.6)</u>
Total operating revenues	983.8	96.9	886.9	43.7	843.2
Non-operating revenues	<u>1.1</u>	<u>0.2</u>	<u>0.9</u>	<u>(0.1)</u>	<u>1.0</u>
Total revenues	984.9	97.1	887.8	43.6	844.2
Direct costs and operating expenses					
Direct costs:					
Prize expense	620.6	64.3	556.3	32.5	523.8
Commissions to retailers	62.6	6.8	55.8	3.0	52.8
Vendor expense	9.7	2.0	7.7	0.3	7.4
Ticket costs	<u>7.9</u>	<u>0.4</u>	<u>7.5</u>	<u>0.9</u>	<u>6.6</u>
Total direct costs	700.8	73.5	627.3	36.7	590.6
Operating expenses	<u>30.1</u>	<u>1.3</u>	<u>28.8</u>	<u>1.5</u>	<u>27.3</u>
Total direct costs and operating expenses	730.9	74.8	656.1	38.2	617.9
Non-operating expenses	1.1	(0.5)	1.6	(0.7)	2.3
Payments to the Commonwealth of Kentucky	<u>253.0</u>	<u>16.9</u>	<u>236.1</u>	<u>10.0</u>	<u>226.1</u>
Total expenses	985.0	91.2	893.8	47.5	846.3
Changes in net position	<u>\$ (0.1)</u>	<u>\$ 5.9</u>	<u>\$ (6.0)</u>	<u>\$ (3.9)</u>	<u>\$ (2.1)</u>

See statements of revenues, expenses, and changes in net position for items included in each line of Table 3. See Tables 4, 5, and 6 for explanation of differences in the above items for 2016 and 2015.

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Sales and Prize Expenses

Sales

Table 4 compares sales, prizes, unclaimed prizes and gross margin (sales minus net prizes) for each lottery game category for 2016, 2015, and 2014. In 2016, the KLC generated ticket sales of \$997.3 million, an increase of \$98.2 million or 10.9 percent when compared to 2015. Total ticket sales, net of \$13.5 million of tickets provided as prizes, were \$983.8 million.

In 2016, operating revenues consisted of ticket sales from three product categories, instant games, draw games, and iLottery instant play games. Instant ticket sales, which accounted for 59.9 percent of all KLC sales, were \$597.3 million, an increase of \$36.8 million or 6.6 percent. When compared to 2015, sales growth within this product category occurred at the \$3 price point with an increase of \$4.3 million or 12.3 percent; the \$5 price point with an increase of \$9.0 million or 5.3 percent; the \$10 price point with an increase of \$9.8 million or 7.9 percent; the \$20 price point with an increase of \$4.7 million or 6.1 percent increase; and the \$25 price point with an increase of \$10.9 million or 20.9 percent. Sales decreases were recognized at the \$1 price point with a decrease of \$0.2 million or 0.7 percent; and the \$2 price point with a decrease of \$1.7 million or 2.6 percent.

Draw game sales were \$399.6 million, an increase of \$61.0 million or 18.0 percent when compared to FY 2015. Draw games accounted for 40.1 percent of all sales and consisted of Pick 3, Pick 4, KY Cash Ball, Powerball, Mega Millions, 5 Card Cash, Keno, and Lucky for Life. Compared to FY 2015, sales increases were recognized in Powerball with sales of \$94.4 million, an increase of \$29.4 million or 45.2 percent, Keno with sales of \$65.9 million, an increase of \$18.6 million or 39.3 percent, Pick 3 with sales of \$139.6 million, an increase of \$8.3 million or 6.3 percent, Lucky for Life with sales of \$9.0 million, an increase of \$6.0 million or 200 percent, and Pick 4 with sales of \$42.6 million, an increase of \$4.1 million or 10.6 percent. Sales decreases were recognized in Mega Millions, a decrease of \$1.9 million or 5.7 percent; 5 Card Cash, a decrease of \$0.6 million or 7.8 percent; and KY Cash Ball, a decrease of \$0.3 million or 3.0 percent.

In April 2016, the KLC began selling products on the internet via the iLottery channel. iLottery instant play sales were \$0.4 million.

In 2015, the KLC produced sales of \$899.1 million, an increase of \$40.3 million when compared to 2014. Instant ticket sales, which accounted for 62.3 percent of all KLC sales, were \$560.5 million, an increase of \$39.0 million or 7.5 percent.

Draw game sales for FY 2015 were \$338.6 million, an increase of \$1.3 million or 0.4 percent when compared to FY 2014. Draw games accounted for 37.7 percent of all sales and consisted of Pick 3, Pick 4, KY Cash Ball, Powerball, Decades of Dollars, Mega Millions, 5 Card Cash, Keno, Monopoly Millionaires' Club which began sales on October 19, 2014 and ceased on December 26, 2014, and Lucky for Life which began sales on March 22, 2015.

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

TABLE 4
LOTTERY SALES AND RELATED PRIZE EXPENSE
(In millions)

