REPORT OF THE AUDIT OF THE KENTUCKY LOTTERY CORPORATION

For The Years Ended
June 30, 2018 and 2017

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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 David Osborne, Speaker Pro Tem, 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, 2018 and 2017, 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

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Financial Report

June 30, 2018 and 2017

KENTUCKY LOTTERY CORPORATION

ANNUAL FINANCIAL REPORT
June 30, 2018 and 2017

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INDEPENDENT AUDITOR'S REPORT

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To the Auditor of Public Accounts,
the 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, 2018 and 2017, 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.

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, 2018 and 2017, 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

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 15 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 October 11, 2018 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, Shymanski & Company, P.S.C.

Louisville, Kentucky
October 11, 2018

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, 2018 and 2017. Please read it in conjunction with the financial statements, which follow.

Financial Highlights for FY 2018

- Record operating revenues, including instant tickets provided as prizes, of $1.04 billion were achieved in 2018, an increase of $42.0 million or 4.2 percent over last year's previous sales record of $1.00 billion. 2018 represents the eighth consecutive year of record sales for the KLC and the second time that sales of more than $1 billion have been achieved.
- Instant ticket sales increased $9.3 million or 1.5 percent to a record $613.1 million. 2018 represents the fourth consecutive year the KLC has achieved record instant ticket sales.
- Draw game sales increased $27.6 million or 7.0 percent over 2017, to a record $419.1 million.
- Keno generated sales of $82.8 million, exceeding prior year by $7.1 million or 9.3 percent. Keno sales have increased each year since sales began in FY 2014.
- iLottery instant play games saw a $5.0 million or 95.6 percent increase in sales over 2017.

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.

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 Statements of Revenues, Expenses, and Changes in Net Position.

Total Assets

Total assets consist primarily of cash and cash equivalents, investments, accounts receivable, deposits, and capital assets. As shown in Table 1, the KLC's total assets increased $3.0 million to $75.5 million in 2018.Total assets decreased $4.6 million to $72.5 million in 2017 from $77.1 million in 2016. 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. Accounts receivable increased $6.9 million to $31.6 million in 2018. This increase was primarily due to the timing of the year-end billing cycle. Accounts receivable decreased $11.7 million to $24.7 million in 2017 from $36.4 million in 2016. This decrease was primarily due to the timing of the year-end billing cycle and a KLC initiated change in billing terms, which sped up the cash collection process.

Capital Assets

The KLC's investment in capital assets, net of accumulated depreciation in 2018 and 2017, was $5.4 and $5.3 million, respectively. The investment in capital assets includes buildings, game equipment, data processing equipment, automobiles, furniture, and fixtures, and computer software. The total increase in the KLC's investment in capital assets for 2018 was $0.1 million or 2.4 percent compared to a decrease of $0.4 million or 7.0 percent in 2017. 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)

	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
Current and other assets	$ 54.8	$ 4.2	$ 50.6	$ (1.8)	$ 52.4
Investments (noncurrent)	10.1	(1.6)	11.7	(2.4)	14.1
Prepaid license	0.0	(0.1)	0.1	(0.1)	0.2
Capital assets, net	5.4	0.1	5.3	(0.4)	5.7
Deposits with MUSL	5.2	0.4	4.8	0.1	4.7
Total assets	75.5	3.0	72.5	(4.6)	77.1
Current liabilities	43.2	4.4	38.8	(1.4)	40.2
Long-term liabilities	14.0	(0.7)	14.7	(1.4)	16.1
Total liabilities	57.2	3.7	53.5	(2.8)	56.3
Net position					
Net investment in capital assets	5.4	0.1	5.3	(0.4)	5.7
Unrestricted - accumulated unrealized gains on investments	1.2	(0.7)	1.9	(0.9)	2.8
Unrestricted	11.7	(0.1)	11.8	(0.5)	12.3
Total net position	$ 18.3	$ (0.7)	$ 19.0	$ (1.8)	$ 20.8

Liabilities

TABLE 2
LIABILITIES
(In millions)

	Current			Long-Term		
	2018	**2017**	**2016**	**2018**	**2017**	**2016**
Accounts payable and other liabilities	$ 6.0	$ 6.3	$ 8.5	$ 1.1	$ 1.2	$ 1.0
Due to Commonwealth	6.1	2.5	5.6	0.0	0.0	0.0
Prize liabilities	31.1	30.0	26.1	12.9	13.5	15.1
Total liabilities	$ 43.2	$ 38.8	$ 40.2	$ 14.0	$ 14.7	$ 16.1

Total current liabilities increased $4.4 million or 11.3 percent in 2018 and decreased $1.4 million or 3.5 percent in 2017. The account titled "Due to Commonwealth" increased $3.6 million in 2018 and decreased $3.1 million in 2017. This is the result of a timing issue which represents payments due to the General Fund and the KEES Reserve Fund after the fiscal year-end, and the fact that there was no undistributed net income at the end of 2017.

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 $0.7 million or 4.8 percent in 2018 and $1.4 million or 8.7 percent in 2017. The decrease is attributable to the maturing of long-term prize liabilities. More detailed information can be obtained in Note 9 to the financial statements.

Net Position

As shown in Table 1 on page 4, the KLC's net position in 2018 decreased $0.7 million to $18.3 million. The decrease was attributable to the reduction in the accumulated unrealized gains on investments the KLC holds to maturity 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. Total net position of $18.3 million included the KLC's net investment in capital assets of $5.4 million and $12.9 million in unrestricted net position. Unrestricted net position was comprised of $1.2 million in accumulated unrealized gains on investments and $11.7 million in working capital and cash flow that is utilized in the KLC's day-to-day operations. In 2017, the KLC's net position decreased $1.8 million to $19.0 million due to dividend transfers from prior year earnings and the reduction in the accumulated unrealized gains on investments the KLC holds to maturity to fund future payments due on annuitized lottery prizes.

