



CALIFORNIA STATE LOTTERY FUND

Financial Statements

June 30, 2014

(With Independent Auditors' Report Thereon)



KPMG LLP
500 Capitol Mall, Ste 2100
Sacramento, CA 95814-4754

Independent Auditors' Report

The California State Lottery Commission
Sacramento, California

We have audited the accompanying statement of net position of the California State Lottery Fund (the Lottery) as of June 30, 2014, and the related statements of revenues, expenses, and changes in net position and cash flows for the year then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this 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. 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.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the California State Lottery Fund as of June 30, 2014, and the changes in its financial position and its cash flows thereof for the year then ended in accordance with accounting principles generally accepted in the United States of America.



Emphasis of Matter

As discussed in note 1, the financial statements present only the California State Lottery Fund and do not purport to, and do not, present fairly the financial position of the State of California as of June 30, 2014, the changes in its financial position, or, where applicable, its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America. Our opinion is not modified with respect to this matter.

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 3–9 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in 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.

KPMG LLP

Sacramento, California
October 14, 2014

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis of the California State Lottery's financial performance provides an overview of financial activities for the fiscal year ended June 30, 2014. Please read it in conjunction with the California State Lottery Financial Statements that follow this section.

FINANCIAL HIGHLIGHTS

- Fiscal year 2013-14 saw sales of \$5.03 billion, once again the highest sales in California State Lottery (Lottery) history. This represents an increase of approximately \$588.8 million or 13.2 percent over the prior year.
- The funds the Lottery allocated to California public schools were also the highest in Lottery history at nearly \$1.35 billion, making this the 14th consecutive year the Lottery has transferred over \$1 billion to its beneficiary.
- Scratchers[®] games, Lotto games, and Hot Spot[®] continue to be strong performers:
 - Lotto games - Powerball[®], Mega Millions[®], and SuperLotto Plus[®] - had a combined growth of 31.5 percent or \$295 million during 2013-14. The first full year of Powerball sales, and large jackpots in both Powerball and Mega Millions, contributed to this growth.
 - The Hot Spot monitor game had a sales increase of 22 percent or \$34 million over the last fiscal year. This is the fourth straight year sales for this popular Keno-style game have increased.
 - Scratchers revenues exceeded those of the previous fiscal year by 9.3 percent or \$278.8 million. The increase in Scratchers sales was due to continued demand for \$5 and \$10 price-point tickets and the introduction of the Lottery's first \$20 price-point game.
- The Lottery returned more than \$3.4 billion to the public in the form of prizes and retailer compensation. Of this, the Lottery paid approximately \$3.1 billion in prizes to players, and approximately \$345.5 million in commissions, cashing bonuses, and other applicable fees to retailers.
- The assets of the Lottery were \$101.1 million greater than the liabilities for the year ended June 30, 2014, which is attributable primarily to realized and unrealized gains on Lottery investments used to fund future payments due on annuitized Lottery prizes.

OVERVIEW OF THE FINANCIAL STATEMENTS

These required statements offer short-term and long-term financial information about the Lottery. The statement of net position provides information about the nature and amounts of investments in resources (assets) and obligations (liabilities) at the close of the fiscal year. All of the current year's revenues and expenses are accounted for in the statement of revenues, expenses, and changes in net position. This statement measures the success of the Lottery's operations over the past year. The final required financial statement is the statement of cash flows. The primary purpose of this statement is to provide information about the Lottery's cash receipts and cash payments during the reporting period. The statement reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities, and provides answers to such questions as where did cash come from and what was cash used for. The financial statements are prepared on the accrual basis in accordance with accounting principles generally accepted in the United States of America. The Lottery is structured as a single enterprise fund with revenues recognized when earned, not when received.

MANAGEMENT'S DISCUSSION AND ANALYSIS

FINANCIAL ANALYSIS

NET POSITION

A summary of the California State Lottery's net position is presented below:

	June 30, 2013	June 30, 2014	Dollar Change	Percent Change
Current and other assets	\$ 1,701,203,472	\$ 1,662,602,592	\$ (38,600,880)	(2.3 %)
Capital assets	82,251,499	95,330,193	13,078,694	15.9 %
Total assets	<u>\$ 1,783,454,971</u>	<u>\$ 1,757,932,785</u>	<u>\$ (25,522,186)</u>	<u>(1.4 %)</u>
Current liabilities	\$ 939,818,016	\$ 932,530,147	\$ (7,287,869)	(0.8 %)
Non-current liabilities	741,569,254	724,293,681	(17,275,573)	(2.3 %)
Total liabilities	<u>\$ 1,681,387,270</u>	<u>\$ 1,656,823,828</u>	<u>\$ (24,563,442)</u>	<u>(1.5 %)</u>
Net investment in capital assets	\$ 82,251,499	\$ 95,330,193	\$ 13,078,694	15.9 %
Restricted by legislation	102,067,701	101,108,957	(958,744)	(0.9 %)
Unrestricted deficit	(82,251,499)	(95,330,193)	(13,078,694)	15.9 %
Total net position	<u>\$ 102,067,701</u>	<u>\$ 101,108,957</u>	<u>\$ (958,744)</u>	<u>(0.9 %)</u>

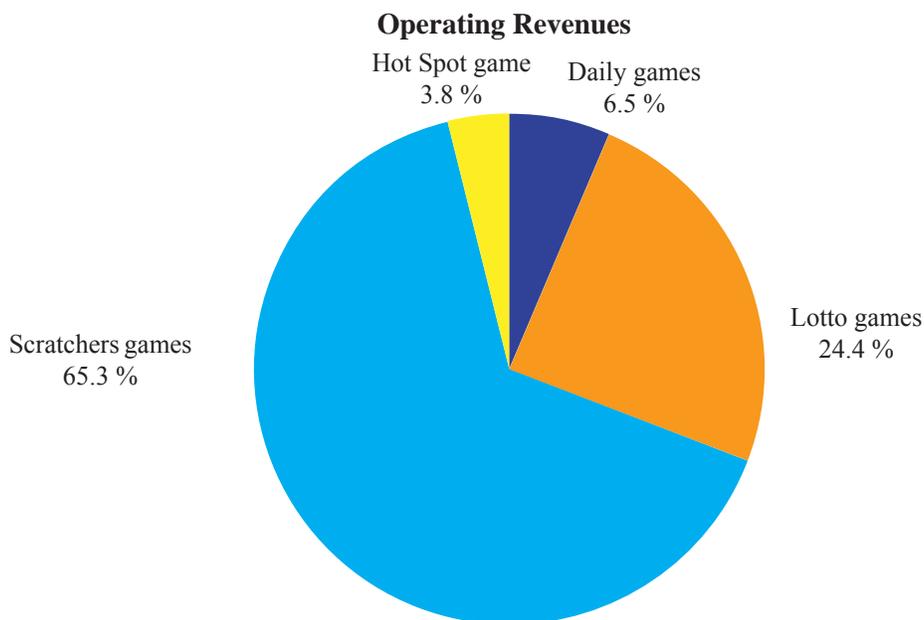
A summary of the California State Lottery's change in net position is presented below:

	June 30, 2013	June 30, 2014	Dollar Change	Percent Change
Operating revenues – Lottery sales	\$ 4,445,874,040	\$ 5,034,661,424	\$ 588,787,384	13.2 %
Prizes	2,652,095,102	3,082,376,405	430,281,303	16.2 %
Sales after prizes	<u>\$ 1,793,778,938</u>	<u>\$ 1,952,285,019</u>	<u>\$ 158,506,081</u>	<u>8.8 %</u>
Game costs	380,097,433	445,540,629	65,443,196	17.2 %
Income before operating expenses	<u>\$ 1,413,681,505</u>	<u>\$ 1,506,744,390</u>	<u>\$ 93,062,885</u>	<u>6.6 %</u>
Operating expenses	152,892,055	180,092,492	27,200,437	17.8 %
Operating income	<u>\$ 1,260,789,450</u>	<u>\$ 1,326,651,898</u>	<u>\$ 65,862,448</u>	<u>5.2 %</u>
Non-operating expenses	(1,314,319,304)	(1,327,610,642)	(13,291,338)	1.0 %
Change in net position	<u>\$ (53,529,854)</u>	<u>\$ (958,744)</u>	<u>\$ 52,571,110</u>	<u>(98.2 %)</u>
Total net position – beginning of year	155,597,555	102,067,701	(53,529,854)	(34.4 %)
Total net position – end of year	<u>\$ 102,067,701</u>	<u>\$ 101,108,957</u>	<u>\$ (958,744)</u>	<u>(0.9 %)</u>