	Instant			Keno			Pick 3		
	2016	2015	2014	2016	2015	2014	2016	2015	2014
Sales	\$ 597.3	\$ 560.5	\$ 521.5	\$ 65.9	\$ 47.3	\$ 29.4	\$ 139.6	\$ 131.3	\$ 125.5
Less tickets as prizes	(13.5)	(12.2)	(15.6)	0.0	0.0	0.0	0.0	0.0	0.0
Total ticket sales	583.8	548.3	505.9	65.9	47.3	29.4	139.6	131.3	125.5
Gross prizes	403.3	377.4	346.9	43.4	30.8	19.2	81.3	77.8	74.6
Less unclaimed prizes	(4.4)	(5.2)	(4.6)	(0.3)	(0.3)	(0.0)	(0.9)	(0.8)	(0.8)
Net prizes	398.9	372.2	342.3	43.1	30.5	19.2	80.4	77.0	73.8
Gross margin	\$ 184.9	\$ 176.1	\$ 163.6	\$ 22.8	\$ 16.8	\$ 10.2	\$ 59.2	\$ 54.3	\$ 51.7
	Pick 4			5 Card Cash			Powerball		
	2016	2015	2014	2016	2015	2014	2016	2015	2014
Sales	\$ 42.6	\$ 38.5	\$ 38.8	\$ 7.1	\$ 7.7	\$ 8.3	\$ 94.4	\$ 65.0	\$ 79.6
Less tickets as prizes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total ticket sales	42.6	38.5	38.8	7.1	7.7	8.3	94.4	65.0	79.6
Gross prizes	22.2	17.5	18.6	4.3	4.6	5.0	47.2	32.5	40.0
Less unclaimed prizes	(0.4)	(0.4)	(0.5)	(0.1)	(0.1)	(0.1)	(1.0)	(1.7)	(1.4)
Net prizes	21.8	17.1	18.1	4.2	4.5	4.9	46.2	30.8	38.6
Gross margin	\$ 20.8	\$ 21.4	\$ 20.7	\$ 2.9	\$ 3.2	\$ 3.4	\$ 48.2	\$ 34.2	\$ 41.0
	KY Cash Ball			Decades of Dollars			Mega Millions		
	2016	2015	2014	2016	2015	2014	2016	2015	2014
Sales	\$ 9.7	\$ 10.0	\$ 10.0	\$ 0.0	\$ 1.7	\$ 5.9	\$ 31.3	\$ 33.2	\$ 39.8
Less tickets as prizes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total ticket sales	9.7	10.0	10.0	0.0	1.7	5.9	31.3	33.2	39.8
Gross prizes	5.6	6.6	4.7	0.0	(1.1)	3.1	15.5	16.7	19.9
Less unclaimed prizes	(0.1)	(0.1)	(0.1)	0.0	(0.1)	(0.1)	(0.5)	(0.6)	(0.6)
Net prizes	5.5	6.5	4.6	0.0	(1.2)	3.0	15.0	16.1	19.3
Gross margin	\$ 4.2	\$ 3.5	\$ 5.4	\$ 0.0	\$ 2.9	\$ 2.9	\$ 16.3	\$ 17.1	\$ 20.5
	Monopoly Millionaires' Club			Lucky For Life			iLottery Instant Play		
	2016	2015	2014	2016	2015	2014	2016	2015	2014
Sales	\$ 0.0	\$ 0.9	\$ 0.0	\$ 9.0	\$ 3.0	\$ 0.0	\$ 0.4	\$ 0.0	\$ 0.0
Less tickets as prizes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total ticket sales	0.0	0.9	0.0	9.0	3.0	0.0	0.4	0.0	0.0
Gross prizes	0.0	1.0	0.0	5.4	1.8	0.0	0.3	0.0	0.0
Less unclaimed prizes	0.0	(0.0)	0.0	(0.2)	(0.0)	0.0	0.0	0.0	0.0
Net prizes	0.0	1.0	0.0	5.2	1.8	0.0	0.3	0.0	0.0
Gross margin	\$ 0.0	\$ (0.1)	\$ 0.0	\$ 3.8	\$ 1.2	\$ 0.0	\$ 0.1	\$ 0.0	\$ 0.0

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

	Total		
	2016	2015	2014
Sales	\$ 997.3	\$ 899.1	\$ 858.8
Less tickets as prizes	<u>(13.5)</u>	<u>(12.2)</u>	<u>(15.6)</u>
Total ticket sales	983.8	886.9	843.2
Gross prizes	628.5	565.6	532.0
Less unclaimed prizes	<u>(7.9)</u>	<u>(9.3)</u>	<u>(8.2)</u>
Net prizes	<u>620.6</u>	<u>556.3</u>	<u>523.8</u>
Gross margin	<u>\$ 363.2</u>	<u>\$ 330.6</u>	<u>\$ 319.4</u>

Prize Expense

In general, prize expense by game should increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, except for the instant game product category, prize expense is also impacted by the luck of the draw. Prize expense for the instant game product category is controllable, to a large degree, by printing a predetermined number and value of winning tickets in the production of each instant game. Prize expense for draw games is not predetermined. While each of the draw games is designed to yield a certain ratio of prizes to sales over a large number of drawings, actual prize payout is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. With that background, Table 4 shows the prize payout by lottery product for 2016, 2015, and 2014.

For FY 2016, gross prize expense (not including unclaimed prizes) of \$628.5 million, reflects a 11.1 percent increase from 2015 gross prize expense of \$565.6 million. The following is a discussion of notable variances in prize expense within certain product categories.

In 2016, cash prize expense for instant games increased to 69.1 percent of cash instant sales compared to 68.8 percent in 2015 and 69.4 percent budgeted.

In 2016, gross prize expense for draw games was 56.3 percent of draw sales compared to 55.6 percent in 2015 and 56.6 percent budgeted. Powerball gross prize expense was 50.0 percent of Powerball sales compared to 49.9 percent in 2015 and 50.0 percent budgeted. Mega Millions gross prize expense was 49.7 percent of Mega Million sales compared to 50.1 percent in 2015 and 50.0 percent budgeted. Pick 3 gross prize expense was 58.2 percent of Pick 3 sales compared to 59.3 percent in 2015 and 60.0 percent budgeted. Pick 4 gross prize expense was 52.1 percent of Pick 4 sales compared to 45.5 percent in 2015 and 50.0 percent budgeted. KY Cash Ball gross prize expense was 57.7 percent of KY Cash Ball sales compared to 65.9 percent in 2015 and 53.8 percent budgeted. 5 Card Cash gross prize expense was 60.6 percent of 5 Card Cash sales compared to 59.7 percent in 2015 and 59.8 percent budgeted. Keno gross prize expense was 65.9 percent of Keno sales compared to 65.2 percent in 2015, and 63.5 percent budgeted. Lucky for Life gross prize expense was 59.9 percent compared to 60.6 percent in 2015 and 65.0 percent budgeted.

In 2016, gross iLottery Instant Play gross prize expense was 74.3 percent compared to 65.0 percent budgeted.

Net prize expense in 2016 was \$620.6 million or 63.1 percent of sales compared to \$556.3 million or 62.7 percent of sales in 2015. Unclaimed prizes in 2016 were \$7.9 million compared to \$9.3 million in 2015.

Gross prize expense in 2015 of \$565.6 million, reflects a 6.3 percent increase from 2014 gross prize expense of \$532.0 million.

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Gross prize expense for instant games in 2015 was 68.8 percent of cash instant sales compared to 68.6 percent in 2014 and 69.7 percent budgeted.

Gross prize expense for draw games in 2015 was 55.6 percent of draw sales compared to 54.9 percent in 2014 and 54.8 percent budgeted.