Changes in Net Position

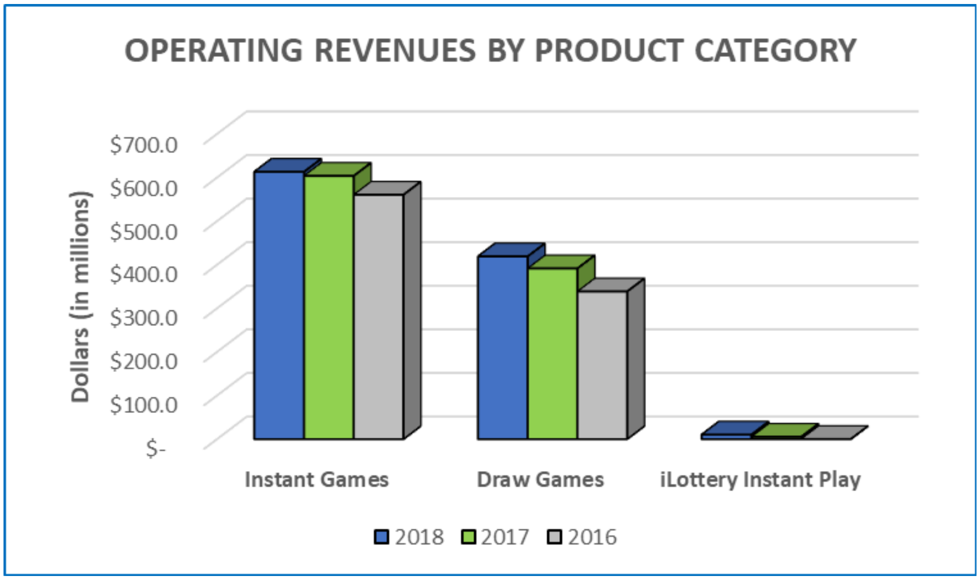
TABLE 3
CHANGES IN NET POSITION
(In millions)

	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
Operating revenues					
Instant games	$ 613.1	$ 9.3	$ 603.8	$ 6.5	$ 597.3
Draw games	419.1	27.6	391.5	(8.1)	399.6
iLottery instant play games	10.3	5.1	5.2	4.8	0.4
Less: tickets provided as prizes	(7.3)	6.2	(13.5)	0.0	(13.5)
Total operating revenues	1,035.2	48.2	987.0	3.2	983.8
Direct costs and operating expenses:					
Direct costs					
Prize expense	657.4	28.6	628.8	8.2	620.6
Payments to retailers	61.1	(0.6)	61.7	(0.9)	62.6
Draw vendor expense	11.4	1.3	10.1	0.4	9.7
Instant ticket costs	8.4	(0.5)	8.9	1.0	7.9
Total direct costs	738.3	28.8	709.5	8.7	700.8
Operating expenses	30.9	0.7	30.2	0.1	30.1
Total direct costs and operating expenses	769.2	29.5	739.7	8.8	730.9
Non-operating expenses	0.3	(0.2)	0.5	0.5	0.0
Payments to the Commonwealth of Kentucky	266.4	17.8	248.6	(4.4)	253.0
Total expenses	1,035.9	47.1	988.8	4.9	983.9
Changes in net position	(0.7)	1.1	(1.8)	(1.7)	(0.1)
Net position at beginning of year	19.0	(1.8)	20.8	(0.1)	20.9
Net position at end of year	$ 18.3	$ (0.7)	$ 19.0	$ (1.8)	$ 20.8

Operating Revenues and Prize Expenses

Operating Revenues

In 2018, operating revenues consisted of ticket sales from three product categories, instant games, draw games, and iLottery instant play games. In 2018, the KLC generated record ticket sales of more than $1.04 billion, an increase of $42.0 million or 4.2 percent when compared to 2017. In 2017, the KLC produced ticket sales of $1.00 billion, an increase of $3.2 million or 0.3 percent when compared to 2016. Total ticket sales for 2018 and 2017, net of $7.3 million and $13.5 million of tickets provided as prizes, were $1.04 billion and $987.0 million, respectively. Total ticket sales for 2016, net of $13.5 million of tickets provided as prizes, were $983.8 million.



Instant Games

Record KLC instant ticket sales of $613.1 million were achieved in 2018, and accounted for 58.8 percent of all KLC sales, or an increase of $9.3 million or 1.5 percent over 2017. 2017 instant ticket sales, which accounted for 60.4 percent of all KLC sales, were $603.8 million, an increase of $6.5 million or 1.1 percent over 2016.

2018 sales growth within the instant product category occurred at the $5, $10, and $25 price points, which saw increases of 2.0 percent, 3.8 percent, and 33.1 percent, respectively. Sales growth in the $25 price point was mainly attributable to an increase in customer demand for the $25 product.

2018 sales decreases were recognized at the $1 price point with a decrease of 18.0 percent; the $2 price point with a decrease of 12.2 percent; the $3 price point with a decrease of 22.3 percent; and the $20 price point with a decrease of 5.2 percent.

2017 sales growth within the instant product category occurred at the $10 and $25 price points, which saw increases of 14.3 percent and 19.1 percent, respectively. The increase in the $10 price point was due, in part, to the introduction of the KLC's first oversized ticket offering, *Big Money*, which sold out in a record three weeks time. Sales growth in the $25 price point was mainly attributable to an increase in the number of game offerings available at this price point, due to strong customer demand for the $25 product.

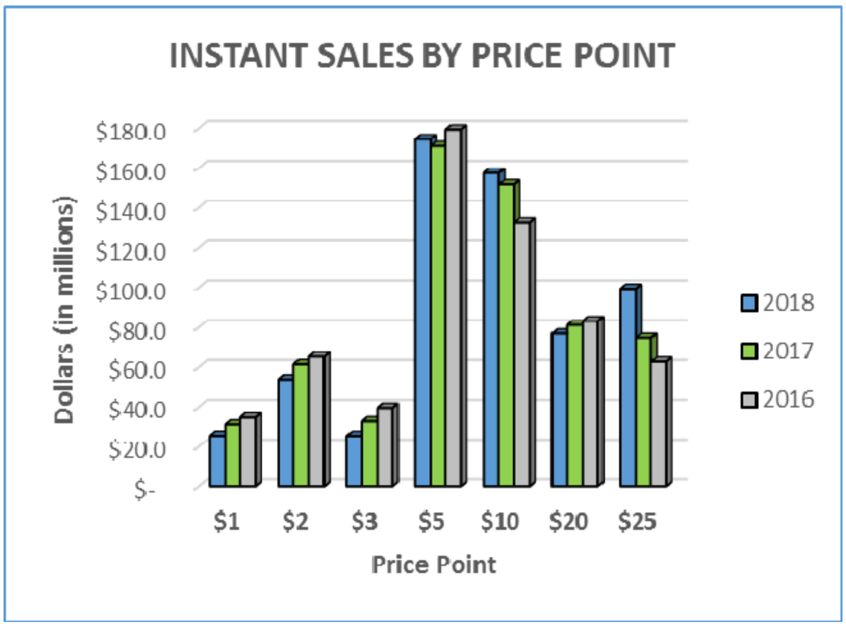
2017 sales decreases were recognized at the $1 price point with a decrease of 10.1 percent; the $2 price point with a decrease of 5.8 percent; the $3 price point with a decrease of 17.4 percent; the $5 price point with a decrease of 4.6 percent; and the $20 price point with a decrease of 2.4 percent.

