



NORTH CAROLINA EDUCATION LOTTERY

Financial Statements

June 30, 2006

(With Independent Auditors' Report Thereon)

Financial Statement Audit Report of the
North Carolina Education Lottery
for the Period ended June 30, 2006

Performed under contract with the
North Carolina Office of the State Auditor
Leslie W. Merritt, Jr., CPA, CFP

NORTH CAROLINA EDUCATION LOTTERY

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STATE OF NORTH CAROLINA
Office of the State Auditor

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

2 S. Salisbury Street
20601 Mail Service Center
Raleigh, NC 27699-0601
Telephone: (919) 807-7500
Fax: (919) 807-7647
Internet
<http://www.ncauditor.net>

AUDITOR'S TRANSMITTAL

The Honorable Michael F. Easley, Governor
The General Assembly of North Carolina
North Carolina State Lottery Commission

This report presents the results of the financial statement audit of the North Carolina Education Lottery (the Lottery), an enterprise fund of the State of North Carolina, for the period ended June 30, 2006. KPMG, L.L.P. performed this audit under contract with the Office of the State Auditor and their report is submitted herewith.

General Statute 18C-116 requires the State Auditor to conduct an annual audit of the Lottery's accounts and transactions. General Statute 147-64.7 allows the State Auditor to obtain the services of independent public accountants to carry out its duties and functions.

North Carolina General Statutes require the State Auditor to make audit reports available to the public. Copies of audit reports issued by the Office of the State Auditor may be obtained through one of the options listed in the back of this report.

Leslie W. Merritt, Jr.

Leslie W. Merritt, Jr., CPA, CFP
State Auditor

December 11, 2006



KPMG LLP
Suite 1200
150 Fayetteville Street
P.O. Box 29543
Raleigh, NC 27626-0543

Independent Auditors' Report

Commissioners
The North Carolina Education Lottery:

We have audited the accompanying statement of net assets of the North Carolina Education Lottery (NCEL) as of June 30, 2006, and the related statements of revenues, expenses, and changes in fund net assets and cash flows for the period August 31, 2005 (period of inception) through June 30, 2006. These financial statements are the responsibility of the NCEL's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the NCEL's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note 2, the financial statements present only the NCEL and do not purport to, and do not, present fairly the financial position of the State of North Carolina, as of June 30, 2006, and the changes in its financial position and its cash flows for the period in conformity with U.S. generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the NCEL as of June 30, 2006, and the changes in its financial position and its cash flows for the period in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 28, 2006 on our consideration of the NCEL'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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 2 - 4 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

November 28, 2006

NORTH CAROLINA EDUCATION LOTTERY

Management's Discussion and Analysis

June 30, 2006

The following is a discussion and analysis of the financial performance of the North Carolina Education Lottery (NCEL) for the period ended June 30, 2006. This section provides an overview of the NCEL's operations and should be read in conjunction with the transmittal letter and the financial statements, including the footnotes.

The NCEL is a major enterprise fund of the primary government of the state of North Carolina. The financial statements were prepared on the accrual basis of accounting in a manner similar to a private enterprise. The principal operating revenues of the NCEL are charges to retailers for sales of lottery tickets. The significant operating expenses include the cost of prizes, retailer commissions, gaming system vendor charges, personnel, and other administrative expenses.

Financial Highlights

- Began selling Instant tickets on March 30, 2006.
- Began selling Powerball tickets on May 30, 2006.
- Repaid, on April 28, 2006, all \$4,000,000 borrowed from the State Treasury to cover initial start-up expenses. The \$30,840 interest due to the State for this loan was paid on June 14, 2006 after receiving the notification of the amount.
- Ended with over \$63.5 million in Net Revenues for educational purposes in North Carolina.

Overview of the Financial Statements

This financial report is designed to inform the public and other interested parties of the financial results of NCEL and show its accountability in meeting the legislated mandate to generate funds to further the goal of providing enhanced educational opportunities so that all students in the public schools can achieve their full potential. As established in House Bill 1023, Section 18C-164, the funds will be distributed in the following manner:

- (1) A sum equal to fifty percent (50%) to support reduction of class size in early grades to class size allotments not exceeding 1:18 in order to eliminate achievement gaps and to support academic prekindergarten programs for at-risk four-year-olds who would otherwise not be served in a high-quality education program in order to help those four-year-olds be prepared developmentally to succeed in school.
- (2) A sum equal to forty percent (40%) to the Public School Building Capital Fund in accordance with G.S. 115C-546.2.
- (3) A sum equal to ten percent (10%) to the State Educational Assistance Authority to fund college and university scholarships in accordance with Article 35A of Chapter 115C of the General Statutes."

Included in this report is the Statement of Net Assets as of June 30, 2006, the Statement of Revenues, Expenses, and Changes in Fund Net Assets for the period ended June 30, 2006, and the Statement of Cash Flows for the period ended June 30, 2006.