Net prize expense in 2015 was \$556.3 million or 62.7 percent of sales compared to \$523.8 million or 62.1 percent of sales in 2014. Unclaimed prizes in 2015 were \$9.3 million compared to \$8.2 million in 2014.

Other Expenses

TABLE 5
COMMISSIONS, OPERATING, AND NON-OPERATING EXPENSES
(In millions)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Retailer commissions	\$ 62.6	\$ 55.9	\$ 52.8
Vendor expense	9.7	7.7	7.4
Ticket costs	7.9	7.5	6.6
Operating expenses	30.1	28.8	27.3
Non-operating expenses			
Amortization of prize discount	1.1	1.6	2.3

Commissions to retailers cover base selling and cashing commissions as well as a retailer incentive plan based on the sale of instant tickets. Retailer commissions for 2016 and 2015 were 6.3 percent of sales. Vendor expenses for 2016 and 2015 were 1.0 and 0.9 percent of sales. Ticket costs include the cost to acquire and ship instant tickets to retailers. Ticket costs for 2016 and 2015 were 0.8 percent of sales. Operating expenses for 2016 and 2015 were 3.1 and 3.2 percent of sales. Amortization of prize discount, which reflects the periodic write-off of the difference between the present value of installment prizes and the face value of said prizes, decreased \$0.5 million in 2016 and \$0.7 million in 2015.

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Other Revenues

TABLE 6
OTHER REVENUES
(In millions)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Unrealized loss on investments	\$ (0.1)	\$ (0.9)	\$ (1.6)
Net accretion of investments	1.0	1.6	2.3
Interest income	0.1	0.1	0.1
Other miscellaneous	<u>0.1</u>	<u>0.1</u>	<u>0.2</u>
Total non-operating revenues	<u>\$ 1.1</u>	<u>\$ 0.9</u>	<u>\$ 1.0</u>

Unrealized loss on investments represents the impact on income of recording investments at their fair value compared to the historical cost method. Accretion of investments reflects the net increase in the accreted cost of the investment.

Interest income consists principally of interest on the KLC's cash balance, which is invested in short-term investments. No change in interest income reflects the federal government's continued policy to keep short-term interest rates at low levels in 2016.

(Continued)

KENTUCKY LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2016 and 2015

Miscellaneous revenues consist primarily of various fees assessed to retailers and income earned from the sale of fixed assets.

Payments to the Commonwealth of Kentucky

In 2016 and 2015, payments to the Commonwealth of Kentucky represent a transfer or an accrual of funds from the KLC to the Commonwealth's general fund and to the Kentucky Educational Excellence Scholarship ("KEES") Program Reserve Account. Payments to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are predominantly used by the General Assembly to provide funding for postsecondary education and literacy development. Payments to the KEES Program Reserve Account represent prizes of instant and draw games that expired (went unclaimed) during the fiscal year. Payments to the Commonwealth of Kentucky in 2016 were \$253.0 million, which consisted of \$245.1 million or an increase of \$18.3 million to the Commonwealth's general fund and \$7.9 million or a decrease of \$1.4 million to the KEES Program Reserve Account. Payments in 2015 were \$236.1 million, which consisted of \$226.8 million to the Commonwealth's general fund and \$9.3 million to the KEES Program Reserve Account.

Currently Known Facts, Decisions, or Conditions

- Instant sales are budgeted to produce sales of \$622 million during FY 2017, an increase of \$24.7 million or 4.1 percent. The KLC will continue to utilize the retailer scorecard system to increase sales and will have a full year of additional self-service vending machines that were added in FY 2016. In addition, the KLC will focus more on large independent accounts.
- Keno is budgeted to produce sales of \$73 million in FY 2017, an increase of \$7.1 million or 10.8 percent. KLC launched Keno drawings every four minutes in June 2016, a reduction from every five minutes, to boost sales. In addition, KLC will have a full year of Keno To Go during FY 2017, which has allowed all retailers to sell the game.
- Powerball game changes went into effect in October 2015 to allow for higher jackpots and Sunday midday drawings were added in February 2016 for the Pick 3 and Pick 4 games. FY 2017 will reflect a full year of these changes.

Contacting the KLC's Financial Management

This financial report is designed to provide the public and other interested parties with an overview of the financial results of the KLC's activities, and to show the KLC's accountability for the revenue that it generates. If you have any questions about this report or need additional financial information, contact the KLC's Public Relations Department at the Kentucky Lottery Corporation, 1011 West Main Street, Louisville, Kentucky 40202.

(Continued)

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF NET POSITION

June 30, 2016 and 2015

(dollars in thousands)

	2016	2015
ASSETS		
Current Assets		
Cash and equivalents	\$ 10,387	\$ 3,775
Cash and equivalents, annuitants	2,600	2,376
Investments at fair value, current portion	1,969	6,538
Accounts receivable, net	36,354	35,177
Prepaid PowerPlay License, current portion	67	67
Other	1,002	711
Total current assets	<u>52,379</u>	<u>48,644</u>
Noncurrent Assets		
Investments at fair value, less current portion	14,084	15,068
Prepaid PowerPlay License, less current portion	180	247
Capital assets, net	5,711	6,689
Deposits with Multi-State Lottery Association	4,734	5,126
Total noncurrent assets	<u>24,709</u>	<u>27,130</u>
Total assets	<u>77,088</u>	<u>75,774</u>
LIABILITIES		
Current Liabilities		
Accounts payable, accrued expenses, and compensated absences, current portion	8,485	7,101
Due to the Commonwealth of Kentucky	5,578	3,278
Estimated prize liability, current portion	26,124	27,820
Total current liabilities	<u>40,187</u>	<u>38,199</u>
Noncurrent Liabilities		
Accrued compensated absences, less current portion	1,035	1,020
Estimated prize liability, less current portion	15,034	15,697
Total noncurrent liabilities	<u>16,069</u>	<u>16,717</u>
Total liabilities	<u>56,256</u>	<u>54,916</u>
NET POSITION		
Net investment in capital assets	5,711	6,689
Unrestricted	15,121	14,169
Net position	<u>\$ 20,832</u>	<u>\$ 20,858</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION For the Years Ended June 30, 2016 and 2015 (dollars in thousands)