Instant Games (Continued)

Table 4 and the accompanying chart compares sales for each instant game price point for 2018, 2017, and 2016.

TABLE 4
INSTANT SALES BY PRICE POINT
(In millions)

Price Point	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
$1	$ 25.5	$ (5.6)	$ 31.1	$ (3.5)	$ 34.6
$2	53.9	(7.5)	61.4	(3.8)	65.2
$3	25.4	(7.3)	32.7	(6.9)	39.6
$5	174.5	3.5	171.0	(8.3)	179.3
$10	157.5	5.7	151.8	19.0	132.8
$20	76.9	(4.2)	81.1	(2.0)	83.1
$25	99.4	24.7	74.7	12.0	62.7
Totals	$ 613.1	$ 9.3	$ 603.8	$ 6.5	$ 597.3



Draw Games

Draw game sales were $419.1 million in 2018, an increase of $27.6 million or 7.0 percent when compared to 2017. Draw games sales accounted for 40.2 percent of all 2018 sales, and consisted of Pick 3, Pick 4, Cash Ball 225, Powerball, Mega Millions, 5 Card Cash, Keno, and Lucky for Life.

Draw game sales for 2017 were $391.5 million, a decrease of $8.1 million or 2.0 percent when compared to 2016. Draw games accounted for 39.1 percent of all 2017 sales and consisted of Pick 3, Pick 4, KY Cash Ball, Powerball, Mega Millions, 5 Card Cash, Keno, and Lucky for Life.

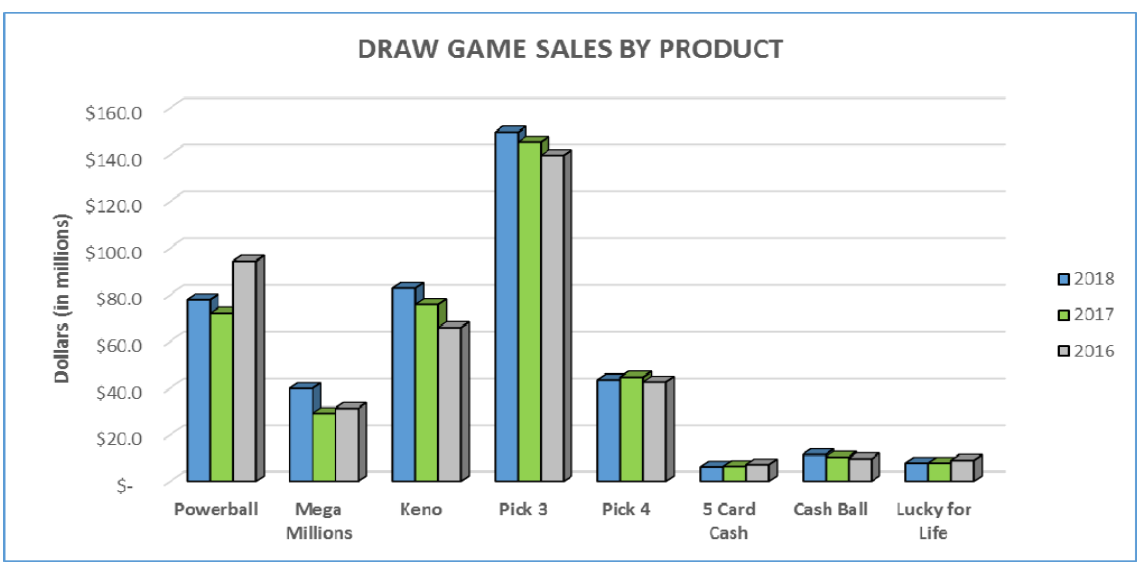
Sales increases were recognized in Powerball, Mega Millions, Keno, Pick 3, and Cash Ball 225 when compared to 2017. Powerball sales saw an 8.0 percent increase. Mega Millions sales saw a 36.8 percent increase. Keno sales saw a 9.2 percent increase. Pick 3 sales saw a 3.0 percent increase. KY Cash Ball sales saw an increase of 10.6 percent.

Sales decreases were recognized in Pick 4 and 5 Card Cash, with decreases of 2.7 percent and 3.2 percent, respectively. Lucky for Life sales were flat between years.

Table 5 and the accompanying chart compares draw game sales by product for 2018, 2017, and 2016.

TABLE 5
DRAW GAME SALES BY PRODUCT
(In millions)

Product	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
Powerball	$ 77.9	$ 5.8	$ 72.1	$ (22.3)	$ 94.4
Mega Millions	39.8	10.7	29.1	(2.2)	31.3
Keno	82.8	7.0	75.8	9.9	65.9
Pick 3	149.7	4.4	145.3	5.7	139.6
Pick 4	43.5	(1.2)	44.7	2.1	42.6
5 Card Cash	6.1	(0.2)	6.3	(0.8)	7.1
Cash Ball	11.5	1.1	10.4	0.7	9.7
Lucky for Life	7.8	-	7.8	(1.2)	9.0
Totals	$ 419.1	$ 27.6	$ 391.5	$ (8.1)	$ 399.6



iLottery Instant Play

iLottery instant play sales were $10.3 million, an increase of $5.1 million when compared to the $5.2 million achieved in 2017. iLottery instant play sales accounted for 1.0 percent of all 2018 sales, and 0.5 percent of all 2017 sales.

Prize Expense and Game Margin

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 revenues 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.

The following is a discussion of notable variances in prize expense within certain product categories. With that background, Table 6 compares the 2018 budgeted gross prize payout percentages for each product category, as well as the actual gross payout percentages for 2018, 2017, and 2016.

TABLE 6
GROSS PRIZE PAYOUT PERCENTAGES
ALL PRODUCTS

	BUDGET 2018	ACTUAL 2018	ACTUAL 2017	ACTUAL 2016
Instant Games	70.2%	70.1%	69.7%	69.1%
Draw Games:				
Powerball	50.0%	50.4%	49.8%	50.0%
Mega Millions	50.0%	50.2%	51.1%	49.7%
Pick 3	60.0%	58.3%	61.2%	58.2%
Pick 4	50.0%	46.1%	44.8%	52.1%
KY Cash Ball	53.8%	51.2%	59.1%	57.7%
5 Card Cash	59.8%	59.3%	59.3%	60.6%
Keno	65.5%	65.4%	65.4%	65.9%
Lucky for Life	59.4%	60.1%	59.2%	59.9%
Draw Games	57.3%	56.0%	57.2%	56.3%
iLottery Instant Play	75.0%	79.6%	73.6%	74.3%
Total Gross Prize Payout Percentage	64.4%	64.5%	64.8%	63.9%
Less: Unclaimed Prizes	-0.9%	-1.0%	-1.1%	-0.8%
Net Prize Payout Percentage	63.5%	63.5%	63.7%	63.1%

For 2018, gross prize expense (not including unclaimed prizes) of $667.7 million, reflects a 28.3 million or 4.4 percent increase from 2017 gross prize expense of $639.4 million. Gross prize expense in 2017 of $639.4 million, reflects a 1.7 percent increase from 2016 gross prize expense of $628.5 million.