The NCEL began operations after July 1, 2005; therefore, these statements reflect only a partial fiscal year. The first full time, permanent employee was hired in December 2005. The first lottery ticket (instant game) began selling on March 30, 2006, and the first on-line (Powerball) game tickets began selling on May 30, 2006.

NORTH CAROLINA EDUCATION LOTTERY

Management's Discussion and Analysis

June 30, 2006

Since this was a start-up period, there were a significant number of initial purchases. Once the NCEL is in operation for a full fiscal year, a number of these initial expenditures will occur over longer time periods as the items purchased require replacement. The capitalization of all items including equipment, computers, and furniture follows North Carolina's Office of State Controller's policies. There is also a significant one time expenditure of \$264,955 for temporary employees. Temporary employees were needed to help operate until the permanent NCEL staff was hired.

Financial Analysis

	<u>2006</u>
Summary results of operations:	
Operating revenue	\$ 216,905,691
Prizes and commissions	<u>(135,031,069)</u>
Gross profit	81,874,622
Operating expenses	<u>(17,657,567)</u>
Operating income	<u>64,217,055</u>
Nonoperating revenue (expense):	
Interest and miscellaneous expense	(437,160)
Investment earnings	808,385
Transfers to the state	<u>(64,588,280)</u>
Total nonoperating revenue (expense)	<u>(64,217,055)</u>
Change in net assets	<u>\$ —</u>

All funds of the NCEL are deposited with the North Carolina State Treasurer and earn interest based on short term investments by the State Treasurer. The State's general obligation bonds are rated "AAA" by Fitch Ratings, "Aa1" by Moody's Investors Service, and "AAA" by Standard & Poor's Rating Service.

Budget and Economic Outlook

The budget for 2006-2007 was approved by the Commission to provide \$401 million to the Education Lottery Fund, which is held by the State of North Carolina. The NCEL is on schedule to complete phase two of its start-up operations by the end of October 2006. Phase one was the implementation of instant and Powerball games. Phase two is the implementation of both Pick 3 and Cash 5 daily online games.

Conditions Expected to Impact Future Operations

The inventory of games available to the consumer will be increased with the implementation in the fall of 2006 of the second and third on-line games. At that time the NCEL will have three on-line (Powerball, Carolina Pick 3, and Carolina Cash 5) and approximately thirty instant games on the market.

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Management's Discussion and Analysis

June 30, 2006

On June 13, 2006, the Commission approved the FY 2007 budget for the NCEL. As part of this budget, the Commission approved a bonus incentive plan for each level of staff in the sales division located throughout the State. This includes the positions of Director of Sales, Corporate Accounts Manager, Regional Sales Manager, Retail Sales Manager, Retail Sales Specialist, and Sales Representative. The plan incentives are based on the achievement of individual, regional, and total sales goals and the maximum annual amounts range between \$8,000 and \$16,000. This plan has a maximum potential cost to the NCEL for FY 2007 of \$1.1 million.

Requests for Information

Any request for information about this report should be sent to the Public Information Officer at the North Carolina Education Lottery, 2100 Yonkers Road, Raleigh, North Carolina 27604.

NORTH CAROLINA EDUCATION LOTTERY

Statement of Net Assets

June 30, 2006

Assets

Current assets:

Cash and cash equivalents:

Cash on hand

\$ 17,551

Pooled cash

18,482,347

Receivables:

Accounts receivable

10,046,858

Interest receivable

183,688

State treasurer's security lending collateral

16,064,246

Total current assets

44,794,690

Capital assets, depreciable (net):

Machinery and equipment

700,701

Accumulated depreciation

(76,198)

Total capital assets, depreciable (net)

624,503

Total assets

\$ 45,419,193

Liabilities

Current liabilities:

Accounts payable

\$ 9,928,319

Accrued payroll

1,583

Other payables

5,276,495

Due to other state funds

13,624,870

Obligations under state treasurer's security lending agreements

16,064,246

Total current liabilities

44,895,513

Noncurrent liabilities:

Accrued paid time off

523,680

Total liabilities

45,419,193

Net assets/deficit:

Invested in capital assets

624,503

Unrestricted net deficit

(624,503)

Total net assets

\$ —

See accompanying notes to financial statements.

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Statement of Revenues, Expenses, and Changes in Fund Net Assets

August 31, 2005 (period of inception) through June 30, 2006

Operating revenues:	
Gross sales	\$ 229,530,492
Less:	
Prize tickets	(14,101,626)
Damaged tickets	(1,324)
Fees and licenses	1,478,149
Total revenues	<u>216,905,691</u>
Operating expenses:	
Salaries, wages, and benefits	5,194,921
Lottery prize	118,974,133
Retailer commissions	16,056,936
Gaming systems services	3,965,800
Advertising	2,260,243
Other services	3,763,042
Furniture, fixture, and equipment	1,567,936
Depreciation/amortization	76,198
Other general and administrative expenses	829,427
Total expenses	<u>152,688,636</u>
Operating income	64,217,055
Nonoperating revenues (expenses):	
Interest and fees	(30,840)
Investment earnings	808,385
Miscellaneous nonoperating expenses	(406,320)
Income before transfers	<u>64,588,280</u>
Transfers out	<u>(64,588,280)</u>
Change in net assets	—
Net assets – August 31, 2005	<u>—</u>
Net assets – June 30, 2006	<u><u>\$ —</u></u>

See accompanying notes to financial statements.