MANAGEMENT'S DISCUSSION AND ANALYSIS

REVENUES

The following chart shows the major sources and the percentages of operating revenues for the fiscal year ended June 30, 2014:



A summary of total revenues for the fiscal years ended June 30, 2013 and 2014, and the amount and percentage of change in relation to prior year amounts is as follows:

	June 30, 2013	June 30, 2014	Dollar Change	Percent Change
Operating revenues:				
Lotto games	\$ 935,660,488	\$ 1,230,661,985	\$ 295,001,497	31.5 %
Scratchers games	3,010,119,929	3,288,922,307	278,802,378	9.3 %
Hot Spot game	154,403,306	188,390,807	33,987,501	22.0 %
Daily games	345,690,317	326,686,325	(19,003,992)	(5.5 %)
Total operating revenues	<u>\$ 4,445,874,040</u>	<u>\$ 5,034,661,424</u>	<u>\$ 588,787,384</u>	<u>13.2 %</u>
Non-operating revenues:				
Unrealized gains (losses) on investments	\$ (42,158,289)	\$ 4,829,544	\$ 46,987,833	(111.5 %)
Interest accreted/earned on investments	38,405,632	37,209,821	(1,195,811)	(3.1 %)
Interest on funds held by State Treasurer	1,220,691	1,249,094	28,403	2.3 %
Other income	47,879	27,400	(20,479)	(42.8 %)
Total non-operating revenues	<u>\$ (2,484,087)</u>	<u>\$ 43,315,859</u>	<u>\$ 45,799,946</u>	<u>(1843.7 %)</u>
Total revenues	<u><u>\$ 4,443,389,953</u></u>	<u><u>\$ 5,077,977,283</u></u>	<u><u>\$ 634,587,330</u></u>	<u><u>14.3 %</u></u>

MANAGEMENT'S DISCUSSION AND ANALYSIS

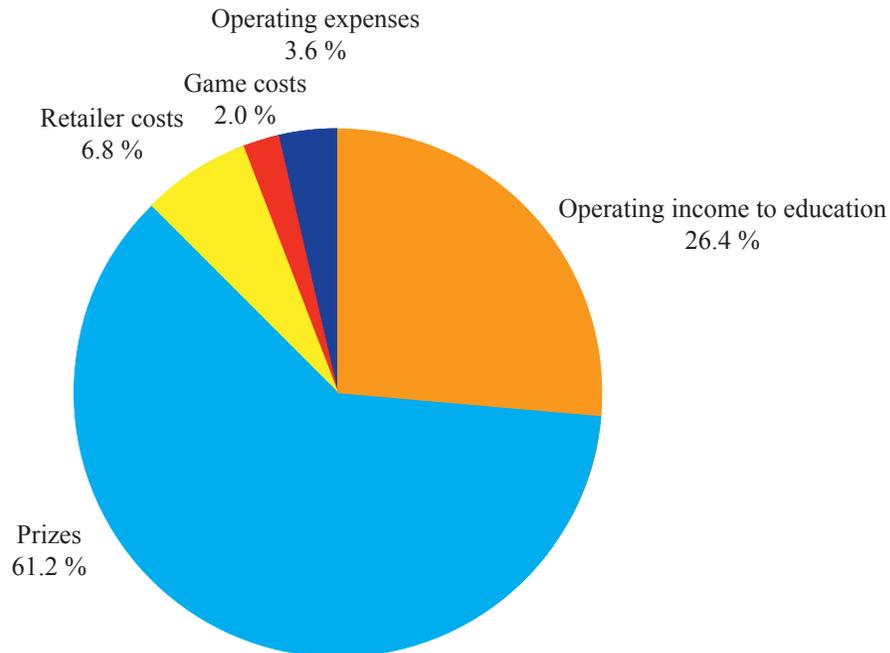
REVENUES (continued)

Lottery operating revenue increased \$588.8 million or 13.2 percent over the previous year, increasing to more than \$5 billion. Lotto games led this increase in sales, with a growth of 31.5 percent or \$295 million, due to large jackpots in both the Mega Millions and Powerball games. Hot Spot sales increased 22 percent during 2013-14, the first full year of higher prize payouts for this game. Promotions and an increase in social media related to Hot Spot also helped to increase sales. Scratchers sales increased 9.3 percent over the previous year primarily due to the introduction of a \$20 price-point game as well as the continued popularity of \$5 and \$10 price-point games. Non-operating revenue increased \$45.8 million due primarily to unrealized gains on investments purchased to pay annuitized prizes.

EXPENSES

The following chart shows prizes, game costs, operating expenses, and allocation to education as a percentage of operating revenues for the fiscal year ended June 30, 2014:

**Prizes and Operating Income Returned to the Public, and Expenses of the Lottery
as a Percentage of Operating Revenues**



MANAGEMENT'S DISCUSSION AND ANALYSIS

EXPENSES (continued)

The Lottery is required to return not less than 87 percent of annual revenues to the public in the form of prizes and contributions to education, and to spend no more than 13 percent of annual revenues on operating expenses of the Lottery.

Lottery prize payments, contributions to education, and operating expenses are shown below as a percentage of operating revenue for the year ended June 30, 2014.

Lottery Sales	\$ 5,034,661,424	100.0 %
Revenue returned to the public		
Prizes	\$ 3,082,376,405	61.2 %
Operating income to education	<u>1,326,663,398</u>	<u>26.4 %</u>
Total revenue returned to the public	<u>\$ 4,409,039,803</u>	<u>87.6 %</u>
Expenses of the Lottery		
Retailer costs	\$ 345,513,054	6.8 %
Game costs	100,027,575	2.0 %
Operating expenses	180,092,492	3.6 %
Less bartered operating expenses	<u>(11,500)</u>	<u>0.00 %</u>
Total expenses of the Lottery	<u>\$ 625,621,621</u>	<u>12.4 %</u>

A summary of the total funds transferred by the Lottery to the education community for the fiscal year ended June 30, 2014, is shown below.

Revenues to Education	
Allocation of sales - operating income	\$ 1,326,663,398
Unclaimed prizes directly allocated to the Education Fund	21,672,671
Interest income	1,249,094
Other income	27,400
Less bartered income	<u>(11,500)</u>
Total declared for allocation to the Education Fund	<u><u>\$ 1,349,601,063</u></u>

MANAGEMENT'S DISCUSSION AND ANALYSIS

EXPENSES (continued)

A summary of expenses for the fiscal years ended June 30, 2013 and 2014, and the amount and percentage change in relation to prior year amounts is as follows:

	<u>June 30, 2013</u>	<u>June 30, 2014</u>	<u>Dollar Change</u>	<u>Percent Change</u>
Prizes:				
Draw game prizes	\$ 723,654,671	\$ 879,474,109	\$ 155,819,438	21.5 %
Scratchers game prizes	1,928,440,431	2,202,902,296	274,461,865	14.2 %
Total prizes	<u>\$ 2,652,095,102</u>	<u>\$ 3,082,376,405</u>	<u>\$ 430,281,303</u>	<u>16.2 %</u>
Game costs:				
Retailer costs	\$ 302,946,127	\$ 345,513,054	\$ 42,566,927	14.1 %
Draw/Scratchers game costs	77,151,306	100,027,575	22,876,269	29.7 %
Total game costs	<u>\$ 380,097,433</u>	<u>\$ 445,540,629</u>	<u>\$ 65,443,196</u>	<u>17.2 %</u>
Operating expenses:				
Salaries, wages, and benefits	\$ 56,781,125	\$ 66,108,672	\$ 9,327,547	16.4 %
Advertising	56,044,193	63,699,190	7,654,997	13.7 %
Promotion, public relations, and point of sale	7,854,549	14,507,326	6,652,777	84.7 %
Other professional services	12,651,314	13,331,461	680,147	5.4 %
Depreciation and amortization	5,980,272	6,075,176	94,904	1.6 %
Other general and administrative expenses	13,580,602	16,370,667	2,790,065	20.5 %
Total operating expenses	<u>\$ 152,892,055</u>	<u>\$ 180,092,492</u>	<u>\$ 27,200,437</u>	<u>17.8 %</u>
Non-operating expenses:				
Allocation to Education Fund	\$ 1,262,058,020	\$ 1,327,928,392	\$ 65,870,372	5.2 %
Interest imputed on annuitized prize liability	49,777,197	42,998,109	(6,779,088)	(13.6 %)
Total non-operating expenses	<u>\$ 1,311,835,217</u>	<u>\$ 1,370,926,501</u>	<u>\$ 59,091,284</u>	<u>4.5 %</u>
Total expenses	<u>\$ 4,496,919,807</u>	<u>\$ 5,078,936,027</u>	<u>\$ 582,016,220</u>	<u>12.9 %</u>

Prize expense and game costs increased as sales increased. Additionally, Scratchers prize expense increased due to the continued emphasis on games with higher prize payouts, and game costs increased with the purchase of gaming equipment and signs. Advertising expense increased due primarily to a Powerball awareness campaign and to more jackpot alerts. The increase in promotion, public relations and point of sale was due to a point of sale refresh effort, and to a new promotions team that held numerous promotional events throughout the state. Salaries increased as the Lottery added 61 positions during fiscal year 2013-14. Other general and administrative expense increased due to the additional staff, mobile devices supplied to the sales force, additional sales conferences, and costs related to a new method of shipping Scratchers tickets back to the warehouses.

MANAGEMENT'S DISCUSSION AND ANALYSIS

CAPITAL ASSETS

A summary of capital assets as of June 30, 2013 and 2014, and the amount and percentage of change in relation to prior year amounts is as follows:

	June 30, 2013	June 30, 2014	Dollar Change	Percent Change
Non-depreciable capital assets:				
Land	\$ 6,469,219	\$ 6,469,219	\$ -	0.0 %
Depreciable capital assets:				
Gaming equipment	\$ 14,392,117	\$ 14,362,992	\$ (29,125)	(0.2 %)
Vending machines	30,044,295	43,462,289	13,417,994	44.7 %
Buildings	69,986,320	69,986,320	-	0.0 %
Data processing equipment	13,361,656	12,406,696	(954,960)	(7.1 %)
Office furniture and equipment	7,642,537	7,756,106	113,569	1.5 %
Leasehold improvements	813,658	813,658	-	0.0 %
Other	6,579,301	8,495,074	1,915,773	29.1 %
Subtotal	<u>\$ 142,819,884</u>	<u>\$ 157,283,135</u>	<u>\$ 14,463,251</u>	<u>10.1 %</u>
Less accumulated depreciation	<u>(67,037,604)</u>	<u>(68,422,161)</u>	<u>(1,384,557)</u>	<u>2.1 %</u>
Total depreciable capital assets	<u>\$ 75,782,280</u>	<u>\$ 88,860,974</u>	<u>\$ 13,078,694</u>	<u>17.3 %</u>
Capital assets, net	<u>\$ 82,251,499</u>	<u>\$ 95,330,193</u>	<u>\$ 13,078,694</u>	<u>15.9 %</u>

Capital assets increased 15.9 percent over the previous fiscal year primarily due to the purchase of new, updated vending machines. Additionally, the Lottery purchased vehicles for new sales staff, to replace old vehicles, and for use at promotional events. More information on the Lottery's capital assets can be found in Note 5.

LONG - TERM DEBT

At June 30, 2014, the California State Lottery had approximately \$724.3 million in non-current liabilities, a decrease of 2.3 percent over the previous fiscal year. This decrease is attributable to prize liability, as the majority of jackpot and annuity-level prize winners choose the cash option rather than annuitized payments. In addition, approximately \$7.3 million was accrued for the Net OPEB Obligation (NOO) as required by Statement No. 45 of the Governmental Accounting Standards Board, bringing the total accrued OPEB liability to \$41.1 million as of June 30, 2014. Additional detailed information on long-term prize liability may be found in Note 6 and additional information on the NOO may be found in Note 10.

CONTACTING THE LOTTERY'S FINANCIAL MANAGER

This financial report is designed to provide a general overview of the Lottery's finances and to demonstrate the accountability for the money the Lottery earns. If you have questions about this report or need additional financial information, contact the California State Lottery, Finance Division, 700 N. 10th Street, Sacramento, CA 95811.

CALIFORNIA STATE LOTTERY FUND
STATEMENT OF NET POSITION
JUNE 30, 2014

ASSETS

Current assets:	
Cash and cash equivalents (Note 2)	\$ 316,260,517
Investments, current portion (Note 2)	116,629,017
Accounts receivable, net of allowances (Note 3)	404,238,835
Due from state funds (Note 4)	295,282
Ticket inventories	7,486,214
Other	<u>5,303,833</u>
 Total current assets	 \$ <u>850,213,698</u>
Non-current assets:	
Investments, less current portion (Note 2)	\$ 796,206,592
Capital assets, net (Note 5)	95,330,193
Long-term prepaid charges, net	<u>16,182,302</u>
 Total non-current assets	 \$ <u>907,719,087</u>
 TOTAL ASSETS	 \$ <u><u>1,757,932,785</u></u>

LIABILITIES

Current liabilities:	
Accounts payable	\$ 52,691,594
Current prize liability (Note 6)	551,259,865
Due to state funds (Note 7)	314,911,688
Accrued liabilities	10,688,184
Unearned revenue	<u>2,978,816</u>
 Total current liabilities	 \$ <u>932,530,147</u>
Non-current liabilities:	
Prize liability, less current portion (Note 6)	\$ 683,179,681
Other postemployment benefits (Note 10)	<u>41,114,000</u>
 Total non-current liabilities	 \$ <u>724,293,681</u>
 TOTAL LIABILITIES	 \$ <u><u>1,656,823,828</u></u>

Commitments and contingencies (Notes 8 and 11)

NET POSITION

Net investment in capital assets (Note 5)	\$ 95,330,193
Restricted by legislation for prizes (Note 2)	101,108,957
Unrestricted deficit	<u>(95,330,193)</u>
 TOTAL NET POSITION	 \$ <u><u>101,108,957</u></u>

See accompanying notes to the financial statements.

CALIFORNIA STATE LOTTERY FUND
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
YEAR ENDED JUNE 30, 2014

Operating revenues: Lottery sales	\$ 5,034,661,424
Prizes	<u>3,082,376,405</u>
Sales after prizes	<u>\$ 1,952,285,019</u>
Less game costs:	
Retailer costs	\$ 345,513,054
Draw game costs	70,486,877
Scratchers [®] game costs	<u>29,540,698</u>
Total game costs	<u>\$ 445,540,629</u>
Income before operating expenses	<u>\$ 1,506,744,390</u>
Operating expenses:	
Salaries, wages, and benefits	\$ 66,108,672
Advertising	63,699,190
Promotion, public relations, and point of sale	14,507,326
Other professional services	13,331,461
Depreciation and amortization	6,075,176
Other general and administrative expenses	<u>16,370,667</u>
Total operating expenses	<u>\$ 180,092,492</u>
Operating income	<u>\$ 1,326,651,898</u>
Non-operating (expenses) revenues:	
Investment earnings (Note 9)	\$ 43,288,459
Interest expense imputed on annuitized prize liability	(42,998,109)
Other income	27,400
Allocation to Education Fund (Note 7)	<u>(1,327,928,392)</u>
Total non-operating expenses	<u>\$ (1,327,610,642)</u>
Change in net position	\$ (958,744)
Total net position - beginning balance	<u>102,067,701</u>
Total net position - ending balance	<u>\$ 101,108,957</u>

See accompanying notes to the financial statements.