Prize Expense and Game Margin (Continued)

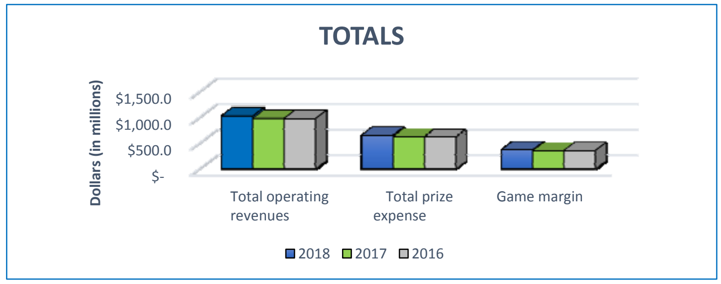
Net prize expense in 2018 was $657.4 million or 63.5 percent of total operating revenues compared to $628.8 million or 63.7 percent in 2017 and $620.6 million or 63.1 percent in 2016. Unclaimed prizes in 2018 were $10.3 million compared to $10.6 million in 2017, and $7.9 million in 2016.

Total game margin in 2018 increased to $377.8 million or 36.5 percent of total operating revenues compared to $358.2 million or 36.3 percent in 2017. 2016 gross margin was $363.2 million or 36.9 percent of operating revenues.

Table 7 and the accompanying chart compares total operating revenues, prize expense, and game margin for 2018, 2017, and 2016.

TABLE 7
TOTAL OPERATING REVENUES, PRIZE EXPENSE, AND GAME MARGIN
(In millions)

Totals	2018	2017	2016
Operating revenues	$ 1,042.5	$ 1,000.5	$ 997.3
Less: instant tickets provided as prizes	(7.3)	(13.5)	(13.5)
Total operating revenues	1035.2	987.0	983.8
Gross prize expense	667.7	639.4	628.5
Less: unclaimed prizes	(10.3)	(10.6)	(7.9)
Total prize expense	657.4	628.8	620.6
Game margin	$ 377.8	$ 358.2	$ 363.2



Instant Prize Expense and Game Margin

In 2018, gross prize expense (not including unclaimed prizes) for instant games increased to $424.6 million or 70.1 percent of total instant game operating revenues compared to 69.7 percent in 2017, and 69.1 percent in 2016. The KLC budgeted 70.2 percent in 2018.

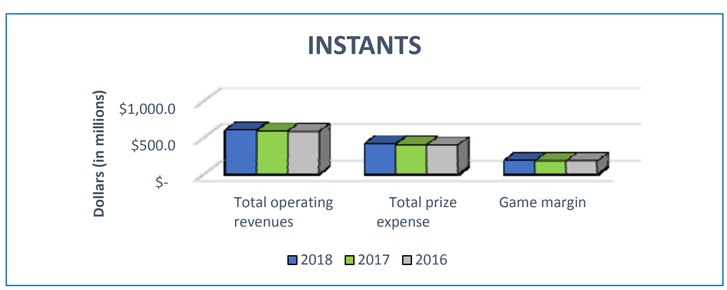
Net prize expense for instant games increased to $418.9 million or 69.1 percent of total instant game operating revenues compared to $405.9 million or 68.8 percent in 2017, and $398.9 million or 68.3 percent in 2016.

Instant game margin increased to $186.9 million or 30.9 percent of total instant game operating revenues compared to $184.4 million or 31.2 percent in 2017. 2016 gross margin was $184.9 million or 31.7 percent.

Table 8 and the accompanying chart compares instant game operating revenues, prize expense, and game margin for 2018, 2017, and 2016.

TABLE 8
INSTANT GAME OPERATING REVENUES, PRIZE EXPENSE, AND GAME MARGIN
(In millions)
(In millions)

Instants	2018	2017	2016
Operating revenues	$ 613.1	$ 603.8	$ 597.3
Less: instant tickets provided as prizes	(7.3)	(13.5)	(13.5)
Total operating revenues	605.8	590.3	583.8
Gross prize expense	424.6	411.7	403.3
Less: unclaimed prizes	(5.7)	(5.8)	(4.4)
Total prize expense	418.9	405.9	398.9
Game margin	$ 186.9	$ 184.4	$ 184.9



Draw Game Prize Expense and Game Margin

In 2018, gross prize expense for draw games was $234.9 million or 56.0 percent of total draw game operating revenues compared to $223.8 million or 57.2 percent in 2017, and $224.9 million or 56.3 percent in 2016. The KLC budgeted 57.3 percent in 2018.

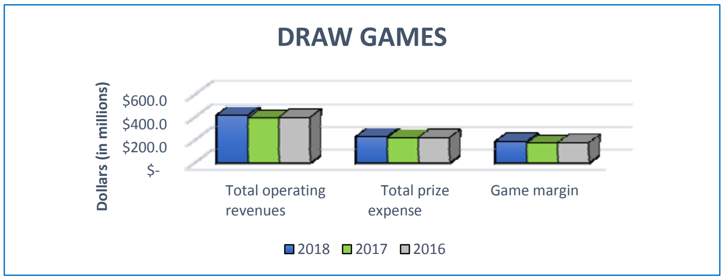
Net prize expense for draw games increased to $230.3 million or 55.0 percent of total draw game operating revenues in 2018 compared to $219.0 million or 55.9 percent in 2017, and $221.4 million or 55.4 percent in 2016.

Draw game margin increased to $188.8 million or 45.0 percent of total draw game operating revenues in 2018 compared to $172.5 million or 44.1 percent in 2017. 2016 draw game margin was $178.2 million or 44.6 percent.

Table 9 and the accompanying chart compares draw game operating revenues, prize expense, and game margin for 2018, 2017, and 2016.