NORTH CAROLINA EDUCATION LOTTERY

Statement of Cash Flows

August 31, 2005 (period of inception) through June 30, 2006

Cash flows from operating activities:	
Receipts from customers	\$ 190,801,897
Payments to employees	(4,669,658)
Payments to prize winners	(108,078,949)
Payments to vendors and suppliers	(7,998,701)
Other receipts/payments	(64)
Net cash flows provided by operating activities	<u>70,054,525</u>
Cash used for noncapital financing activities:	
Transfer to State Education Fund Reserve	(50,000,000)
Transfers to other state agencies	(5,041,527)
Transfers from other state agencies	4,000,000
Interest expense	(30,840)
Total cash used for noncapital financing activities	<u>(51,072,367)</u>
Cash used for capital financing activities:	
Acquisition of capital assets	(700,701)
Total cash used for capital financing activities	<u>(700,701)</u>
Cash provided from investment activities:	
Investment earnings	218,441
Total cash provided from investment activities	<u>218,441</u>
Net increase in cash and cash equivalents	18,499,898
Cash and cash equivalents at beginning of period	<u>—</u>
Cash and cash equivalents at end of period	<u><u>\$ 18,499,898</u></u>
Reconciliation of operating income to net cash provided by operating activities:	
Operating income	\$ 64,217,053
Adjustments to reconcile operating income to cash provided by operating activities:	
Depreciation/amortization	76,198
Reimbursement of retailer bank fees	(64)
(Increases) decreases in assets:	
Accounts receivable	(10,046,858)
Increases (decreases) in liabilities:	
Accounts payable	9,928,319
Accrued payroll and related liabilities	525,263
Other payables	5,354,614
Total cash provided by operating activities	<u><u>\$ 70,054,525</u></u>
Noncash investing, capital, and financing activities:	
Assets acquired through the assumption of a liability	\$ 16,064,246

See accompanying notes to financial statements.

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Notes to the Financial Statements

June 30, 2006

(1) Organization

The North Carolina State Lottery Commission (aka, North Carolina Education Lottery (NCEL)) was created with the enactment of House Bill 1023 effective August 31, 2005 as an independent, self-supporting, and revenue-raising agency of the State of North Carolina (the State). The purpose of the NCEL is to generate funds to further the goal of providing enhanced educational opportunities so that all students in the public schools can achieve their full potential, to support school construction, and to fund college and university scholarships. The operations of the NCEL are overseen by a nine member commission, five of whom are appointed by the Governor and four of whom are appointed by the General Assembly. The period referred to on the Statement of Revenues, Expenses and Changes in Fund Net Assets and the Statement of Cash Flows includes the ten months in fiscal year 2006 after the passage of the Lottery Act in August and the end of the fiscal year in June, 2006.

The NCEL commenced operations on March 30, 2006 with the sale of instant scratch-off tickets. In March 2006, the NCEL joined the Multi-State Lottery Association (MUSL) composed of a group of U.S. lotteries that combine jointly to sell on-line Powerball lottery tickets. Powerball sales began on May 30, 2006.

(2) Summary of Significant Accounting Policies

(a) Reporting Entity

For financial reporting purposes, the North Carolina Education Lottery is a major enterprise fund of the primary government of the State of North Carolina and is reported as such in the Comprehensive Annual Financial Report (CAFR) of the State. These financial statements for the NCEL are separate and apart from those of the State of North Carolina and do not present the financial position of the State nor changes in the State's financial position and cash flows.

(b) Basis of Presentation

The NCEL is accounted for as an enterprise fund of the state of North Carolina. The financial statements are prepared on the accrual basis of accounting in a manner similar to a private enterprise. The NCEL elected to apply all applicable Governmental Accounting Standards Board (GASB) pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. As permitted by GASB Statement Number 20, the NCEL elected not to apply FASB statements or interpretations issued on or after November 30, 1989, unless specifically adopted by GASB.

As an enterprise fund, the NCEL is accounted for using the "economic resources" measurement focus. This means that all the assets and liabilities related to its operations are included on its balance sheet, and its operating statement includes all revenues (increases) and expenses (decreases) in total assets. The NCEL distinguishes operating from nonoperating revenues and expenses. Operating revenues and expenses generally relate to the NCEL's primary ongoing operations of selling lottery tickets and redeeming prizes; all revenues and expenses not meeting this definition are reported as nonoperating. The principal operating revenues of the NCEL are charges to retailers for sales of lottery tickets. The significant operating expenses include the cost of prizes, retailer commissions, gaming system vendor charges, personnel, and other administrative expenses.