	2016	2015
Operating revenues		
Instant games	\$ 597,325	\$ 560,494
Draw games	399,573	338,628
iLottery instant play games	421	0
Less instant tickets provided as prizes	<u>(13,477)</u>	<u>(12,192)</u>
Total operating revenues	<u>983,842</u>	<u>886,930</u>
Direct costs		
Prizes expense		
Instant games	398,852	372,186
Draw games	221,405	184,090
iLottery instant play games	<u>313</u>	<u>0</u>
Total prize expense	<u>620,570</u>	<u>556,276</u>
Commissions to retailers	62,574	55,857
Vendor expense	9,728	7,680
Ticket costs	<u>7,926</u>	<u>7,479</u>
Total direct costs	<u>700,798</u>	<u>627,292</u>
Operating revenues net of direct costs	<u>283,044</u>	<u>259,638</u>
Operating expenses		
Advertising and promotion	10,293	9,291
Salaries, wages, and benefits	14,465	13,952
Contracted and professional services	2,189	1,966
Depreciation	1,313	1,326
Other general and administrative	<u>1,849</u>	<u>2,251</u>
Total operating expenses	<u>30,109</u>	<u>28,786</u>
Operating income	<u>252,935</u>	<u>230,852</u>
Non-operating revenue (expense)		
Payments to the Commonwealth of Kentucky	(253,044)	(236,101)
Investment income	1,111	716
Interest expense	(1,029)	(1,572)
Other income	<u>1</u>	<u>184</u>
Total non-operating expense	<u>(252,961)</u>	<u>(236,773)</u>
Change in net position	<u>(26)</u>	<u>(5,921)</u>
Net position at beginning of year	<u>20,858</u>	<u>26,779</u>
Net position at end of year	<u>\$ 20,832</u>	<u>\$ 20,858</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF CASH FLOWS For the Years Ended June 30, 2016 and 2015 (dollars in thousands)

	<u>2016</u>	<u>2015</u>
Cash Flows from Operating Activities		
Cash received from customers	\$ 982,665	\$ 881,100
Cash payments to prize winners	(622,929)	(570,776)
Cash payments to suppliers	(94,537)	(83,378)
Cash payments to employees for services	(14,696)	(14,009)
Net cash provided by operating activities	<u>250,503</u>	<u>212,937</u>
Cash Flows from Noncapital Financing Activities		
Payments to the Commonwealth of Kentucky	<u>(250,745)</u>	<u>(233,068)</u>
Cash Flows from Capital and Related Financing Activities		
Purchases of capital assets	<u>(551)</u>	<u>(917)</u>
Cash Flows from Investing Activities		
Proceeds from sale of investments	7,128	13,415
Decrease in deposits at MUSL	392	505
Investment income	109	249
Net cash provided by investing activities	<u>7,629</u>	<u>14,169</u>
Increase (decrease) in cash and cash equivalents	6,836	(6,879)
Cash and cash equivalents at beginning of year	<u>6,151</u>	<u>13,030</u>
Cash and equivalents at end of year	<u>\$ 12,987</u>	<u>\$ 6,151</u>
Reconciliation of Operating Income to Net Cash Provided by Operating Activities		
Operating income	<u>\$ 252,935</u>	<u>\$ 230,852</u>
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	1,313	1,326
Provision for losses on accounts receivable	257	110
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	(2,007)	(5,367)
Prepaid PowerPlay License	67	67
Other assets	(291)	(10)
Accounts payable and accrued expenses	1,617	2,031
Estimated prize liability	<u>(3,388)</u>	<u>(16,072)</u>
Total adjustments	<u>(2,432)</u>	<u>(17,915)</u>
Net cash provided by operating activities	<u>\$ 250,503</u>	<u>\$ 212,937</u>

Noncash capital and investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability for the years ended June 30, 2016 and 2015 totaled \$1,029 and \$1,572, respectively.

The fair value of investments decreased \$26 and \$921 for the years ended June 30, 2016 and 2015, respectively. See accompanying notes.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 1 – Organization

The Kentucky Lottery Corporation (KLC) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (Commonwealth). The KLC is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the KLC are separate and distinct from other operations of the Commonwealth.

The KLC commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of draw games began October 16, 1989. In January 1991, the KLC joined the Multi-State Lottery Association (MUSL), a group of states that combine lottery sales for draw games.

Note 2 – Summary of Significant Accounting Policies

Reporting Entity

The KLC has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, as amended by GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units* and GASB Statement No. 61, *The Financial Reporting Entity: Omnibus – An Amendment of GASB Statements No. 14 and No. 34*, under which the financial statements include all the organizations, activities, functions and component units for which the KLC is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's Board, and either (1) the KLC's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the KLC.

The KLC has determined that no outside agency meets the above criteria; therefore, no other agency has been included as a component unit in the KLC's financial statements. In addition, since the KLC provides a financial benefit for the Commonwealth, the KLC is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Comprehensive Annual Financial Report as a blended component unit. The accompanying financial statements are not intended to present the financial position or the results of operations and cash flows of the Commonwealth or its proprietary funds.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 2 – Summary of Significant Accounting Policies (Continued)

Basis of Presentation

The KLC is accounted for as an enterprise fund. The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The financial statements are reported using the economic resources measurement focus. The financial statements include the accounts of KLC and have been prepared on the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recorded when an obligation has been incurred.

As an enterprise fund, the KLC distinguishes *operating* revenues and expenses from *non-operating* items. Operating revenues and expenses generally result from providing services and delivering goods in connection with the KLC's principal ongoing operations. The principal operating revenues of the KLC are charges to customers for sales of lottery products. Operating expenses include the cost of sales and services, selling and administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Revenue and Accounts Receivable Recognition

Revenue and accounts receivable for draw games are recognized when tickets are sold to the public by contracted retailers.

Revenue and accounts receivable for instant games are recognized based on a retailer's billing type. For Bill Immediate retailers, revenue is recognized at the time of issuance of the tickets to the retailers. For Issue-Based retailers, revenue is recognized upon activation, or 30 days from the date of issuance, whichever is sooner. Finally, for Activation-based retailers, revenue is recognized upon activation, or 50 days from the date of issuance, whichever is sooner. Beginning in fiscal year 2009, the KLC implemented instant games that include instant tickets provided as prizes, which entitle the holder to exchange one instant ticket for another of equal value. The redemption of these instant tickets is netted against total operating revenue.