TABLE 9
DRAW GAME OPERATING REVENUES, PRIZE EXPENSE, AND GAME MARGIN
(In millions)
(In millions)

Draw Games	2018	2017	2016
Operating revenues	$ 419.1	$ 391.5	$ 399.6
Less: instant tickets provided as prizes	0.0	0.0	0.0
Total operating revenues	419.1	391.5	399.6
Gross prize expense	234.9	223.8	224.9
Less: unclaimed prizes	(4.6)	(4.8)	(3.5)
Total prize expense	230.3	219.0	221.4
Game margin	$ 188.8	$ 172.5	$ 178.2



iLottery Instant Play Prize Expense and Game Margin

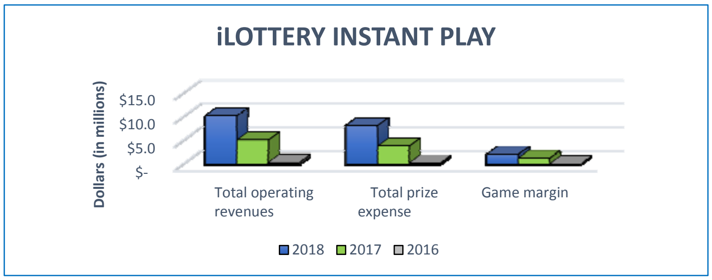
In 2018, gross iLottery Instant Play gross and net prize expense was $8.2 million or 79.6 percent of total iLottery Instant Play operating revenues compared to $3.9 million or 75.0 percent in 2017, and 75.0 percent budgeted.

iLottery Instant Play game margin increased to $2.1 million or 20.4 percent of iLottery Instant Play operating revenues in 2018 compared to $1.3 million or 25.0 percent in 2017, and $0.1 million or 25.0 percent in 2016.

Table 10 and the accompanying chart compares iLottery Instant Play operating revenues, prize expense, and game margin for 2018, 2017, and 2016.

TABLE 10
iLOTTERY INSTANT PLAY OPERATING REVENUES, PRIZE EXPENSE, AND GAME MARGIN
(In millions)
(In millions)

iLottery Instant Play	2018	2017	2016
Operating revenues	$ 10.3	$ 5.2	$ 0.4
Less: instant tickets provided as prizes	0.0	0.0	0.0
Total operating revenues	10.3	5.2	0.4
Gross prize expense	8.2	3.9	0.3
Less: unclaimed prizes	0.0	0.0	0.0
Total prize expense	8.2	3.9	0.3
Game margin	$ 2.1	$ 1.3	$ 0.1



Other Expenses

TABLE 11
PAYMENTS TO RETAILERS, OPERATING, AND NON-OPERATING EXPENSES
(In millions)

	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
Payments to retailers	$ 61.1	$ (0.6)	$ 61.7	$ (0.9)	$ 62.6
Draw vendor expense	11.4	1.3	10.1	0.4	9.7
Instant ticket costs	8.5	(0.4)	8.9	1.0	7.9
Operating expenses	30.9	0.7	30.2	0.1	30.1
Non-operating expenses					
Amortization of prize discount	0.2	(0.4)	0.6	(0.5)	1.1

Payments to retailers cover base selling and cashing commissions as well as a retailer incentive plan based on the sale of Instant and Keno tickets. Payments to retailers for 2018 and 2017 were 5.9 percent and 6.3 percent of total operating revenues, respectively. Draw vendor expenses for 2018 and 2017 were 1.1 percent and 1.0 percent of total operating revenues, respectively. Instant ticket costs include the cost to acquire and ship instant tickets to retailers and were 0.8 percent and 0.9 percent of total operating revenues in 2018 and 2017. Operating expenses were 3.0 percent and 3.1 percent of total operating revenues for 2018 and 2017. 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 $0.4 million in 2018 and $0.5 million in 2017.

Investment Income (Loss)

TABLE 12
INVESTMENT INCOME (LOSS)
(In millions)

	2018	Increase (Decrease)	2017	Increase (Decrease)	2016
Unrealized loss on investments	$ (0.7)	$ 0.3	$ (1.0)	$ (0.9)	$ (0.1)
Accretion of investments	0.6	(0.1)	0.7	(0.3)	1.0
Security lending income	0.1	0.0	0.1	0.0	0.1
Interest income	0.2	0.1	0.1	0.0	0.1
Total investment income (loss)	$ 0.2	$ 0.3	$ (0.1)	$ (1.2)	$ 1.1

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 policy to raise short-term interest rates in 2018.

Payments to the Commonwealth of Kentucky

In 2018 and 2017, 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 2018 were $266.4 million, which consisted of $256.1 million or an increase of $18.1 million to the Commonwealth’s general fund and $10.3 million or an decrease of $0.3 million to the KEES Program Reserve Account. Payments in 2017 were $248.6 million, which consisted of $238.0 million to the Commonwealth’s general fund and $10.6 million to the KEES Program Reserve Account.

Currently Known Facts, Decisions, or Conditions

The Kentucky Lottery Corporation's mission is to produce the maximum net revenues for the Commonwealth by offering the best lottery games to its citizens, games of the highest quality and integrity, which are consistent with good public policy and social responsibility, and to operate within the framework of public accountability. To achieve this mission, the KLC will continue to introduce new and/or enhanced instant, draw, and iLottery instant play product offerings to further increase sales in FY 2019.

Instant sales are budgeted to produce sales of $679.0 million during FY 2019, an increase of $59.0 million or 9.5 percent.

- The KLC plans to add 270 new touch screen vending machines to retail locations throughout the Commonwealth. These self-service machines contain 28 ticket bins instead of the 24 that current machines have, which will allow for more product to be on display at retail locations, and should lead to instant sales increases in FY 2019.
- The KLC will continue to utilize "families" (like-branded groups of games selling at different price points) of instant game products which will allow for more game specific marketing efforts and help to increase product awareness of specific games at retail locations.
- A $30 instant ticket commemorating the KLC's 30th Anniversary will be introduced in February 2019.
- Beginning in September 2018, the KLC's instant ticket vendor will begin providing the internal sales and distribution functions for related to instant tickets.

Draw game sales are budgeted to produce sales of $437.2 million during FY 2019, an increase of $33.6 million or 8.3 percent.