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Notes to the Financial Statements

June 30, 2006

In June 1999, GASB approved Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments*. This statement requires that the financial statements include a Management's Discussion and Analysis (MD&A) section providing an analysis of the NCEL's overall financial position and results of operations.

(c) Cash and Cash Equivalents

Cash and cash equivalents include undeposited receipts, imprest funds, and deposits pooled by the State Treasurer in the State Treasurer's Short Term Investment portfolio. The Short Term Investment portfolio maintained by the State Treasurer has the general characteristics of a demand deposit account in that participants may deposit additional cash at any time and also may withdraw cash at any time without prior notice or penalty.

(d) Capital Assets

The NCEL defines capital assets as assets with an initial unit cost of \$5,000 or greater and an estimated useful life of two or more years. This definition conforms to the policy of the NC Office of State Controller. Depreciation is computed using the straight-line method over the estimated lives of the assets. The NCEL uses the half year convention. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation will be removed from the books and any resulting gain or loss reflected in operations of the period of disposal. Capital assets are carried at cost less accumulated depreciation. The estimated useful lives by general category are as follows:

<u>Category</u>	<u>Years</u>
Equipment	5-7
Furniture	5
Computers and Software	3-5

(e) Game Revenue Recognition

For the NCEL's only on-line game Powerball, revenue is recognized at the time of sale on a daily basis. For instant games, revenue is recognized at the time a pack of tickets is settled. Instant ticket packs are considered settled in the gaming system 21 days after packs have been activated by the lottery game retailer or when manually entered into the gaming system as sold in full by the retailer, whichever is earlier. Lottery game retailers are required to pay for settled packs at the close of the accounting week in which that 21st day occurs.

(f) Lottery Prize Expense Recognition

For Powerball, prize expense is recorded at 50% of sales on a daily basis. For instant games, prize expense is accrued based on the final production prize structure percentage provided by the gaming vendor for each game and recorded daily on value of packs settled. Certain games include free tickets which entitle the holder to exchange one instant ticket for another of equal value (prize tickets). For the instant games with prize tickets, the final prize structure percentage used is adjusted to eliminate the value of the prize tickets.

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Notes to the Financial Statements

June 30, 2006

(g) *State Treasurer's Securities Lending Collateral*

While the NCEL does not directly engage in securities lending transactions, it deposits certain funds with the State Treasurer's Short-Term Investment Fund which participates in securities lending activities. Based on the State Treasurer's allocation of these transactions, the NCEL recognizes its allocable share of the assets and liabilities related to these transactions on the accompanying financial statements as "State Treasurer's Securities Lending Collateral" and "Obligations Under State Treasurer's Securities Lending Agreements."

Based on the authority provided in General Statutes 147-69.3(e), the State Treasurer lends securities from its investment pools to brokers-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. The Treasurer's custodian manages the securities lending program. During the year the Treasurer's custodian lent U.S. government and agency securities, GNMA's, corporate bonds and notes for collateral. The Treasurer's custodian is permitted to receive cash, U.S. government securities, or irrevocable letters of credit as collateral for the securities lent. The collateral is initially pledged at 102% of the market value of the securities lent, and additional collateral is required if its value falls to less than 100% of the market value of the securities lent. There are no restrictions on the amount of loans that can be made. Substantially all security loans can be terminated on demand by either the State Treasurer or the borrower.

Additional details on the State Treasurer's securities lending program are included in the State of North Carolina's *Comprehensive Annual Financial Report*. An electronic version of this report is available by accessing the North Carolina Office of the State Controller's Internet home page <http://www.osc.state.nc.us/> and clicking on "Financial Reports," or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

(h) *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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. Actual results could differ from those estimates.

(i) *Allowance for Doubtful Accounts*

An allowance for doubtful accounts has not been established because there are no indications of significant delinquencies from the collection of retailer accounts as of June 30, 2006.

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Notes to the Financial Statements

June 30, 2006

(3) Revenue

(a) Operating Revenue

Game Revenue

Instant packs are settled manually by the retailer or automatically by the gaming system 21 days after pack activation, whichever is earlier. Operating revenues are reduced by the value of prize tickets validated during a period. The instant revenue is an estimate of the actual sales of tickets by retailers to players.

	<u>Instant</u>	<u>On-line</u>	<u>Total</u>
Gross revenue	\$ 202,212,898	27,317,594	229,530,492

Fees and Licenses

The majority of fees and licenses represent a weekly retailer communication fee charged to active retailers for terminal satellite communications and an application fee for new retailers and changes in ownership.