Allowance for Doubtful Accounts

The KLC uses the allowance method to account for uncollectible accounts receivable. Trade receivables are written-off when deemed uncollectible. Recoveries of trade receivables previously written-off are recorded when received. KLC wrote off approximately \$306,000 and \$49,000 for the years ended June 30, 2016 and 2015, respectively. A trade receivable is considered uncollectible after no payment has been received in 120 days.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 2 – Summary of Significant Accounting Policies (Continued)

Prizes

Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for draw games is recorded after each draw and is based on actual draw results. Grand prizes are awarded related to the Decades of Dollars, Win for Life, Lucky for Life, Powerball, and Mega Millions draw games.

Decades of Dollars grand prizes are paid in annual installments of \$250,000 for 30 years. Decades of Dollars prize expense is recorded after each draw and is based on actual draw results. A portion of the Decades of Dollars sales of the KLC is remitted to the Virginia State Lottery, the designated administrator for Decades of Dollars, to fund grand prize payments. All Decades of Dollars grand prizes are funded through the purchase of U.S. Treasury zero-coupon bonds. The Party Lottery which sold the grand prize winning ticket has the first option of purchasing the investments, but may defer the purchase to another Party Lottery. The KLC ended participation in the Decades of Dollars draw game in October 2014.

Win for Life grand prizes are paid in quarterly instalments for the life of a winner, or a minimum of ten years. The KLC recognized Win for Life prize expense after each draw and was based on actual draw results. Initial prize liability was based on an actuarial study. The KLC reviewed those statistics to actual results for any changes that needed to be made based on the age of the winner. All Win for Life grand prizes are funded through the purchase of U.S. Treasury zero-coupon bonds. The KLC ended participation in the Win for Life draw game in January 2011.

Lucky for Life grand prizes are paid in annual installments of \$365,000 for the life of a winner, or a minimum of 20 years. Lucky for Life second tier prizes are paid in annual installments of \$25,000 for the life of a winner, or a minimum of 20 years. A single lump-sum cash payment is also available. Lucky for Life prize expense is recognized after each draw and is based on actual draw results. All Lucky for Life prizes are funded through the purchase of U.S. Treasury zero-coupon bonds.

Powerball grand prizes are paid in 30 annual installments or in a single lump-sum payment equal to the estimated present cash value of 30 annual payments. The KLC recognizes Powerball prize expense after each draw and is based on actual draw results. A portion of Powerball sales of the KLC is remitted to MUSL to fund prize payments. MUSL purchases U.S. Treasury certificates and other U.S. Government backed investments to fund prize liability to Powerball winners electing annual installments.

Mega Millions grand prizes are paid in 30 annual installments or in a single lump-sum payment equal to the estimated present cash value of 30 annual payments. The KLC recognizes Mega Millions prize expense after each draw and is based on actual draw results. A portion of Mega Millions sales of the KLC is remitted to MUSL to fund prize payments. MUSL purchases U.S. Treasury certificates and other U.S. Government backed investments to fund prize liability to Mega Millions winners electing annual installments.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 2 – Summary of Significant Accounting Policies (Continued)

Cash and Equivalents

For financial statement purposes, the KLC considers all highly liquid investments with an original maturity of less than 90 days to be cash equivalents. This category includes repurchase agreements, which are recorded at cost.

Investments

Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. Fair value of investments is based on quoted market prices or matrix pricing. Investments are in U.S. Treasury zero-coupon bonds and other U.S. Government backed securities and are purchased to meet future instalment payments to grand prize winners. There are generally no realized gains or losses on investments, as it is the KLC's policy to hold the investments to maturity.

Capital Assets

Capital assets are carried at cost less accumulated depreciation. The KLC defines capital assets as assets with an initial, individual cost of more than \$5,000 and an estimated useful life in excess of one year. Depreciation is computed using the straight-line method over estimated lives of the assets. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. The estimated useful lives by general classification are as follows:

Buildings	30 years
Leasehold improvements	The lesser of the life of the lease or asset
Game equipment	5 years
Data processing equipment	5 years
Automobiles, furniture, and fixtures	3 - 5 years

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 2 – Summary of Significant Accounting Policies (Continued)

Amortization of leasehold improvements is computed using the straight-line method over lease terms ranging from three to five years. Interest related to construction of capital assets is capitalized. No interest was capitalized for the years ended June 30, 2016 and 2015.

Intangible assets consist of software internally generated by KLC personnel or by a third-party contractor on behalf of the KLC. Intangible assets are to be capitalized if the intangible asset costs in excess of \$100,000 and has a useful life of more than one year as dictated by GASB Statement No. 51. Amortization is computed using the straight-line method over estimated lives of the intangible assets. When intangible assets are retired or otherwise disposed of, the cost and related accumulated amortization are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. The KLC concluded that there were intangible assets totaling \$0 required to be capitalized in 2016, and \$144,000 in 2015.

Deposits with MUSL

Deposits are carried at cost. MUSL is a non-profit, government-benefit voluntary association created for the purpose of administering joint lottery games, such as Powerball. In January 2010, the Mega Millions states and MUSL signed an agreement for cross-selling of each other's products. MUSL currently includes 34 state lottery entities, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The chief executive officer of each member lottery serves on the MUSL Board of Directors. As a member of MUSL, the KLC is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities.

All prize reserve funds remitted, and the related interest earnings, will be returned to the KLC upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund.

Estimated Prize Liability

A liability for grand prize winners electing annual installments is recorded based on the cost of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the statement of net position, net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.

Draw game, non-grand prize liabilities are known and recorded daily after each draw. Instant prize liabilities are based on the prize statistics that each game is designed around, and are recognized at the same time as the associated revenues.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS **June 30, 2016 and 2015**

Note 2 – Summary of Significant Accounting Policies (Continued)

Net Position

Net position of the KLC are classified and displayed as three components:

- Net investment in capital assets - Consists of capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets.
- Restricted net position - Consists of assets with constraints placed on the use either by (1) external groups such as creditors, grantors, contributors, or laws or regulations of other governments; or (2) law through constitutional provisions or enabling legislation.
- Unrestricted net position - All other net position that do not meet the definition of "net investment in capital assets" or "restricted".

As of June 30, 2016 and 2015, the KLC had no restricted net position.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Accordingly, actual results could differ from those estimates.

Subsequent Events Evaluation

Since the KLC is part of the reporting entity of the Commonwealth and is included in the Commonwealth's Comprehensive Annual Financial Report as a blended component unit, management has evaluated subsequent events through September 20, 2016, and will re-evaluate subsequent events before the Commonwealth completes its Comprehensive Annual Financial Report in December 2016.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 2 – Summary of Significant Accounting Policies (Continued)

Recently Adopted Accounting Pronouncements

Adoption of these Statements did not have a material impact on the KLC's financial position or results of operations.