- 1-Off, a new wager type which will allow players to win prizes even if the numbers they play are not exact matches to the winning numbers drawn, will be added to the Pick 3 and Pick 4 games in July 2018. This feature should result in sales increases for both games.
- Sunday drawings will be held for the 5 Card Cash game beginning in August 2018, which should result in a sales increase for that game.
- Keno is budgeted to produce sales of $87.4 million in FY 2019, an increase of $3.4 million or 4.0 percent. Bullseye, an add-on feature to the Keno game, will be available for purchase beginning in December 2018, which should result in a sales increase for FY 2019.
- Kentucky's Quick Bucks, a new draw game offering, will begin sales in February 2019, and has budgeted sales of $3.2 million for FY 2019.
- Win Place Show, a lottery game based on the results of live horse racing, will be offered at select KLC retailers beginning in the Spring of 2019 as part of a trial pilot program.
- Cash Ball 225 will add the EZ Match feature in fourth quarter of FY 2019, which should result in a sales increase for that game.

iLottery instant play sales are budgeted to produce sales of $14.3 million during FY2019, an increase of $5.3 million or 58.9 percent.

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.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF NET POSITION
June 30, 2018 and 2017
(dollars in thousands)

	2018	2017
ASSETS		
Current Assets		
Cash and cash equivalents	**$ 17,682**	$ 20,149
Cash and cash equivalents, annuitants	**2,600**	2,600
Investments at fair value, current portion	**1,836**	2,159
Accounts receivable, net	**31,628**	24,692
Prepaid PowerPlay License, current portion	**67**	67
Other	**948**	888
Total current assets	**54,761**	50,555
Noncurrent Assets		
Investments at fair value, less current portion	**10,083**	11,681
Prepaid PowerPlay License, less current portion	**45**	112
Capital assets, net	**5,441**	5,314
Deposits with Multi-State Lottery Association	**5,182**	4,848
Total noncurrent assets	**20,751**	21,955
Total assets	**75,512**	72,510
LIABILITIES		
Current Liabilities		
Accounts payable, accrued expenses, and compensated absences, current portion	**5,981**	6,332
Due to the Commonwealth of Kentucky	**6,131**	2,555
Estimated prize liability, current portion	**31,061**	29,954
Total current liabilities	**43,173**	38,841
Noncurrent Liabilities		
Accrued compensated absences, less current portion	**1,136**	1,167
Estimated prize liability, less current portion	**12,907**	13,493
Total noncurrent liabilities	**14,043**	14,660
Total liabilities	**57,216**	53,501
NET POSITION		
Net investment in capital assets	**5,441**	5,314
Unrestricted	**12,855**	13,695
Net position	**$ 18,296**	$ 19,009

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET POSITION
For the Years Ended June 30, 2018 and 2017
(dollars in thousands)

	2018	2017
Operating revenues		
Instant games	**$ 613,134**	$ 603,823
Draw games	**419,126**	391,436
iLottery instant play games	**10,252**	5,242
Less instant tickets provided as prizes	**(7,309)**	(13,541)
Total operating revenues	**1,035,203**	986,960
Direct costs		
Prizes expense		
Instant games	**418,862**	405,888
Draw games	**230,337**	219,084
iLottery instant play games	**8,163**	3,859
Total prize expense	**657,362**	628,831
Payments to retailers	**61,138**	61,672
Draw game vendor expense	**11,370**	10,094
Instant ticket costs	**8,474**	8,871
Total direct costs	**738,344**	709,468
Operating revenues net of direct costs	**296,859**	277,492
Operating expenses		
Advertising and promotion	**10,268**	10,074
Salaries, wages, and benefits	**15,318**	14,831
Contracted and professional services	**2,374**	2,265
Depreciation	**1,186**	1,312
Other general and administrative	**1,769**	1,671
Total operating expenses	**30,915**	30,153
Operating income	**265,944**	247,339
Nonoperating revenue (expense)		
Payments to the Commonwealth of Kentucky	**(266,417)**	(248,571)
Investment income (loss)	**176**	(129)
Interest expense	**(651)**	(736)
Other income	**235**	274
Total nonoperating expense	**(266,657)**	(249,162)
Change in net position	**(713)**	(1,823)
Net position at beginning of year	**19,009**	20,832
Net position at end of year	**$ 18,296**	$ 19,009

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF CASH FLOWS
For the Years Ended June 30, 2018 and 2017
(dollars in thousands)

	2018	2017
Cash Flows from Operating Activities		
Cash received from customers	**$ 1,028,267**	$ 998,622
Cash payments for deposits at the Multi-State Lottery Association	**(334)**	(114)
Cash payments to prize winners	**(656,841)**	(626,542)
Cash payments to suppliers	**(96,802)**	(97,378)
Cash payments to employees for services	**(14,935)**	(14,659)
Net cash provided by operating activities	**259,355**	259,929
Cash Flows from Noncapital Financing Activities		
Payments to the Commonwealth of Kentucky	**(262,841)**	(251,594)
Cash Flows from Capital and Related Financing Activities		
Purchases of capital assets	**(1,313)**	(915)
Cash Flows from Investing Activities		
Proceeds from sale of investments	**1,859**	1,974
Investment income	**473**	368
Net cash provided by investing activities	**2,332**	2,342
Increase (decrease) in cash and cash equivalents	**(2,467)**	9,762
Cash and cash equivalents at beginning of year	**22,749**	12,987
Cash and cash equivalents at end of year	**$ 20,282**	$ 22,749
Reconciliation of Operating Income to Net Cash Provided by Operating Activities		
Operating income	**$ 265,944**	$ 247,339
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	**1,186**	1,312
Provision for losses on accounts receivable	**99**	170
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	**(7,218)**	11,492
Prepaid PowerPlay License	**67**	67
Other assets	**(60)**	114
Deposits with Multi-State Lottery Association	**(334)**	(114)
Accounts payable and accrued expenses	**(199)**	(2,004)
Estimated prize liability	**(130)**	1,553
Total adjustments	**(6,589)**	12,590
Net cash provided by operating activities	**$ 259,355**	$ 259,929

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, 2018 and 2017 totaled $651 and $736, respectively.

The fair value of investments decreased $713 and $958 for the years ended June 30, 2018 and 2017, respectively.

See accompanying notes.

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 (1) the appointment of a voting majority of the potential component unit's Board, and either (a) the KLC's ability to impose its will over the potential component unit, or (b) the possibility that the potential component unit will provide a financial benefits to or impose a financial burden on the KLC, or (2) the potential component unit is fiscally dependent on the KLC, and 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 discretely presented 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.

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 *nonoperating* 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 nonoperating 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 Validation-Based retailers, revenue is recognized at the time packs of tickets are marked due or upon activation, whichever is sooner. Finally, for Activation-Based retailers, revenue is recognized upon activation. 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 $30 and $246 for the years ended June 30, 2018 and 2017, respectively. A trade receivable is considered uncollectible after no payment has been received in 90 days.