CALIFORNIA STATE LOTTERY FUND
STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2014

Cash flows from operating activities:	
Receipts from customers	\$ 5,013,486,952
Payments for prizes	(3,567,223,613)
Payments to retailers	(345,503,499)
Payments to suppliers for goods and services	(218,881,446)
Payments to employees	(50,725,767)
Internal activity-payments to state funds	(15,070,429)
Receipts from other states	499,057,503
Other receipts	<u>141,301</u>
Net cash flows provided by operating activities	<u>\$ 1,315,281,002</u>
Cash flows from non-capital financing activities:	
Distributions to Education Fund	<u>\$ (1,415,701,540)</u>
Net cash flows used in non-capital financing activities	<u>\$ (1,415,701,540)</u>
Cash flows from capital and related financing activities:	
Proceeds from disposal of property and equipment	\$ 38,746
Payments for capital assets	<u>(19,177,790)</u>
Net cash flows used in capital and related financing activities	<u>\$ (19,139,044)</u>
Cash flows from investing activities:	
Purchase of securities	\$ (65,036,957)
Proceeds from matured securities	134,853,000
Investment Portfolio and SMIF interest received	<u>23,079,585</u>
Net cash flows provided by investing activities	<u>\$ 92,895,628</u>
Decrease in cash and cash equivalents	<u>\$ (26,663,954)</u>
Cash and cash equivalents at July 1, 2013	<u>\$ 342,924,471</u>
Cash and cash equivalents at June 30, 2014	<u><u>\$ 316,260,517</u></u>

See accompanying notes to the financial statements.

**CALIFORNIA STATE LOTTERY FUND
STATEMENT OF CASH FLOWS
YEAR ENDED JUNE 30, 2014**

Cash flows from operating activities:	
Operating income	\$ 1,326,651,898
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation and amortization	\$ 6,075,176
Provision for doubtful accounts	464,780
Provision for returned tickets	(175,065)
Provision for free ticket redemptions	632,358
Net non-cash other postemployment cost	7,326,000
Net gain on retirement or disposal of capital assets	(14,826)
Other income	27,400
Changes in assets and liabilities:	
Increase in accounts receivable	(42,663,781)
Decrease in ticket inventories	376,915
Decrease in other assets	464,159
Decrease in long-term prepaid charges	3,230,391
Decrease in accounts payable	(1,811,824)
Increase in prize liability	14,210,295
Decrease in due to state funds	(145,017)
Increase in accrued liabilities	793,967
Decrease in unearned revenues	(161,824)
Net cash flows provided by operating activities	<u>\$ 1,315,281,002</u>

Supplemental disclosure of non-cash activities:

Interest accreted on annuitized prizes	<u>\$ 42,998,109</u>
Unclaimed prizes directly allocated to the Education Fund	<u>\$ 21,672,671</u>
Unrealized gain on investments	<u>\$ 4,829,544</u>
Interest accreted on zero coupon bonds	<u>\$ 15,608,267</u>

See accompanying notes to the financial statements.

CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

The California State Lottery Fund (the Fund) was created with the passage of the California State Lottery Act of 1984 (the Act). The Fund is a part of the primary government of the State of California and is reported as a proprietary fund and business-type activity within the State of California's financial statements. The purpose of the Act is to support the preservation of the rights, liberties, and welfare of the people by providing additional monies to benefit education without the imposition of additional or increased taxes. The operations of the Fund are separate and distinct from other operations of the State of California.

On April 8, 2010, the Governor signed Assembly Bill (AB) 142 amending the Lottery Act to allow the Lottery to offer its players a higher prize payout percentage. Research shows that higher prize payouts result in increased sales revenues and thus will afford increased allocations to education. Under AB 142 beginning with the 2010-11 fiscal year, the Lottery is required to return not less than 87 percent of revenues to the public in the form of prizes and contributions to education, and to spend no more than 13 percent of revenues on operating expenses of the Lottery.

In addition, AB 142 requires that for each fiscal year beginning with 2010-11, the Lottery's contribution to education under the new percentages be greater than it was in the 2008-09 base fiscal year; otherwise, the law reverts back to previous percentages. Previously, the Act mandated that, as nearly as practical, 50 percent of the total annual revenues from Lottery sales be returned to the public in the form of prizes, at least 34 percent be allocated to benefit public education, and no more than 16 percent of the total annual revenues from sales of tickets or shares be allocated for payment of operating expenses of the Lottery.

Basis of Presentation

The Fund is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting and the economic resources measurement focus in accordance with accounting principles generally accepted in the United States of America. Operating revenue and expenses are those that result from providing services and producing and delivering goods and/or services. The principal operating revenue of the Fund is the sale of lottery tickets. The principal operating expenses of the Fund are prizes, retailer commissions, contractual services, advertising and marketing, salaries and benefits, and depreciation of assets.

Revenue Recognition – Scratchers Games

Sales of lottery tickets are made to the public through contracted retailers. Revenue is recognized upon the sale of tickets to the retailers for active games. An allowance is recognized for the retailers' right to return unsold tickets. Operating revenue is reduced for free tickets. Retailers receive a commission of six percent which is recognized when tickets are sold to the retailers.

Revenue Recognition - Draw Games

Lottery sales are made to the public through gaming terminals at contracted retailers. Revenue is recognized upon the sale to the public. With the exception of Powerball® and Mega Millions®, the public has the right to cancel a sale on the same day before pool closure. All Powerball and Mega Millions sales are final. The applicable retailers' commission of four and one-half to six percent is recognized when sales are made to the public. Recognition of the revenue from sales for future draws is considered unearned until those draws become current. The retailers' commission related to the unearned revenue is reflected as a prepaid expense until the revenue is recognized.

Prizes – Scratchers Games

Prize expense for Scratchers games is recognized based on the predetermined prize structure for each game in the period revenue is recognized. Prizes that are not claimed are recognized as unclaimed prizes 180 days after

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Prizes – Scratchers Games (continued)

the end of each game. Unclaimed prizes not directly payable by the Lottery are recognized as a reduction of prize expense and included in the Lottery's operating income that is allocated to the Education Fund. Unclaimed prizes directly payable by the Lottery are allocated directly to the Education Fund.

Scratchers games with annuitized prizes are generally paid in equal, annual installments over 20 or 25 years. Some games offer graduated, annual payments, and others offer the choice of an annuitized prize paid in weekly installments or a lump sum cash payment. Prize expense for annuity prizes is based on the present value of the annuity using an interest rate equal to the interest yield on the zero coupon U.S. Treasury bonds. Interest earned is imputed on the annuity using the same interest rate.

Prizes - Draw Games

Powerball and Mega Millions - The California Lottery joined the multi-state game Powerball on April 8, 2013, for the draw on April 10, 2013. Prize expense for each of the twice-weekly multi-state draw games is recognized on the basis of the predetermined prize structure when the revenue is recognized. Nine distinct prize categories for each game are established which are dependent upon the amount of money wagered and the quantity of numbers to be matched. In the event that no winning share for a specific prize category of Powerball or Mega Millions is selected, all monies allocated for that prize are carried forward to the following drawing and remain in the pool for that same prize category.