- GASB Statement No. 72, *Fair Value Measurement and Application*, issued February 2015. The provisions of this Statement are effective for periods beginning after June 15, 2015. This Statement provides guidance for determining a fair value measurement for financial reporting purposes. This Statement also provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements.
- GASB Statement No. 76, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, issued June 2015. The provisions of this Statement are effective for reporting periods beginning after June 15, 2015. The objective of this Statement is to identify, in the context of the current governmental financial reporting environment, the hierarchy of generally accepted accounting principles (GAAP). The "GAAP hierarchy" consists of the sources of accounting principles used to prepare financial statements of state and local governmental entities in conformity with GAAP and the framework for selecting those principles.

Note 3 – Cash and Cash Equivalents

The components of cash and cash equivalents for the years ended June 30, 2016 and 2015 consisted of the following (in thousands):

	<u>2016</u>	<u>2015</u>
Cash on deposits in banks	\$ 127	\$ 116
Checks issued against cash on deposit	(376)	(651)
Repurchase agreement sweep accounts	<u>13,236</u>	<u>6,686</u>
	<u>\$ 12,987</u>	<u>\$ 6,151</u>

All of the KLC's deposits are either insured or collateralized. All deposits exceeding the federal depository insurance coverage level are collateralized with securities held by the KLC's agents in the KLC's name. The KLC's policy regarding custodial credit risk for all overnight repurchase agreements to be fully collateralized by U.S. Government securities held by the KLC or by the KLC's agent in the KLC's name.

The KLC had deposits with financial institutions at June 30, 2016 and 2015 of approximately \$127 and \$116, respectively, which are fully covered by federal depository insurance.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 4 – Investments

The KLC categorizes its fair value measurements within the fair value hierarchy established by accounting principles generally accepted in the United States of America. The hierarchy is based on the valuation inputs to measure the fair value of the asset. Level 1 inputs are quoted prices in active markets for identical assets; Level 2 inputs are significant other observable inputs; Level 3 inputs are significant unobservable inputs. The KLC's investments in U.S. Treasury Strips are valued using quoted market prices (Level 1 inputs) and the U.S. Government backed investments are valued using similar assets using matrix pricing (Level 2 inputs).

At June 30, 2016, the KLC's investment balances were as follows (in thousands):

<u>Investment Type</u>	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Maturity</u>
U.S. Treasury Strips	\$ 10,954	\$ 10,954		Weighted average maturity of 5.24 years
Other U.S. Government backed	<u>5,099</u>	<u> </u>	<u>5,099</u>	Weighted average maturity of 5.09 years
Total	<u>\$ 16,053</u>	<u>\$ 10,954</u>	<u>\$ 5,099</u>	

At June 30, 2015, the KLC's investment balances were as follows (in thousands):

<u>Investment Type</u>	<u>Fair Value</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Maturity</u>
U.S. Treasury Strips	\$ 11,995	\$ 11,995		Weighted average maturity of 5.26 years
Other U.S. Government backed	<u>9,611</u>	<u> </u>	<u>9,611</u>	Weighted average maturity of 3.33 years
Total	<u>\$ 21,606</u>	<u>\$ 11,995</u>	<u>\$ 9,611</u>	

Interest Rate Risk – The KLC has a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates. It is the policy of the KLC to hold investments to maturity.

Credit Risk – This is the risk that a counter party will fail to fulfill its obligation. The KLC mitigates this risk through its investment policy, which limits the purchase of investments to U.S. Treasury Strips or other debt securities backed by the U.S. Government.

Concentration of Credit Risk – The KLC's general investment policy is to take a very conservative approach when investing KLC money. The policy requires 100 percent of KLC's investments must be in U.S. Treasuries or other debt securities backed by the U.S. Government.

Custodial Credit Risk – The custodial credit risk for investments is the risk that in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of its investments or collateral securities that are in the possession of another party. A trust agreement documenting the custody arrangement is executed between the custodian and the KLC. Such agreement provides, among other stipulations, that the securities are not assets of the custodian subject to disposition in the event of the insolvency of the custodian.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 4 – Investments (Continued)

The net decrease in the fair value of investments includes all changes in fair value that occurred during the year. The calculation of realized gains and losses is independent of the calculation of the change in the fair value of investments. Realized gains and losses of the current period include unrealized amounts from prior periods. The components of investment income for the years ended June 30, 2016 and 2015 consisted of the following (in thousands):

	<u>2016</u>	<u>2015</u>
Unrealized loss on investments	\$ (26)	\$ (921)
Accretion of investments	1,029	1,572
Security lending income	8	10
Interest income	<u>100</u>	<u>55</u>
Total investment income	<u>\$ 1,111</u>	<u>\$ 716</u>

When compared to the historical cost method, recording investments at fair value results in a decrease in income by approximately \$26 and \$921 in 2016 and 2015, respectively.

Unrealized gains accumulated in unrestricted net position at June 30, 2016 and 2015 are as follows (in thousands):

	<u>2016</u>	<u>2015</u>
Unrestricted net position excluding unrealized gains on investments	\$ 12,293	\$ 11,315
Unrealized gains on investments	<u>2,828</u>	<u>2,854</u>
Total unrestricted net position	<u>\$ 15,121</u>	<u>\$ 14,169</u>

The KLC is authorized by state statutes and investment policies approved by the Board of Directors to lend its investment securities. The lending is managed by the Commonwealth of Kentucky's securities lending agent. The KLC's securities are co-mingled with the rest of the Commonwealth's securities. Please refer to the Commonwealth of Kentucky's Comprehensive Annual Financial Report for details. All loans can be terminated on demand by either the KLC or the borrowers, although the average term of loans is approximately one day.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 4 – Investments (Continued)

The Commonwealth's securities lending agent and its affiliates are prohibited from borrowing the KLC's securities. The Commonwealth's securities lending agent lends cash collateral of 100 percent of the market value of the securities loaned. There are no restrictions on the amount of securities that can be lent at one time or to one borrower. The KLC cannot pledge or sell collateral securities unless the borrower defaults. The agent indemnifies the KLC from any losses from borrowers. At June 30, 2016 and 2015, the KLC had no credit risk exposure to borrowers because the amounts the KLC owed to borrowers exceed the amounts the borrowers owe to the KLC.