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; after the last date to claim has passed, the prize expense is adjusted, if necessary, 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 Win for Life, Lucky for Life, Powerball, and Mega Millions draw games.

Win for Life grand prizes are paid in quarterly installments 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 reviews 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, but continues to have financial obligation to past winners.

Lucky for Life grand prizes and second tier prizes are paid in annual installments 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. As of June 30, 2018, the KLC has had three Lucky for Life grand prize winners, and four second tier prize winners. All winners elected to receive the single lump-sum cash payment.

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.

Cash and Cash 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. Cash equivalents are reported at cost.

(dollars in thousands)

Note 2 – Summary of Significant Accounting Policies (Continued)

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. 72, *Fair Value Measurement and Application*. 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 installment 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 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
Game equipment	5 years
Data processing equipment	5 years
Automobiles, furniture, and fixtures	3 - 5 years
Computer software	7 years

Interest related to construction of capital assets is capitalized. No interest was capitalized for the years ended June 30, 2018 and 2017.

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 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 was $472 related to new computer software required to be capitalized in 2018. No intangible assets were capitalized in 2017.

Note 2 – Summary of Significant Accounting Policies (Continued)

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 33 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.

Net Position

Net position of the KLC is 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 does not meet the definition of "net investment in capital assets" or "restricted".

As of June 30, 2018 and 2017, the KLC had no restricted net position.

Note 2 – Summary of Significant Accounting Policies (Continued)

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 discretely presented component unit, management has evaluated subsequent events through October 11, 2018, and will re-evaluate subsequent events before the Commonwealth completes its Comprehensive Annual Financial Report in December 2018.

Pending Accounting Pronouncements Not Yet Adopted

The GASB has issued the following statement not yet implemented by the KLC:

GASB Statement No. 87, *Leases*, issued June 2017. The provisions of this statement require governments to recognize certain lease assets and liabilities for leases that previously were classified as operating leases and recognized as inflows or outflows of resources based on the payment provisions of the contract. It establishes a single model for lease accounting based on the foundational principle that leases are financings of the right to use an underlying asset. Under this Statement, a lessee is required to recognize a lease liability and an intangible right-to-use lease asset, and a lessor is required to recognize a lease receivable and a deferred inflow of resources, thereby enhancing the relevance and consistency of information about governments' leasing activities. The requirements of this Statement are effective for reporting periods beginning after December 15, 2019. This statement is not expected to have a material impact on the KLC's financial position or results of operations.

(dollars in thousands)

Note 3 – Cash and Cash Equivalents

The components of cash and cash equivalents for the years ended June 30, 2018 and 2017 consisted of the following:

	2018	2017
Cash on deposits in banks	$ 21,215	$ 23,555
Checks issued against cash on deposit	(933)	(806)
	$ 20,282	$ 22,749

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 cash on deposit in banks is to be fully collateralized by U.S. Government securities held by the KLC or by the KLC's agent in the KLC's name.

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, 2018, the KLC's investment balances were as follows:

Investment Type	Fair Value	Level 1	Level 2	Maturity
U.S. Treasury Strips	$ 7,964	$ 7,964	$ 0	Weighted average maturity of 4.57 years
Other U.S. Government backed	3,955	0	3,955	Weighted average maturity of 4.14 years
Total	$ 11,919	$ 7,964	$ 3,955	

(dollars in thousands)

Note 4 – Investments (Continued)

At June 30, 2017, the KLC's investment balances were as follows:

Investment Type	Fair Value	Level 1	Level 2	Maturity
U.S. Treasury Strips	$ 9,324	$ 9,324	$ 0	Weighted average maturity of 4.87 years
Other U.S. Government backed	4,516	0	4,516	Weighted average maturity of 4.61 years
Total	$ 13,840	$ 9,324	$ 4,516	

Credit Rating – U.S. Treasury obligations which are backed by the full faith and credit of the U.S. Government are not rated. For 2018, $2,406 of the other U.S. Government backed investments are not rated and the remaining $1,549 are all rated Aaa. For 2017, $2,656 of the other U.S. Government backed investments are not rated, and the remaining $1,860 are all rated Aaa. Ratings are provided by Moody's.

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. For 2018 and 2017, approximately 13 percent of total investments were in Resolution Funding Corporation Strips and 13 percent in Israel Bonds, all of which are U.S. Government backed.

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.

(dollars in thousands)

Note 4 – Investments (Continued)

The net change 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 (loss) for the years ended June 30, 2018 and 2017 consisted of the following:

	2018	2017
Unrealized change in fair value of investments	$ (713)	$ (958)
Accretion of investments	651	736
Security lending income	10	10
Interest income	228	83
Total investment income (loss)	$ 176	$ (129)

When compared to the historical cost method, recording investments at fair value results in a decrease in income by approximately $713 and $958 in 2018 and 2017, respectively.

Unrestricted net position at June 30, 2018 and 2017 is as follows:

	2018	2017
Unrestricted net position excluding unrealized gains on investments	$ 11,698	$ 11,825
Accumulated unrealized gains on investments	1,157	1,870
Total unrestricted net position	$ 12,855	$ 13,695

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'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.

The Commonwealth's securities lending agent and its affiliates are prohibited from borrowing the KLC's securities. The Commonwealth's securities lending agent lends KLC's securities in exchange for cash. The cash is used to invest in repurchase agreements and securities are pledged as collateral. 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, 2018 and 2017, the KLC had no credit risk exposure to borrowers because the amounts the KLC owed to borrowers exceeded the amounts the borrowers owed to the KLC.

(dollars in thousands)

Note 4 – Investments (Continued)

At June 30, 2018 and 2017, the KLC had loaned investments with fair values of approximately $1,171 and $3,838, 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 $1,186 and $3,925 at June 30, 2018 and 2017, 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, 2018 and 2017 consisted of the following:

	2018	2017
Accounts receivable	$ 31,910	$ 24,906
Allowance for doubtful accounts	(282)	(214)
Accounts receivable, net	$ 31,628	$ 24,692

(dollars in thousands)

Note 6 – Capital Assets

Capital asset activity for the year ended June 30, 2018 was as follows:

	Beginning Balance	Increases	Decreases	Ending balance
Capital assets not being depreciated				
Land	$ 423	$ 0	$ 0	$ 423
Net capital assets, non-depreciable	423	0	0	423
Capital assets being depreciated				
Buildings	7,925	154	0	8,079
Game equipment	562	0	0	562
Data processing equipment and software	17,230	1,043	(13,311)	4,962
Automobiles, furniture, and fixtures	3,238	116	(949)	2,405
Total other capital assets at cost	28,955	1,313	(14,260)	16,008
Less accumulated depreciation for				
Buildings	(4,826)	(266)	0	(5,092)
Game equipment	(555)	(6)	0	(561)
Data processing equipment and software	(15,732)	(722)	13,311	(3,143)
Automobiles, furniture, and fixtures	(2,951)	(192)	949	(2,194)
Total accumulated depreciation	(24,064)	(1,186)	14,260	(10,990)
Net capital assets, depreciable	4,891	127	0	5,018
Total capital assets, net	$ 5,314	$ 127	$ 0	$ 5,441