(b) Nonoperating Revenue

The cash accounts of the NCEL are Short-term Investment Fund (STIF) Accounts which are interest bearing accounts held with the NC State Treasurer. Investments are limited to those authorized for the State's General Fund, pursuant to NC General Statute 147-69.1. The \$402,129 interest earned on these balances is recorded as nonoperating revenue. Earnings on the accounts are credited on a monthly basis. The allocable share of the revenues arising from State Treasurer's Securities Lending Collateral program transactions, totaling \$406,257, are also included as nonoperating revenue.

(4) Expenses

(a) Operating Expenses

Lottery Prize Expense

This represents approximately one month's activity for Powerball and three months' activity for instant tickets.

	<u>Instant</u>	<u>On-line</u>	<u>Total</u>
Lottery prize expenses	\$ 105,315,336	13,658,797	118,974,133

Retailer Commissions

	<u>Instant</u>	<u>On-line</u>	<u>Total</u>
Retailer commissions	\$ 14,144,704	1,912,232	16,056,936

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Other Services

The principal expenses included are: security services, background checks, communications, legal services, travel, marketing, and costs for temporary employees for start-up.

Security services	\$	830,956
Background checks		715,065
Communications, including wiring		433,044
Legal services		408,906
Travel		315,814
Temporary employee services		297,620
Marketing		155,204
Other		606,433
	\$	<u>3,763,042</u>

Furniture, Fixtures, and Equipment

To set-up and begin operating a new lottery, numerous items of equipment, furniture, and ticket dispensers were required. Most of these items were one time purchases to be replaced as needed at various points in the future. These items were also below our threshold for capitalization (see note 6C – Capital Assets) and therefore expensed. The total for these expenses was \$1,567,936.

Leases – Buildings and Offices

The NCEL has entered into various operating leases through the North Carolina State Department of Administration for building and office facilities. These leases are for initial terms of seven to ten years. Projected lease payments for these facilities are:

	<u>Amount</u>
Year ending (June 30):	
2007	\$ 808,992
2008	825,373
2009	843,281
2010	857,884
2011	872,408
2012 – 2016	<u>3,371,274</u>
Total	\$ <u>7,579,212</u>

The total space rental costs for the period ended June 30, 2006 was \$361,008.

(b) *Nonoperating Expenses*

Interest

The NCEL paid interest of \$30,840 on \$4,000,000 borrowed from the State Treasury to cover the costs of start-up before beginning to collect operating revenues. This loan was authorized in the

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Notes to the Financial Statements

June 30, 2006

initial enabling legislation (HB 1023) which states: “The State Treasurer shall lend to the North Carolina State Lottery Commission, at a rate of interest comparable to short-term rates in the private capital market and with repayment terms satisfactory to both parties, sufficient funds to cover initial operating expenses of the Commission, except that the total amount borrowed by the Commission shall not exceed ten million dollars (\$10,000,000).” The allocable share of the expenses arising from State Treasurer’s Securities Lending Collateral program transactions are also included here.

Transfers Out

There were two significant transfers out of the NCEL. \$1,020,110 was transferred to the NC Department of Administration, Motor Fleet Management, to cover the cost of obtaining vehicles for the exclusive use of the NCEL. The NCEL has entered into a pay for service arrangement with Motor Fleet Management on a continuing basis with the payments covering all costs related to the vehicles including gas, oil, service, care, and replacement.

The second transfer is in compliance with the North Carolina State Lottery Act. This Act requires all “Net Revenues” of the NCEL to be transferred to the North Carolina Education Fund for the educational purposes set forth in the legislation. NC General Statute 18C states: “The funds remaining in the North Carolina State Lottery Fund after receipt of all revenues to the Lottery Fund and after accrual of all obligations of the Commission for prizes and expenses shall be considered to be the net revenues of the North Carolina State Lottery Fund.” Of the \$63,546,752 of “Net Revenues” (see note 12) for the period ended June 30, 2006, \$50,000,000 was actually transferred to the NC Education Fund Reserve. The remaining was recorded as a payable to the State, but remained in the NCEL temporarily to cover any additional start-up costs and unforeseen cash flow requirements from the initiation of additional on-line games. The remaining amount was transferred during October, 2006.

There were other miscellaneous transfers of \$21,418.

(5) Assets

(a) Cash

All cash of the NCEL is deposited with the NC State Treasurer. All deposits are combined with other State agencies and invested by the State Treasurer until needed to cover disbursements. All NCEL accounts are interest bearing.

(b) Accounts Receivable

Accounts Receivable primarily represents amounts due from retailers for settlement of packs of tickets less commissions and prizes paid by the retailers. Electronic Funds Transfer is used to collect receivables weekly from retailer bank accounts that were set up in trust for the NCEL.