At June 30, 2016 and 2015, the KLC had loaned investments with fair values of approximately \$3,045 and \$2,223, respectively, to authorized brokers for a fee. Cash received from securities loans is invested in repurchase agreements with at least 102 percent collateral pledge. The repurchase agreements have carrying values of approximately \$3,368 and \$2,266 at June 30, 2016 and 2015, respectively, which are held by the KLC's securities custodian. The KLC loaned investments are included in the investments reported in the financial statements rather than the securities received in the exchange.

Note 5 – Accounts Receivable

Accounts receivable at June 30, 2016 and 2015 consisted of the following (in thousands):

	<u>2016</u>	<u>2015</u>
Accounts receivable	\$ 36,645	\$ 35,517
Allowance for doubtful accounts	<u>(291)</u>	<u>(340)</u>
Accounts receivable, net	<u>\$ 36,354</u>	<u>\$ 35,177</u>

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 6 – Capital Assets

Capital asset activity for the year ended June 30, 2016 was as follows (in thousands):

	Beginning Balance	Increases	Decreases	Ending balance
Capital assets not being depreciated				
Land	\$ 442	\$ 0	\$ 0	\$ 442
Net capital assets, non-depreciable	442	0	0	442
Capital assets being depreciated				
Buildings	7,647	87	0	7,734
Game equipment	2,158	0	0	2,158
Data processing equipment and software	16,729	375	(246)	16,858
Automobiles, furniture, and fixtures	3,487	89	(4)	3,572
Total other capital assets at cost	30,021	551	(250)	30,322
Less accumulated depreciation for				
Buildings	(4,330)	(255)	0	(4,585)
Game equipment	(2,033)	(66)	0	(2,099)
Data processing equipment and software	(14,257)	(765)	30	(14,992)
Automobiles, furniture, and fixtures	(3,154)	(227)	4	(3,377)
Total accumulated depreciation	(23,774)	(1,313)	34	(25,053)
Net capital assets, depreciable	6,247	(762)	(216)	5,269
Total capital assets, net	\$ 6,689	\$ (762)	\$ (216)	\$ 5,711

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 6 – Capital Assets (Continued)

Capital asset activity for the year ended June 30, 2015 was as follows (in thousands):

	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
Capital assets not being depreciated				
Land	\$ 442	\$ 0	\$ 0	\$ 442
Net capital assets, non-depreciable	<u>442</u>	<u>0</u>	<u>0</u>	<u>442</u>
Capital assets being depreciated				
Buildings	7,583	64	0	7,647
Game equipment	2,158	0	0	2,158
Data processing equipment and software	16,158	588	(17)	16,729
Automobiles, furniture, and fixtures	<u>3,668</u>	<u>265</u>	<u>(446)</u>	<u>3,487</u>
Total other capital assets at cost	<u>29,567</u>	<u>917</u>	<u>(463)</u>	<u>30,021</u>
Less accumulated depreciation for				
Buildings	(4,078)	(252)	0	(4,330)
Game equipment	(1,968)	(65)	0	(2,033)
Data processing equipment and software	(13,517)	(757)	17	(14,257)
Automobiles, furniture, and fixtures	<u>(3,348)</u>	<u>(252)</u>	<u>446</u>	<u>(3,154)</u>
Total accumulated depreciation	<u>(22,911)</u>	<u>(1,326)</u>	<u>463</u>	<u>(23,774)</u>
Net capital assets, depreciable	<u>6,656</u>	<u>(409)</u>	<u>0</u>	<u>6,247</u>
Total capital assets, net	<u>\$ 7,098</u>	<u>\$ (409)</u>	<u>\$ 0</u>	<u>\$ 6,689</u>

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 7 – Compensated Absences

It is the KLC’s policy to permit employees to accumulate earned but unused sick pay and vacation benefits. There is no liability recorded for unpaid accumulated sick leave since the KLC does not have a policy to pay unused amounts when employees separate from service. All vacation pay is accrued when incurred. Employees can accrue no more than up to 16 weeks of vacation. Accrued vacation at June 30, 2016 and 2015, included in accrued expenses in the accompanying statements of net position, consisted of the following (in thousands):

	2016	2015
Current	\$ 160	\$ 139
Compensated absences, less current portion	1,035	1,020
Total compensated absences	\$ 1,195	\$ 1,159

Years Ended June 30,	Beginning Balance	Increases	Decreases	Ending Balance
2016	\$ 1,159	\$ 127	\$ (91)	\$ 1,195
2015	1,107	212	(160)	1,159

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 8 – Estimated Prize Liability

Estimated prize liability at June 30, 2016 and 2015 consisted of the following (in thousands):

	<u>2016</u>	<u>2015</u>
Current:		
Grand prizes	\$ 1,922	\$ 7,129
Other prizes	<u>24,202</u>	<u>20,691</u>
Total current portion	<u>\$ 26,124</u>	<u>\$ 27,820</u>
Long-term:		
Grand prizes	<u>\$15,034</u>	<u>\$ 15,697</u>

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 8 – Estimated Prize Liability (Continued)

Liability activity of grand prize awards payable was as follows (in thousands):

Years Ended June 30,	<u>Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending Balance</u>
2016	\$ 22,826	\$ 1,283	\$ (7,153)	\$ 16,956
2015	36,192	2,474	(15,840)	22,826

Liabilities for future payments of grand prize liabilities are summarized as follows (in thousands):

Years Ending June 30,	
2017	\$ 1,922
2018	1,807
2019	1,807
2020	1,542
2021	1,332
2022 through 2026	6,302
2027 through 2031	2,130
2032 through 2036	1,716
2037 through 2041	1,196
2042 through 2046	676
2047 through 2051	<u>312</u>
Total	20,742
Less unamortized discount	<u>(3,786)</u>
Total at present value	16,956
Less current portion	<u>(1,922)</u>
Total long-term portion at present value	<u><u>\$ 15,034</u></u>

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately \$1,029 and \$1,572 in 2016 and 2015, respectively, is included in interest expense. These amounts comprise the entire amounts of interest expense for the years ended June 30, 2016 and 2015.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 9 – Retirement Plan

Kentucky Revised Statute (KRS) 154A.080 states, "The Corporation shall provide a retirement plan for its employees." The KLC Board of Directors has the authority to establish contribution requirements and amend any of the plan's provisions. The KLC has a money-purchase retirement plan (Plan) covering all full-time employees that is a Defined Contribution plan. The Plan is currently administered by Fidelity Investments. Upon retirement or departure of employment from the KLC, participants have the option to leave their assets in the Plan or withdraw from the Plan completely. The fair value of investments is determined by the quoted market prices for each investment at the close of market. Prior to April 1, 2007, under the terms of the Plan, the KLC and employees each contribute 6.2 percent (Mandatory and Supplemental Contributions) of the employee's compensation for the calendar year, not to exceed the Taxable Wage Base as defined by the Plan. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan. On and after April 1, 2007, a participant, as defined by the Plan, who makes and for whom the employer makes payments into the Social Security System under the Federal Insurance Contributions Act, shall not be eligible for the Mandatory and Supplemental Contributions.