(dollars in thousands)

Note 6 – Capital Assets (Continued)

Capital asset activity for the year ended June 30, 2017 was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets not being depreciated				
Land	$ 423	$ 0	$ 0	$ 423
Net capital assets, non-depreciable	423	0	0	423
Capital assets being depreciated				
Land improvements	19	0	(19)	0
Buildings	7,734	191	0	7,925
Game equipment	2,158	0	(1,596)	562
Data processing equipment and software	16,858	372	0	17,230
Automobiles, furniture, and fixtures	3,572	352	(686)	3,238
Total other capital assets at cost	30,341	915	(2,301)	28,955
Less accumulated depreciation for				
Land improvements	(19)	0	19	0
Buildings	(4,566)	(260)	0	(4,826)
Game equipment	(2,099)	(52)	1,596	(555)
Data processing equipment and software	(14,992)	(740)	0	(15,732)
Automobiles, furniture, and fixtures	(3,377)	(260)	686	(2,951)
Total accumulated depreciation	(25,053)	(1,312)	2,301	(24,064)
Net capital assets, depreciable	5,288	(397)	0	4,891
Total capital assets, net	$ 5,711	$ (397)	$ 0	$ 5,314

(dollars in thousands)

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 16 weeks of vacation. Accrued vacation at June 30, 2018 and 2017, included in accrued expenses in the accompanying Statements of Net Position, consisted of the following:

	2018	2017
Current	$ 228	$ 155
Compensated absences, less current portion	1,136	1,167
Total compensated absences	$ 1,364	$ 1,322

Years Ended June 30,	Beginning Balance	Increases	Decreases	Ending Balance
2018	$ 1,322	$ 203	$ (161)	$ 1,364
2017	1,195	276	(149)	1,322

(dollars in thousands)

Note 8 – Severance

On March 9, 2018, KLC announced that it was outsourcing and eliminating certain positions. KLC designed a severance plan for an estimated 18 eliminated positions, payable based on years of service. Employees will be provided one week of pay for every year of service, with a minimum of eight weeks and maximum of 26. To receive the severance, employees must still be employed as of an agreed upon date.

Accrued severance at June 30, 2018 is included in accrued expenses in the accompanying statements of net position, classified as current. The total value accrued was $216, based on the expected future payments. Lump sum payments will be made after each employee's termination date. All benefits are expected to be paid by June 30, 2019.

Note 9 – Estimated Prize Liability

Estimated prize liability at June 30, 2018 and 2017 consisted of the following:

	2018	2017
Current:		
Grand prizes	$ 1,934	$ 1,832
Other prizes	29,127	28,122
Total current portion	$ 31,061	$ 29,954
Long-term:		
Grand prizes	$12,907	$ 13,493

(dollars in thousands)

Note 9 – Estimated Prize Liability (Continued)

Liability activity of grand prize awards payable was as follows:

Years Ended June 30,	Beginning Balance	Increases	Decreases	Ending Balance
2018	$ 15,325	$ 1,450	$ (1,934)	$ 14,841
2017	16,956	756	(2,387)	15,325

Liabilities for future payments of grand prize liabilities are summarized as follows:

Years Ending June 30,	
2019	$ 1,934
2020	1,617
2021	1,407
2022	1,407
2023	1,355
2023 through 2027	5,051
2028 through 2032	2,247
2033 through 2037	1,885
2038 through 2042	936
2043 through 2047	572
2048 through 2050	104
Total	18,515
Less unamortized discount	(3,674)
Total at present value	14,841
Less current portion	(1,934)
Total long-term portion at present value	$ 12,907

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 $651 and $736 in 2018 and 2017, respectively, is included in interest expense. These amounts comprise the entire amounts of interest expense for the years ended June 30, 2018 and 2017.

Note 10 – 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. Employees become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

During 2018 and 2017, the KLC's contributions were calculated using the eligible compensation amount for eligible employees of $6,132 and $6,419, respectively, for the 6.2 percent employer contribution (Mandatory and Supplemental Contributions), and $10,371 and $10,552, respectively, for the eight percent employer contribution (Basic Contributions). Employer contributions actually made to the Plan were approximately $1,210 and $1,242 in 2018 and 2017, respectively. Employee contributions to the Plan were approximately $380 and $398 in 2018 and 2017, respectively. At June 30, 2018 and 2017, the KLC had an outstanding liability of approximately $24 and $23, respectively, owed to the Plan, as part of the accrued salaries balance.

During 2018 and 2017, forfeitures of $0 and $4, respectively, 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.

(dollars in thousands)

Note 11 – 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 seven years.

Approximate minimum rental payments are:

Years Ending June 30,		
2019	$	108
2020		84
2021		48
	$	240

Total rental expense for 2018 and 2017 was approximately $155.

Note 12 – 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, 2018 and 2017, all unclaimed prize money was transferred to the KEES Program Reserve Account as required by HB 303 of the 2016 Regular Session. Payments are made at the end of each quarter.

(dollars in thousands)

Note 12 – Payments to the Commonwealth (Continued)

Payments, including amounts accrued, to the Commonwealth for the years ended June 30, 2018 and 2017 included payments to the following funds:

	2018	2017
General Fund	$ 256,146	$ 238,000
KEES Scholarship Reserve Fund	10,271	10,571
	$ 266,417	$ 248,571

Note 13 – 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 amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage.

Note 14 – 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.

INDEPENDENT AUDITOR'S 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

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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, 2018 and the related notes to the financial statements, and have issued our report thereon dated October 11, 2018.

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.

INDEPENDENT AUDITOR'S 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.

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

Louisville, Kentucky
October 11, 2018

SCHEDULE OF FINDINGS
Year Ended June 30, 2018

Schedule of auditor's results

We have issued an unmodified opinion, dated October 11, 2018, on the financial statements of the Kentucky Lottery Corporation as of and for the year ended June 30, 2018.

Our audit disclosed no instances of noncompliance 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*.

SCHEDULE OF PRIOR AUDIT FINDINGS AND THEIR RESOLUTIONS
Year Ended June 30, 2018

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