The total Grand/Jackpot prize liability for each multi-state Powerball or Mega Millions drawing is shared by each participating state lottery (Party Lottery) as follows: each Party Lottery is responsible for an amount equal to a percentage of that Party Lottery's Powerball or Mega Millions sales, said percentage being the proportion of the total Grand/Jackpot prize liability to the total Powerball or Mega Millions sales. The California Lottery is prohibited by state law from paying fixed prizes and participating in the liability calculation for prize levels two through nine. The California Lottery is therefore solely responsible for its own prize liability for levels two through nine for the multi-state games.

Powerball and Mega Millions grand/jackpot prizes won in California are paid in 30 graduated, annual installments. For each game, winners have up to 60 days after the date they become entitled to the prize to irrevocably elect to receive the cash value of the prize instead of annual payments. Payments for all other prize categories are made in a single payment.

In the event that a Powerball or Mega Millions jackpot won in California is unclaimed, the prize monies will be returned to the Party Lotteries in the same ratio that each Party Lottery contributed to the prize plus interest, and the amount contributed by the California State Lottery will be allocated to the Education Fund. The unclaimed prize monies for all other Powerball or Mega Millions prize categories won in California but not claimed within the specified period are allocated directly to the Education Fund.

SuperLotto Plus[®] - Prize expense for the twice-weekly draw game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Nine distinct prize categories are established which are dependent upon the amount of money wagered and the quantity of numbers to be matched. In the event that no winning share for a specific prize category in SuperLotto Plus is chosen, all monies allocated for that prize are carried forward to the following drawing and added to the 5 of 5 plus Mega number category (grand prize).

SuperLotto Plus grand/jackpot prizes of \$1 million or more won prior to April 1, 1998, are paid in 20 equal, annual installments. Grand/jackpot prizes of \$1 million or more won between April 1, 1998, and May 10, 2013, are paid either in 26 graduated, annual payments or in a single payment equal to the cash value of the 26-payment annuity, in accordance with the rules and regulations of the Lottery. Beginning September 21, 2005, claimants have up to 60 days after they became entitled to the prize to irrevocably elect to receive the cash payment instead of the

CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Prizes – Draw Games (continued)

annuitized payments. Starting May 11, 2013, grand prizes are paid in 30 graduated, annual payments or in a single payment equal to the estimated cost to fully fund the advertised annuity prize. Such estimated cost is determined by market pricing for U.S. Treasury bonds. Payments for all other prize categories are made in a single payment. All SuperLotto Plus prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Fantasy 5 - Prize expense for the seven-draws-per-week game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established which are dependent upon the amount of money wagered and the quantity of numbers to be matched. In the event that no winning share for a specific prize category is selected, all monies allocated for that prize category are carried forward to the following drawing and added to the 5 of 5 prize category. All Fantasy 5 prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Daily 3 - Prize expense for the two-draws-per-day game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established which are dependent upon the amount of money wagered, the quantity of numbers to be matched, and the order of numbers chosen. All Daily 3 prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Daily 4 - Prize expense for the seven-draws-per-week game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established which are dependent upon the amount of money wagered, the quantity of numbers to be matched, and the order of numbers chosen. All Daily 4 prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Daily Derby[®] - Prize expense for the seven-draws-per-week game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established which are dependent upon the amount of money wagered, the quantity of numbers to be matched, and the order of numbers chosen. In the event that no winning share for a specific prize category is selected, all monies allocated for that prize category are carried forward to the following drawing and added to the Grand Prize category. All Daily Derby prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Hot Spot[®] - Prize expense for the multiple-draws-per-day game is recognized on the basis of the predetermined prize structure when the revenue is recognized. On November 27, 2006, the Lottery established Typical Prize Pools (TPP's) for the 8 Spot Match 8 of 8 category and Typical Prize Amounts (TPA's) for all spots other than the 8 Spot Match 8 of 8 prize. On that date, the Lottery also made an irrevocable transfer to a Hot Spot Wagered Prize Fund (fund) to pay these prizes. On August 1, 2011, the Lottery expanded the prize categories from 5 spots to 10 spots, and expanded the TPP's to include the 9 Spot Match 9 of 9 and the 10 Spot Match 10 of 10 categories. In addition to the initial transfer made in 2006, the fund balance is adjusted daily based upon daily sales contributions and prizes won. In the event the balance in the fund is not sufficient to pay the allocations and amounts of a particular draw, prizes will be systematically reduced until the fund is sufficient to pay the reduced amounts. The Director will authorize promotions to ensure that the fund balance at the end of any given fiscal year is liquidated. All Hot Spot prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Prior to the changes made on November 27, 2006, and August 1, 2011, distinct prize categories were established which were dependent upon the amount of money wagered and the quantity of numbers to be matched. In the event that no winning share for a specific Hot Spot prize category was selected, all monies allocated for that prize category were carried forward to the following drawing and added to its respective prize category.

Raffle - The Lottery may periodically conduct raffle games. The \$1 million top prizes for the two raffle games held to date were each paid in single payments.

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Cash Equivalents

Cash equivalents represent cash deposited in the Surplus Money Investment Fund (SMIF).

Investments

The Lottery applies Statement No. 31 of the Governmental Accounting Standards Board (GASB 31), *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This statement establishes accounting and financial reporting standards for all investments held by governmental external investment pools and establishes fair value standards for other governmental entities. In accordance with GASB 31 the Lottery has stated investments at fair value. The difference between the carrying value and the fair value of investments is reported as a component of total net position on the statement of net position.

The Lottery applies GASB 40, *Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3*. This statement addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, this statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this statement also are required to be disclosed.

Allowances for Doubtful Accounts, Ticket Returns, and Free Ticket Redemptions

The allowance for doubtful accounts is based on an analysis of collectibility of accounts receivable which considers the age of the accounts and historical collection results. An allowance for ticket returns for Scratchers games is estimated using sales revenue and historical return data for the games in progress at the end of the reporting period. An allowance for free ticket redemptions for Scratchers games is estimated using sales revenue and free ticket redemption data for games in progress at the end of the reporting period.

Ticket Inventories

Inventories are carried at cost and consist of tickets for games in progress not yet sold to retailers and tickets for future games. The cost of tickets is charged to operations when the tickets are sold to retailers. The cost of unissued and returned tickets is written off at the end of each game.

Capital Assets

The Lottery has adopted a policy of capitalizing assets with an acquisition cost or established value of \$5,000 or greater. Capital assets are carried at cost. Depreciation on property and equipment is computed using the straight-line method over estimated lives ranging from one to ten years. Depreciation on buildings, improvements, and land improvements is computed using the straight-line method over estimated lives of five to 40 years. When assets are retired or otherwise disposed of, the costs and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over the remaining lease terms.

Long-term Prepaid Charges

The Lottery incurs costs in connection with certain contracts which extend beyond a one-year period. These costs are prepaid and amortized over the life of the contracts.

Advertising

Advertising costs are expensed when the related liability is incurred. Advertising expense totaled \$63,699,190 for the year ended June 30, 2014.

CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Investment Earnings

Investment earnings are composed of unrealized gains or losses associated with the change in fair value of investments and interest income including interest accreted on investments. Unrealized gains and losses are generally not realized as the investments are held to satisfy annuitized prizes. As investments must be stated at fair value, investment earnings or losses are created as a result of the adjustment from carrying value to fair value. Generally, all cash is held on deposit with the California State Treasurer and is invested by that office in the Surplus Money Investment Fund. Interest on funds held by the State Treasurer is distributed quarterly.

Compensated Absences Payable

Vested vacation balances are accrued as a liability and adjusted quarterly.

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 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.

2. DEPOSITS AND INVESTMENTS

The Lottery presents its deposits and investments in accordance with GASB 40, *Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3*. This statement requires the disclosure of the following risks to the extent that they exist at the date of the statement of net position:

Interest Rate Risk

Interest rate risk is the risk that the value of fixed income securities will decline due to changing interest rates. The prices of fixed income securities with longer time to maturity tend to be more sensitive to changes in interest rates than those with shorter durations.