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Notes to the Financial Statements

June 30, 2006

(c) **Capital Assets**

The activity for capital assets for the period ended June 30, 2006 was:

Category	Balance Aug 31, 2005	Increases	Decreases	Balance June 30, 2006
Capital assets, nondepreciable:				
Improvements in progress	\$ —	194,745	—	194,745
Total capital assets, nondepreciable	—	194,745	—	194,745
Capital assets, depreciable:				
Equipment	—	483,809	—	483,809
Motorized equipment	—	22,147	—	22,147
Total capital assets, depreciable	—	505,956	—	505,956
Less accumulated depreciation for:				
Equipment	—	73,983	—	73,983
Motorized equipment	—	2,215	—	2,215
Total accumulated depreciation	—	76,198	—	76,198
Total capital assets, depreciable, net	—	429,758	—	429,758
Capital assets, net	\$ —	624,503	—	624,503

(6) **Liabilities**

(a) **Accounts payable**

This primarily represents trade payables to vendors, instant prize liability, and Powerball low-tier liability. At period end, June 30, 2006, the balances were:

Type Account	Balance
Trade payables to vendors	\$ 2,444,879
Instant prize liability	5,518,688
Powerball low-tier liability	1,956,983
Other	7,769
Total	\$ 9,928,319

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Notes to the Financial Statements

June 30, 2006

(b) Other Payables

This represents amounts due MUSL for the NCEL’s share of Powerball jackpot prizes, federal and state withholding on prize payments, and various clearing accounts.

Account	Balance
Due to MUSL	\$ 3,407,762
Federal Withholding	1,426,392
State Withholding	430,589
Other	11,752
Total	\$ 5,276,495

(c) Due to other funds

As explained in note 4b, \$13,546,752 of this represents the amount of the “Net Revenues” for 2006 not yet transferred to the NC Education Fund as of June 30, 2006, but that will be transferred during 2007. The remainder is due other state agencies for services provided to the NCEL.

(d) Accrued Paid Time Off

Paid time off (PTO) is provided to employees for use whenever vacation, sick leave, personal leave or bereavement leave is requested and approved. Under this policy, every calendar year, on January 1st, a specific amount of PTO will be credited to Director’s and above PTO accounts. All other employees’ PTO accounts will be credited on a monthly basis as earned. Employees must be employed at least one year to receive pay for accrued leave balances. Directors and above will be paid out accrued leave balances upon separation provided they have attained a minimum of six (6) months’ service on the date of separation.

Commonly referred to as Compensated Absences, a liability is recorded to reflect the balances for unpaid PTO earned.

(7) Other Important Items

(a) Deposits with Multi-State Lottery Association (MUSL)

MUSL is a voluntary association created for the purpose of administering joint, multi-jurisdictional lottery games, such as Powerball. MUSL currently includes 29 state lotteries, the District of Columbia 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 NCEL is required to contribute to various prize reserve funds maintained by MUSL. These contributions are included in the 50% prize expense computed on Powerball sales. The net amount of the 50% prize expense less the amount required to pay low-tier prizes within the State is paid to MUSL. This payment is to cover the NCEL’s share of current jackpot prizes based on the NCEL’s percent of sales for each drawing and the NCEL share of the prize reserve fund. The prize reserve fund serves as a contingency reserve to protect all MUSL members including the NCEL from unforeseen prize liabilities. All prize reserve funds remitted, and

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

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the related interest earnings, will be returned to the NCEL upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund. As of June 30, 2006, the NCEL had been credited with \$185,893 in the MUSL prize reserve funds.

(b) *Unclaimed Prizes*

As of June 30, 2006, the NCEL had no unclaimed prizes. The first Powerball draw after the NCEL started selling tickets was on May 31, 2006, and therefore, 180 days had not passed. Also, no instant game had been terminated.

(c) *Compulsive Gambling Contribution*

By North Carolina General Statute the NCEL must make “a transfer of one million dollars (\$1,000,000) annually to the Department of Health and Human Services (DHHS) for gambling addiction education and treatment programs.” Because of the late start in the year, the NCEL only transferred \$2,274 as requested. During 2007, \$1,000,000 will be accrued & paid.

(d) *Limitations on Operating and Advertising Expenses*

As established in North Carolina General Statute 18C; “to the extent practicable...No more than eight percent (8%) of the total annual revenues, as described in this Chapter, shall be allocated for payment of expenses of the Lottery. Advertising expenses shall not exceed one percent (1%) of the total annual revenues.” The one percent for advertising expenses is included in the eight percent maximum for Lottery expenses. Total annual revenues are defined by the statute as proceeds from the sale of lottery tickets, interest earned by the NCEL, and all other funds credited to the Lottery from any source.

(e) *Start-up Working Capital Advance*

Section 15 of NC House Bill 1023 states: “The State Treasurer shall lend to the North Carolina State Lottery Commission, at a rate of interest comparable to short-term rates in the private capital market and with repayment terms satisfactory to both parties, sufficient funds to cover initial operating expenses of the Commission, except that the total amount borrowed by the Commission shall not exceed ten million dollars (\$10,000,000).” Consistent with this provision of legislation, the NCEL borrowed \$4,000,000 from the State Treasurer at 4% interest on February 15, 2006 to help cover start up expenses before the start of ticket sales. These funds were repaid to the State Treasurer on April 28, 2006.