The KLC also makes a contribution (Basic Contribution) equal to eight percent of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

For 2016 and 2015, total payroll was approximately \$11.1 and \$10.7 million, respectively. During 2016 and 2015, the KLC's contributions were calculated using the base salary amount for eligible full-time employees of \$6.4 and \$6.6 million, respectively, for the 6.2 percent employer contribution, and \$10.3 and \$9.4 million, respectively, for the eight percent employer contribution. Employer contributions actually made to the Plan were approximately \$1.2 and \$1.2 million (19.2 percent and 17.5 percent of covered payroll) and employee contributions to the Plan were approximately \$394,000 and \$411,000 (6.2 percent and 6.2 percent of covered payroll) in 2016 and 2015, respectively. At June 30, 2016 and 2015, the KLC had an outstanding liability of approximately \$71,000 and \$54,000 owed to the Plan, as part of the accrued salaries balance.

During 2016 and 2015, forfeitures of \$0 and \$10,000 were reflected as a reduction to retirement plan expense.

In addition to the Plan, the KLC's employees are also eligible to participate in two deferred compensation plans sponsored by the Commonwealth. These plans are organized as a Section 457 plan and as a Section 401(k) plan under the Internal Revenue Code. Both plans permit employees to defer a portion of their salary until future years. Deferred compensation is not available to employees until termination, retirement, death, or financial hardship. The Commonwealth's Comprehensive Annual Financial Reports should be referred to for further disclosures related to the deferred compensation plans. The KLC provides no matching of contributed funds to the deferred compensation plans.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 10 – Leases

The KLC has entered into operating leases for the rental of office equipment and office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

<u>Years Ending June 30,</u>	
2017	\$ 25
2018	20
2019	<u>9</u>
	<u>\$ 54</u>

Total rental expense for 2016 and 2015 was approximately \$152 and \$458, respectively.

Note 11 – Payments to the Commonwealth

Payments to the Commonwealth represent transfers of funds from the KLC to the Commonwealth's General Fund and the Kentucky Educational Excellence Scholarship (KEES) Program Reserve Account. The payments to the General Fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The payments to the KEES Program Reserve Account are used to provide college or technical school scholarships to Kentucky high school students. The amounts payable to the KEES Program Reserve Account result from unclaimed prizes on instant and draw games. Prizes not claimed within 180 days of the drawing date for draw games or game ending date for instant tickets are forfeited and considered unclaimed. In accordance with KRS 154A.110(3), any unclaimed prize money from these games may be retained by the KLC and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the KLC for any public purpose. During the years ended June 30, 2016 and 2015, all unclaimed prize money was transferred to the KEES Program Reserve Account as required by HB 235 of the 2014 Regular Session. Payments are made as necessary at the end of each quarter.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2016 and 2015

Note 11 – Payments to the Commonwealth (Continued)

Payments, including amounts accrued, to the Commonwealth for the years ended June 30, 2016 and 2015 included payments to the following funds (in thousands):

	<u>2016</u>	<u>2015</u>
General Fund	\$ 245,127	\$ 226,778
KEES Scholarship Reserve Fund	<u>7,917</u>	<u>9,323</u>
	<u>\$ 253,044</u>	<u>\$ 236,101</u>

Note 12 – Risk Management

The KLC is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; data breach; and natural disasters. The KLC has purchased commercial insurance to cover these risks except for workers' compensation and damage to buildings and personal property for which the KLC utilizes the Commonwealth's Risk Management Fund to cover the exposure to these potential losses. The Commonwealth's Comprehensive Annual Financial Reports should be referred to for additional disclosures related to the Risk Management Fund. The KLC also retains risk of loss for the value of certain gaming equipment located at retail establishments. As of June 30, 2016 and 2015, there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years.

Note 13 – Commitments and Contingencies

The KLC is a party to various litigation and other claims in the ordinary course of business. KLC management is of the opinion, based upon the advice of legal counsel, that the ultimate resolution of these matters will not have a material effect on the financial statements of the KLC.

**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**

Auditor of Public Accounts,
the Commonwealth of Kentucky, and
the Board of Directors of the
Kentucky Lottery Corporation
Louisville, Kentucky

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 Statement of Net Position, Statement of Revenues, Expenses and Changes in Net Position, and the Statement of Cash Flows of the Kentucky Lottery Corporation, a component unit of the Commonwealth of Kentucky, as of and for the year ended June 30, 2016 and the related notes to the financial statements, and have issued our report thereon dated September 20, 2016.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Kentucky Lottery Corporation's internal control over financial reporting (internal control) to determine 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 Kentucky Lottery Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of Kentucky Lottery Corporation's internal control.

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

**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 (CONTINUED)**

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

Compliance and Other Matters

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

Purpose of this Report

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

Wardrig, Shymanski & Company, P.S.C.

Louisville, Kentucky
September 20, 2016

KENTUCKY LOTTERY CORPORATION

SCHEDULE OF FINDINGS **Year Ended June 30, 2016**

Schedule of auditor's results

We have issued an unmodified opinion, dated September 20, 2016, on the financial statements of the Kentucky Lottery Corporation as of and for the year ended June 30, 2016.

Our audit disclosed no instances of non-compliance which are material to the Kentucky Lottery Corporation's financial statements.

Findings relating to the financial statements

Our audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.

KENTUCKY LOTTERY CORPORATION

SCHEDULE OF PRIOR AUDIT FINDINGS AND THEIR RESOLUTIONS
Year Ended June 30, 2016

The prior year's audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.