Credit Risk

Credit risk is the risk that a debt issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline.

Custodial Credit Risk

Custodial credit risk is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of its deposits, investments, or collateral.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of an investor's holdings in a single issuer.

Investments

The deposit and investment policies of the Lottery are determined by the Lottery Commission and state statute. Prize investments consist of zero coupon U.S. Treasury bonds, zero coupon agency bonds, and municipal bonds. Zero coupon U.S. Treasury bonds and zero coupon agency bonds are carried at fair value and are adjusted for the accretion of interest based on the purchase yield and maturity date. Municipal bonds are carried at fair value, and interest is accrued based on the coupon rate.

CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014

2. DEPOSITS AND INVESTMENTS (continued)

Investments (continued)

As of June 30, 2014, the Lottery's investments, with yields ranging from 0.06 percent to 6.06 percent, consist of the following:

	<u>Face Amount</u>	<u>Cost</u>	<u>Fair Value</u>
Current portion:			
U.S. Treasury Bonds	\$ 11,992,000	\$ 11,011,264	\$ 11,984,745
U.S. Agency Bonds	41,913,000	35,309,531	41,865,992
U.S. Municipal Bonds	<u>62,000,000</u>	<u>62,075,284</u>	<u>62,778,280</u>
Total current portion	<u>\$ 115,905,000</u>	<u>\$ 108,396,079</u>	<u>\$ 116,629,017</u>
Long-term portion:			
U.S. Treasury Bonds	\$ 280,973,000	\$ 163,617,295	\$ 194,924,537
U.S. Agency Bonds	235,582,000	139,444,628	195,906,756
U.S. Municipal Bonds	<u>358,710,000</u>	<u>360,287,857</u>	<u>405,375,299</u>
Total long-term portion	<u>\$ 875,265,000</u>	<u>\$ 663,349,780</u>	<u>\$ 796,206,592</u>
 Total investments	 <u>\$ 991,170,000</u>	 <u>\$ 771,745,859</u>	 <u>\$ 912,835,609</u>

As discussed in Note 1, the Lottery applies the provisions of GASB 31. In accordance with GASB 31, the Lottery carries its investments at fair value. The fair value of investments is based on published market prices and quotations from an independent pricing vendor. The following represents the changes in fair value of investments for the year ended June 30, 2014, in accordance with the requirements of GASB 31.

Changes in fair value of investments:

Unrealized investment gains at July 1, 2013	\$ 79,090,350
Unrealized investment gain, current period	<u>4,829,544</u>
Total unrealized investment gains	<u>\$ 83,919,894</u>

On January 28, 2009, the Lottery Commission approved an amendment to the Lottery's investment policy that allowed for the restructuring of its investment portfolio to maximize the investment return. Prior to this, the Lottery's policy limited investments to U.S. Treasury zero coupon bonds. The amendment authorizes the Lottery to sell its previously held U.S. Treasury zero coupon bonds and replace them with municipal and agency bonds, as well as with other U.S. Treasuries. The Lottery conducted an investment portfolio restructuring program from May 2009 through September 2010. By replacing U.S. Treasury zero coupon bonds with higher yielding investments, the Lottery generated cash proceeds that were used to further the Lottery's directives.

As a result of the restructuring transactions, the interest imputed on prize liability will no longer equal the interest earned on the restructured investment portfolio. The difference will be reported in the statement of revenues, expenses, and changes in net position and result in an adjustment to net position restricted by legislation. As the realized and unrealized investment gain and loss activity relates to investments that must be held to satisfy prize liabilities, they are deemed statutorily restricted and therefore reported as restricted by legislation.

CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014

2. DEPOSITS AND INVESTMENTS (continued)

Interest Rate Risk – Investments

The Lottery does not have a specific policy to manage interest rate risk, as investments are purchased to mirror the payment stream of recorded prize liability. The Lottery's investments have weighted average maturities based on the final maturity dates of all investments as follows:

U.S. Treasury Strips	10.82 years
U.S. Agency Holdings	5.04 years
U.S. Municipal Bond Holdings	6.43 years
Surplus Money Investment Fund	0.64 years

Credit Risk and Concentration of Credit Risk - Investments

The Lottery has adopted a specific policy to manage credit risk in the Lottery's investment portfolio. The zero coupon U.S. Treasury bonds and U.S. Treasury bills are backed by the full faith and credit of the United States government. Therefore, the U.S. Treasury obligation investments are not considered to have credit risk or a concentration of credit risk, as defined by the Governmental Accounting Standards Board. The Lottery's policy to manage credit risk requires municipal bonds to have a minimum double A credit rating by Fitch, Moody's, or Standard and Poor's to be eligible for purchase as part of the Lottery's investment portfolio. Agency bonds have a triple A credit rating and the Surplus Money Investment Fund is not rated at June 30, 2014. Credit risk is further mitigated by a \$2.7 million par value agency bond reserve. The bond reserve has a fair value of \$1,889,976.

As of June 30, 2014, the fair value of the Lottery's investment portfolio expressed as a percentage of Moody's credit rating categories was as follows:

Moody's Credit Rating	Fair Value	Percent of Total Portfolio
Aaa	\$ 457,744,209	50.15 %
Aa1	147,445,919	16.15 %
Aa2	51,576,962	5.65 %
Aa3	228,626,921	25.05 %
A3	22,031,735	2.41 %
Baa1	5,409,863	0.59 %
Totals	<u>\$ 912,835,609</u>	<u>100.00 %</u>

The following table provides information about the Lottery's concentration of credit risk. It shows investments by any one issuer representing five percent or more of the Lottery's total portfolio, and not explicitly guaranteed by the U.S. government.

Issuer	Cost	Fair Value	Percent of Total Portfolio	Moody's Credit Rating
State of California	\$ 164,475,817	\$ 178,345,496	19.54 %	Aa3
Commonwealth of Massachusetts	\$ 62,546,830	\$ 69,039,180	7.56 %	Aa1
New York City	\$ 47,293,479	\$ 51,576,962	5.65 %	Aa2

CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014

2. DEPOSITS AND INVESTMENTS (continued)

Custodial Credit Risk – Investments

The Lottery does not have a formal investment policy for custodial credit risk for investments. As of June 30, 2014, all the prize investments are uninsured, registered investments held in book-entry form by the State Treasurer's Office in a master custody account with Citibank, N.A.

Deposits

The following deposits, included in cash and cash equivalents, are in pools managed by other State of California government units and are not evidenced by securities. Interest income earned on outstanding cash balances is allocated among pool participants based on average daily cash balances. As of June 30, 2014, the carrying value of deposits in the Surplus Money Investment Fund approximated fair value.

State Treasury	\$ 11,703,737
Surplus Money Investment Fund (SMIF)	304,519,000
	<u>\$ 316,222,737</u>

The total cash and cash equivalents of \$316,260,517 also includes retailer payments delivered to the Lottery but not deposited into Lottery accounts by period end. At June 30, 2014, this cash on hand totaled \$37,780.

The SMIF consists of available cash of all special funds of the State of California which do not have investment authority of their own. Cash balances in excess of needs in any of these participating funds are invested by the State Treasurer. The Pooled Money Investment Board (PMIB) provides regulatory oversight over the State Treasurer's pooled investment program and is responsible for determining whether any cash balances of the participating funds are in excess of current needs and available for investment, or whether it is necessary to liquidate previous investments to meet current requirements. The PMIB is composed of the State Treasurer, as chairman; the State Controller; and the Director of Finance for the State of California.

All of the resources of the SMIF are invested through the Pooled Money Investment Account (PMIA). By law, PMIA monies can be invested only in the following categories: U.S. Government securities; securities of federally-sponsored agencies; domestic corporate bonds; interest-bearing time deposits in California banks, savings and loan associations, and credit unions; prime-rated commercial paper; repurchase and reverse repurchase agreements; security loans; banker's acceptances; negotiable certificates of deposit; and loans to various bond funds.