(8) *Risk Management*

The NCEL 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; and natural disasters. The NCEL participates in the State’s Risk Management Program for property, liability, crime and automobile coverage, and pays an annual premium for this coverage. The Lottery has not experienced any losses during the period ended June 30, 2006.

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The types of coverage, limits, and deductibles as of June 30, 2006 are described below.

<u>Type coverage</u>	<u>Limits (\$)</u>	<u>Deductible (\$)</u>	<u>Comments</u>
Public officers and employee liability	500,000/ 5,000,000	—	
All risk – property contents	1,326,732	500	Except for theft, then \$1,000 per occurrence
Auto – bodily injury and property damage	500,000/ 5,000,000	—	
Theft, disappearance, destruction	250,000	2,500	Inside premises
Computer Fraud	5,000,000	50,000	Outside premises
Employee dishonesty	5,000,000	50,000	+10% over \$50,000
Forgery and alteration	100,000	—	+10% over \$50,000
Robbery and safe burglary-money/securities	500,000	1,000	

Employees and retirees are provided health care coverage by the State of North Carolina's Comprehensive Major Medical Plan. This employee benefit plan is funded by employer and employee contributions.

The North Carolina Workers' Compensation Program provides benefits to workers injured on the job. All employees of the State are included in the program. When an employee is injured, the NCEL's primary responsibility is to arrange for and provide the necessary treatment for work related injury. The State is self-insured for workers' compensation. A third party administrator processes workers' compensation claims. State agencies, including the NCEL, contribute to a fund administered by the office of the State Controller to cover their workers' compensation claims. The third party administrator receives a per case administration fee and draws down State funds to make medical and indemnity payments on behalf of the State in accordance with the North Carolina Workers' Compensation Act.

Additional details on State-administered risk management programs are disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

(9) Pension and Deferred Compensation Plans

(a) Retirement Plan

All full-time employees participate in the Teachers' and State Employees' Retirement System (the Retirement System) of North Carolina. The Retirement System is a multiple-employer, cost sharing defined benefit pension plan administered by the North Carolina State Treasurer.

After five years of creditable service, members of the Retirement System qualify for a vested deferred benefit. Employees who retire on or after age 65 and complete 5 years of membership service, reach age 60 with 25 years of membership service, or complete 30 years of creditable service receive a retirement allowance of 1.82% of an average final compensation (based on the four consecutive years that produce the highest average) multiplied by the number of years of creditable service.

NORTH CAROLINA EDUCATION LOTTERY

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Employees may retire with reduced benefits if they reach age 50 with 20 years of creditable service or reach age 60 with 5 years of creditable service. Benefit and contribution provisions for the Retirement System are established by North Carolina General Statute 135-5 and 135-8 and may be amended only by the North Carolina General Assembly. Employer and member contribution rates are set each year by the North Carolina General Assembly based on annual actuarial valuations. For the state fiscal year ended June 30, 2006, these rates were set at 6.82% of covered payroll for employers and 6.00% of covered payroll for members.

For the period ended June 30, 2006, the NCEL had a total payroll of \$3,841,912, all of which was covered under the Retirement Fund. Total employee and employer contributions for pension benefits for the period were \$230,515 and \$262,018, respectively. The NCEL made one hundred percent of its annual required contributions for the period ended June 30, 2006, which was \$262,018.

(b) *Supplemental Retirement Income Plan*

IRC Section 401(k) Plan – All full-time employees are eligible to enroll in the Supplemental Retirement Income Plan, a defined contribution plan, created under Internal Revenue Code Section 401(k). All costs of administering the plan are the responsibility of plan participants. The Plan is provided by Prudential Retirement, administered by the NC Department of the State Treasurer and sponsored by the State of North Carolina. The effective date of participation was January 30, 2006.

(c) *Deferred Compensation Plan*

IRC Section 457 Plan – The State of North Carolina offers its permanent employees a deferred compensation plan created in accordance with Internal Revenue Code Section 457 through the North Carolina Public Employee Deferred Compensation Plan (the Plan). The Plan permits each participating employee to defer a portion of his or her salary until future years. The deferred compensation is available to employees upon separation from service, death, disability, retirement or financial hardships if approved by the Board of Trustees of the Plan. The Board, a part of the North Carolina Department of Administration, maintains a separate fund for the exclusive benefit of the participating employees and their beneficiaries, the North Carolina Public Employee Deferred Compensation Trust Fund. The Board also contracts with an external third party to perform certain administrative requirements and to manage the trust fund's assets. All costs of administering and funding the Plan are the responsibility of the Plan participants. The effective date of participation was January 30, 2006.