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

2. DEPOSITS AND INVESTMENTS (continued)

Deposits (continued)

At June 30, 2014, the allocation of the deposits held by the Lottery in the SMIF was estimated as follows:

	Lottery's Share of SMIF
U.S. Treasury Securities	\$ 163,901,568
Federal Agency Debt	25,321,633
Supranational Debentures	704,014
Bank Notes	2,817,613
Certificates of Deposit	56,352,696
Commercial Paper	31,451,134
Time Deposits	22,494,600
AB 55 and General Fund Loans	1,475,742
Total	\$ 304,519,000

The value of the deposits in the State Treasurer's pooled investment program, including the SMIF, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2014, this difference was immaterial to the valuation of the deposits held by the Lottery in the SMIF.

The Lottery's share in the interest earnings of the PMIA is based on its ratio of dollar-day contributions to the total dollar-day investments of the PMIA. The overall return on investment for the PMIA was 0.25 percent for the year ended June 30, 2014.

3. ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

Amounts due, primarily from retailers	\$ 461,201,638
Less: Allowance for free ticket redemption	(32,286,531)
Allowance for doubtful accounts	(4,610,271)
Allowance for ticket returns	(20,066,001)
Accounts receivable, net	\$ 404,238,835

4. DUE FROM STATE FUNDS

Due from state funds consists primarily of interest income due on cash deposited with the State Treasurer in the Surplus Money Investment Fund.

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

5. CAPITAL ASSETS

Capital assets consist of the following:

	Beginning Balance	Increase	Decrease	Ending Balance
Non-depreciable capital assets:				
Land	\$ 6,469,219	\$ -	\$ -	\$ 6,469,219
Depreciable capital assets:				
Gaming equipment	14,392,117	-	(29,125)	14,362,992
Vending machines	30,044,295	15,538,474	(2,120,480)	43,462,289
Buildings	69,986,320	-	-	69,986,320
Data processing equipment	13,361,656	1,152,534	(2,107,494)	12,406,696
Office furniture and equipment	7,642,537	204,575	(91,006)	7,756,106
Leasehold improvements	813,658	-	-	813,658
Other	6,579,301	2,282,207	(366,434)	8,495,074
	<u>\$ 149,289,103</u>	<u>\$ 19,177,790</u>	<u>\$ (4,714,539)</u>	<u>\$ 163,752,354</u>
Less accumulated depreciation and amortization:				
Gaming equipment	\$ (13,839,886)	\$ (355,615)	\$ 25,511	\$ (14,169,990)
Vending machines	(30,044,295)	(251,480)	2,120,480	(28,175,295)
Buildings	(3,963,771)	(1,786,968)	-	(5,750,739)
Data processing equipment	(8,369,317)	(1,884,445)	2,107,494	(8,146,268)
Office furniture and equipment	(4,556,460)	(1,013,678)	70,700	(5,499,438)
Leasehold improvements	(707,886)	(76,394)	-	(784,280)
Other	(5,555,989)	(706,596)	366,434	(5,896,151)
	<u>\$ (67,037,604)</u>	<u>\$ (6,075,176)</u>	<u>\$ 4,690,619</u>	<u>\$ (68,422,161)</u>
Capital assets, net	<u>\$ 82,251,499</u>	<u>\$ 13,102,614</u>	<u>\$ (23,920)</u>	<u>\$ 95,330,193</u>

Depreciation and amortization charged to income on capital assets was \$6,075,176 for the year ended June 30, 2014.

CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014

6. PRIZE LIABILITY

Prize liability consists of the following:

	Scratchers Games	Draw Games	Total
Current:			
Annuitized prizes	\$ 21,409,648	\$ 189,439,940	\$ 210,849,588
Other prizes	311,762,795	28,647,482	340,410,277
Total current prize liability	<u>\$ 333,172,443</u>	<u>\$ 218,087,422</u>	<u>\$ 551,259,865</u>
Long-term annuitized prizes	\$ 190,880,000	\$ 797,253,000	\$ 988,133,000
Less imputed interest	<u>(49,070,104)</u>	<u>(255,883,215)</u>	<u>(304,953,319)</u>
Net present value of long-term prizes	<u>\$ 141,809,896</u>	<u>\$ 541,369,785</u>	<u>\$ 683,179,681</u>
Total prize liability	<u>\$ 474,982,339</u>	<u>\$ 759,457,207</u>	<u>\$ 1,234,439,546</u>

The amount of prizes due within one year is \$551,259,865.

Long-term prize liability as of June 30, 2014, for each of the next five years and for subsequent years is as follows:

	Principal	Interest	Total
For the year ending June 30, 2016	\$ 47,645,762	\$ 49,132,085	\$ \$96,777,847
2017	38,494,010	30,059,284	68,553,294
2018	32,922,596	21,623,162	54,545,758
2019	31,550,777	20,686,696	52,237,473
2020	30,211,628	19,716,029	49,927,657
2021-2025	130,260,306	82,141,215	212,401,521
2026-2030	79,772,675	31,586,102	111,358,777
2031-2035	20,968,789	1,777,463	22,746,252
2036-2040	10,185,708	230,065	10,415,773
2041-2045	<u>4,151,531</u>	<u>63,798</u>	<u>4,215,329</u>
Total long-term prize liability	<u>\$ 426,163,782</u>	<u>\$ 257,015,899</u>	<u>\$ 683,179,681</u>

Activity in the prize liability accounts consists of:

Balance, July 1, 2013	\$ 1,198,903,813
Prize expense	3,082,376,405
Prize payments	(3,567,223,613)
Grand/Jackpot prize contributions from Other Party Lotteries	499,057,503
Interest imputed on annuities	42,998,109
Unclaimed prizes	<u>(21,672,671)</u>
Balance, June 30, 2014	<u>\$ 1,234,439,546</u>

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

7. DUE TO STATE FUNDS

Due to state funds consists of the following:

Due to Education Fund	\$ 314,619,810
Due to other state funds	<u>291,878</u>
 Total due to state funds	 <u><u>\$ 314,911,688</u></u>

Activity in the Due to Education Fund account consists of:

Balance, July 1, 2013	\$ 380,720,287
Allocation to Education Fund, earned by the California State Lottery Fund	\$ 1,327,928,392
Unclaimed prizes directly allocated to the Education Fund	<u>21,672,671</u>
	\$ 1,349,601,063
 Distribution to the Education Fund	 <u>(1,415,701,540)</u>
 Balance, June 30, 2014	 <u><u>\$ 314,619,810</u></u>

8. LEASES

The Lottery leases office, warehouse, and parking lot facilities under operating leases. These leases expire in various years through September 30, 2023. Most operating leases have a provision for early termination. These leases could be terminated between December 2014 and September 2023.

The future minimum lease payments under operating leases as of June 30, 2014, are as follows:

	Operating Leases
For the year ending June 30, 2015	\$ 1,447,808
2016	1,292,991
2017	1,329,057
2018	724,942
2019	524,519
Thereafter	<u>1,276,175</u>
 Total minimum payments	 <u><u>\$ 6,595,492</u></u>

Rental expense for all operating leases totaled \$1,536,337 for the year ended June 30, 2014.

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

9. INVESTMENT EARNINGS

Investment earnings consist of:

Interest on funds held by State Treasurer	\$ 1,249,094
Change in Fair Market Value of Investments	4,829,544
Interest accreted/earned on investments	37,209,821
Total investment earnings	\$ 43,288,459

10. RETIREMENT PLAN AND OTHER POSTEMPLOYMENT BENEFITS

Retirement Plan

The Lottery contributes to the Public Employees' Retirement Fund administered by the California Public Employees' Retirement System (CalPERS), an agent multiple-employer public employee defined benefit pension plan. The State of California (State) is considered the employer and the Lottery is a department of the State. CalPERS provides retirement benefits to plan members and beneficiaries. CalPERS acts as a common investment and administrative agent for participating public entities within the State and uses the accrual basis of accounting. Benefit provisions and all other requirements are established by state statute. Since all state agencies are considered collectively to be a single employer, the actuarial present value of vested and non-vested accumulated plan benefits attributable to the Lottery's employees cannot be determined. Similarly, the net assets available for benefits of Lottery employees cannot be determined. CalPERS issues a separate comprehensive annual financial report that includes financial statements and required supplementary information. CalPERS' annual financial report may be obtained by writing to the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229 or by visiting the CalPERS web site at www.CalPERS.ca.gov.