(10) Other Postemployment Benefits

(a) *Health Care for Long-Term Disability Beneficiaries and Retirees*

The NCEL participates in state administered programs which provide post employment health insurance to eligible former employees. Eligible former employees include long-term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement Fund.

These benefits were established by Chapter 135, Article 3, Part 3, of the General Statutes and may be amended only by the North Carolina General Assembly. Funding for the health care benefit for

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long-term disability beneficiaries and retirees is financed on a pay-as-you-go basis. The NCEL contributed 3.80% of the covered payroll under the Teachers' and State Employees' Retirement Fund for these health care benefits. For the period ended June 30, 2006, the NCEL's total contribution to the Plan was \$145,993. The NCEL assumes no liability for retiree health care benefits provided by the programs other than its required contribution. Additional detailed information about these programs is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

(b) Long-Term Disability

The NCEL participates in the Disability Income Plan of North Carolina (DIPNC). Established by Chapter 135, Article 6, of the General Statutes, the DIPNC provides short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement Fund. Long-term disability income benefits are advance funded on an actuarially determined basis using the one-year term cost method. For the period ended June 30, 2006, the NCEL made a contribution to fund disability benefits of 0.52% or \$19,978. Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

(11) Litigation

As of June 30, 2006, the NCEL is not, nor anticipates being, a party to any litigation.

(12) Allocation of Total Annual Revenues/Transfers to NC Education Lottery Fund

In accordance with the Section § 18C-162 of the NCEL Act, Allocation of revenues:

- (a) To the extent practicable, the Commission shall allocate revenues to the North Carolina State Lottery Fund in the following manner:
- (1) At least fifty percent (50%) of the total annual revenues, as described in this Chapter, shall be returned to the public in the form of prizes.
 - (2) At least thirty-five percent (35%) of the total annual revenues, as described in this Chapter, shall be transferred as provided in G.S. 18C-164.
 - (3) No more than eight percent (8%) of the total annual revenues, as described in this Chapter, shall be allocated for payment of expenses of the Lottery. Advertising expenses shall not exceed one percent (1%) of the total annual revenues.
 - (4) No more than seven percent (7%) of the total annual revenues, as described in this Chapter, shall be allocated for compensation paid to lottery game retailers.

NORTH CAROLINA EDUCATION LOTTERY

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Additionally, in accordance with Section § 18C-142 of the NCEL Act, Compensation for lottery game retailers, “The amount of compensation paid to lottery game retailers for their sales of lottery tickets or shares shall be seven percent (7%) of the retail price of the tickets or shares sold for each lottery game.”

Lottery ticket sales	\$ 229,530,492	
Damage tickets	(1,324)	
Fees, licenses and fines	1,478,149	
Investment earnings	<u>808,385</u>	
Total annual revenue	231,815,702	
Less prize tickets	<u>(14,101,626)</u>	6% of total annual revenue
Total net revenue	<u>217,714,076</u>	
Prize expense	(118,974,133)	51% of total annual revenue
Advertising	(2,260,243)	1% of total annual revenue
All other expenses and transfers	<u>(16,876,014)</u>	
Total Section 18C-162.a.3	<u>(19,136,257)</u>	8% of total annual revenue
Commissions (per 18C-142)	(16,056,936)	7% of lottery ticket sales
Transfer to NC Education Lottery Reserve Fund	50,000,000	
Transfer to NC Education Lottery Fund Payable	<u>13,546,752</u>	
Net revenues to NC Education Fund	\$ <u><u>63,546,752</u></u>	27% of total annual revenue

§ 18C-161. Types of income to the North Carolina State Lottery Fund:

The following revenues shall be deposited in the North Carolina State Lottery Fund:

- (1) All proceeds from the sale of lottery tickets or shares.
- (2) The funds for initial start-up costs provided by the State.
- (3) All other funds credited or appropriated to the Commission from any source.
- (4) Interest earned by the North Carolina State Lottery Fund.

As of October 19, the NCEL transferred \$63,546,752 for the period ended June 30, 2006 to the NC Education Lottery Fund.



KPMG LLP
Suite 1200
150 Fayetteville Street
P.O. Box 29543
Raleigh, NC 27626-0543

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

The Board of Directors
The North Carolina Education Lottery:

We have audited the financial statements of the North Carolina Education Lottery (NCEL) as of June 30, 2006 and for the period August 31, 2005 (period of inception) through June 30, 2006, and have issued our report thereon dated November 28, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the NCEL's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the NCEL'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*.

We noted certain matters that we reported to management of the NCEL in a separate letter dated November 28, 2006.

This report is intended solely for the information and use of the commission, the Audit Committee, management, and various regulatory agencies and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

November 28, 2006

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State of North Carolina
2 South Salisbury Street
20601 Mail Service Center
Raleigh, North Carolina 27699-0601
Telephone: 919-807-7500
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