Generally, full-time employees are eligible to participate as members of CalPERS and are eligible to retire at age 50 with at least five years of service or age 55 with at least ten years of service, depending on the plan selected by the employee. Employees hired after January 1, 2013, must be at least age 52. Annual retirement benefits are determined based on age at retirement, the length of membership service, and the amount of earnings based on the highest or last 12 or 36 consecutive months' average. Health care and dental benefits may be provided to members depending on the date hired and the years of credited service of a member. If members are not fully vested, the health care and dental contributions are prorated based on the years of service.

Active plan members are required to contribute a percentage of their salary depending on their plan selection and employment classification. Employees' required contributions vary from zero to 13 percent. The Lottery is required to contribute at an actuarially determined rate. The Lottery's contributions are based on a percentage of annual covered payroll depending on the plan selected and member status. For the year ended June 30, 2014, the Lottery's payroll for employees covered by CalPERS was approximately \$38.6 million and the total payroll for the period was approximately \$39.3 million. The contribution requirements of plan members and the Lottery are established and may be amended by CalPERS. Required employer contribution rates (expressed as a percentage of compensation) as of July 2013 for the 2013-14 fiscal year are as follows:

State Miscellaneous Member First Tier	21.121 %
State Miscellaneous Member Second Tier	20.992 %
State Safety Member	17.205 %
Peace Officer	30.495 %

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

10. RETIREMENT PLAN AND OTHER POSTEMPLOYMENT BENEFITS (continued)

Retirement Plan (continued)

The Lottery's pension cost for the year ended June 30, 2014, was equal to the Lottery's required contributions which were determined as part of the actuarial valuation performed by CalPERS dated June 30, 2012.

Three year trend information for the Lottery:

Fiscal Year Ending	Annual Pension Cost (APC)	Percentage Of APC Contributed	Net Pension Obligation
6/30/12	\$6,800,344	100 %	\$0
6/30/13	\$6,036,633	100 %	\$0
6/30/14	\$7,262,938	100 %	\$0

Other Postemployment Benefits

Post-retirement health care benefits are also provided to Lottery employees through the programs sponsored by the State as administered by CalPERS and the California Department of Human Resources (CalHR). As the post-retirement health care plan is sponsored by the State it is considered a single-employer plan. The Lottery is considered a department of the State. The total other postemployment benefits (OPEB) actuarial accrued liability is reported at the State level.

Health care and dental benefits may be provided to members depending on the date hired and the member's years of credited service. Post-retirement health benefits include medical, prescription drug, and dental benefits, and are currently funded on a pay-as-you-go basis. Employer contributions for health premiums during the 2013-14 fiscal year maintained the 100/90 percent contribution formula established by Government Code. Under this formula, the State uses 100 percent of the weighted average premiums of the four largest health benefit plans in order to calculate the maximum amount the State will contribute toward the retiree's health benefits. The State also contributes 90 percent of this average for the health benefits of each of the retiree's dependents. The retiree is responsible for paying all health benefit plan costs that exceed the average of the four largest benefit plans. The monthly estimated contribution is \$642 for a single enrollee, \$1,218 for an enrollee and one dependent, and \$1,559 for an enrollee and two or more dependents. Dental care premiums vary by plan and number of dependents. The contribution formulas are subject to approval and amendment by the State Legislature. If members are not fully vested, the health care and dental contributions are prorated based on the years of service.

The Lottery paid approximately \$4 million for post-retirement health and dental benefits for retired members for the year ended June 30, 2014. The Lottery adopted GASB 45 during the 2007-08 fiscal year. GASB 45 was implemented prospectively and the Lottery had a zero net OPEB obligation (NOO) upon adoption. The Lottery's annual OPEB cost (AOC) is calculated based on the annual required contribution (ARC). The AOC recorded by the Lottery is calculated by the primary government and represents an allocation of the total ARC of the State, adjusted for interest and other adjustments. The allocation is based on the Lottery's retiree health benefit costs in relation to the total State retiree health benefit costs. The ARC represents the normal cost plus an amortization of the difference between the actuarial accrued liability and any assets available to pay benefits. The AOC for the year ended June 30, 2014, was \$11,346,000. The total NOO liability recorded as of June 30, 2014, is \$41,114,000. The following table shows the components of the Lottery's AOC, the amount actually contributed to the plan and the NOO as of and for the year ended June 30, 2014, and the previous two fiscal years.

**CALIFORNIA STATE LOTTERY FUND
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2014**

10. RETIREMENT PLAN AND OTHER POSTEMPLOYMENT BENEFITS (continued)

Other Postemployment Benefits (continued)

Net OPEB obligation (NOO), July 1, 2011	\$ 20,408,000
Allocated annual OPEB cost (AOC)	10,088,000
Fund allocated contributions	<u>(3,590,000)</u>
Net OPEB obligation (NOO), July 1, 2012	26,906,000
Allocated annual OPEB cost (AOC)	10,581,000
Fund allocated contributions	<u>(3,699,000)</u>
Net OPEB obligation (NOO), July 1, 2013	33,788,000
Allocated annual OPEB cost (AOC)	11,346,000
Fund allocated contributions	<u>(4,020,000)</u>
Net OPEB obligation (NOO), June 30, 2014	<u>\$ 41,114,000</u>

The actuarial valuation report for OPEB may be obtained by writing to the Office of State Controller John Chiang, P.O. Box 942850, Sacramento, CA 94250, or by visiting the State Controller's Web site at www.SCO.ca.gov. The Lottery's ARC, AOC, and NOO are calculated and adjusted for on an annual basis.

11. COMMITMENTS AND CONTINGENCIES

A contract has been awarded to GTECH that includes both gaming and telecommunication systems and services. The Lottery pays a fee of 1.36 percent of sales up to \$4 billion in one year, 1.20 percent of sales over \$4 billion and up to \$5 billion, and 1.10 percent of sales over \$5 billion. The original contract ran through October 13, 2009, and had a total estimated cost of \$300 million. A series of contract extensions were awarded. The latest, signed by the Director in September 2010, extends the contract to October 13, 2019, and includes a complete upgrade of the gaming system. The total contract expenditure is not to exceed \$1.075 billion. Approximately \$637.1 million in fees have been incurred under the contract as of June 30, 2014.

The Lottery has been named as a defendant in various lawsuits and claims. While the ultimate monetary outcome of these claims cannot be estimated at this time, it is the opinion of management, after consulting with legal counsel, that the disposition of any litigation in which the Lottery is involved will not have a material adverse effect on the financial condition or on the results of operations of the Lottery.

12. RISK MANAGEMENT

Since its inception, the Lottery has been primarily self-insured for risks such as flood, business interruption, theft, employee errors and omissions, and other potential liabilities. Losses are recognized when conditions for accrual are met.

The Lottery has purchased property insurance for its headquarters campus, including its new headquarters building and central utility plant, and thereby has transferred the risk of loss due to a catastrophic event from the Lottery to the insurance carrier. The Lottery has purchased automobile insurance for its fleet of vehicles and insurance for electronic data processing equipment through the California Department of General Services, Office of Risk & Insurance Management.

Liabilities for workers' compensation costs are accrued based on estimates derived from the State Compensation Insurance Fund. This estimate is based on actuarial reviews of the employee workers' compensation program and includes indemnity payments, compensation benefits, and leave benefits. The liability for workers' compensation claims is not material to the financial statements taken as a whole.