

NORTH CAROLINA EDUCATION LOTTERY

Financial Statements

June 30, 2008

(With Independent Auditors' Report Thereon)

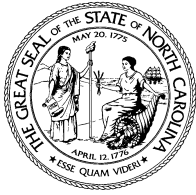
Financial Statement Audit Report of the
North Carolina Education Lottery
For the Period Ended June 30, 2008

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

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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 North Carolina Education Lottery (the Lottery), an enterprise fund of the State of North Carolina, for the period ended June 30, 2008. Cherry, Bekaert, and Holland, 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 accountant 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
November 12, 2008



Independent Auditors' Report

To the Commissioners
North Carolina Education Lottery
Raleigh, North Carolina

We have audited the accompanying statements of net assets of the North Carolina Education Lottery (NCEL) as of June 30, 2008 and 2007, and the related statements of revenues, expenses and changes in fund net assets and cash flows for the years then ended. 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 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 of material misstatement. 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the NCEL as of June 30, 2008 and 2007, and the respective changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

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 and for the years ended June 30, 2008 and 2007, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 15, 2008, 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, 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 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

CHERRY, BEKAERT & HOLLAND, L.L.P.

Cherry, Bekaert & Holland LLP.

Raleigh, North Carolina
October 15, 2008

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2008 and 2007

The following is a discussion and analysis of the financial performance of the North Carolina Lottery Commission [aka, North Carolina Education Lottery (NCEL)] for the fiscal years ended June 30, 2008 and 2007 and should be read in conjunction with the financial statements, including the footnotes. This report consists of three parts: management's discussion and analysis, the basic financial statements and the notes to the financial statements. Included below and on the following pages are the financial highlights, summary of contributions to the state, and summary results of operations for years ended June 30, 2008 and 2007.

Financial Highlights

For fiscal year 2008, net ticket sales surpassed \$1 billion representing a \$192.5 million dollar increase over 2007. Total revenues earned for the NC Education Lottery fund were \$348.3 million, which represented an increase of \$34 million over fiscal year 2007. Other significant financial highlights include the following:

- Due to increases in instant prize payouts, gross tickets sales for fiscal year 2008 increased by 21.7% over 2007.
- Prize expense increased \$136.7 million during fiscal year 2008. This expense increases or decreases proportionally to ticket sales and represented approximately 55% of gross ticket sales.
- This year we increased the number of retailers to over 5800 and provided service to our retailers on a regular basis.
- We created 51 new instant scratch-off games and introduced them every two to three weeks.

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. Accordingly, the focus of the financial statements is determining funds available for payment to the State's Education Lottery Fund. It is important to note that most financial statement balances have a direct or indirect relationship to revenue. As lottery sales increase, the amount paid to the State's Education Lottery Fund also increases. Similarly, increases in revenue generally result in direct increases to cost of sales, including, but not limited to prize expense, retailer commission expense and gaming system vendor charges.

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 business entity. The principal operating revenues of the NCEL are sales of lottery products to retailers. Operating expenses include the cost of prizes, retailer commissions, gaming system vendor charges, personnel, and other administrative expenses.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2008 and 2007

Included in this report is the Statement of Net Assets as of June 30, 2008 and 2007, the Statement of Revenues, Expenses, and Changes in Fund Net Assets for the periods ended June 30, 2008 and 2007, and the Statement of Cash Flows for the periods ended June 30, 2008 and 2007.

As established in House Bill 1023, Section 18C-164, the NCEL transfers its net assets to the Office of State Budget and Management (OSBM) for credit to the State's Education Lottery Fund. Education Lottery Funds are distributed by OSBM 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."*

Total Assets

Total assets at the end of fiscal year 2008 were \$81 million compared to \$120 million at the end of fiscal year 2007, representing a decrease of \$39 million.

Current assets decreased from \$119 million in 2007 to \$79 million in 2008, representing a decrease of \$40 million. This decrease is primarily due to a \$10.8 million decrease in cash and cash equivalents and a \$31 million decrease in deposits held by the State Treasurer in the State Treasurer's Short Term Investment portfolio. These decreases were due to the transfers to the State Education Fund before year-end.

The Short Term Investment portfolio has the general characteristics of a demand deposit account in that participants may deposit additional cash at any time and may withdraw cash at any time without prior notice or penalty. All deposits are combined with other State agencies and invested by the State Treasurer until needed to cover disbursements. Investments are limited to those authorized for the State's General Fund, pursuant to NC General Statute 147-69.1. Interest earned of \$5.2 million on these balances is recorded as non-operating 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 are also included as non-operating revenue.

A \$2.7 million increase in accounts receivable in 2008 over 2007 primarily represents amounts due from retailers for settlement of packs of tickets less commissions and prizes paid by the retailers. The increase is primarily due to the timing of the end of the accounting week for billing and collections from our retailers at year end. Electronic Funds Transfer is used to sweep receivables weekly from retailer bank accounts that are set up in trust for the NCEL.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2008 and 2007

The NCEL's investment in capital assets, net of accumulated depreciation, in 2008 was \$1.5 million which is approximately \$200,000 higher than 2007. The majority of capital asset investments were during our first full year of operation in 2007. The investment in capital assets includes game equipment, data processing equipment, telephone equipment, software and fixtures. The capitalization of all items including equipment, computers, and furniture follows North Carolina's Office of State Controller's policies. 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. Capital assets are carried at cost less accumulated depreciation.

Additional information on the NCEL's capital assets can be found in Notes 2F and 5D to the financial statements.

The activity for capital assets for the year ended June 30, 2008 (in thousands) was:

<u>Category</u>	<u>Balance July 1, 2007</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2008</u>
Capital Assets, Depreciable				
Furniture	\$ 29	\$ -	\$ -	\$ 29
Equipment	1,652	587	-	2,239
Motorized Equipment	67	-	-	67
Total Capital Assets, Depreciable	1,748	587	-	2,335
Less Accumulated Depreciation for:				
Furniture	4	7	-	11
Equipment	450	363	-	813
Motorized equipment	12	12	-	24
Total Accumulated Depreciation	466	382	-	848
Total Capital Assets, Depreciable, Net	1,282	205	-	1,487
Capital Assets, Net	<u>\$ 1,282</u>	<u>\$ 205</u>	<u>\$ -</u>	<u>\$ 1,487</u>

Total Liabilities

Total current liabilities for the NCEL were \$80 million in 2008 decreasing by \$39 million from 2007. The change is due primarily to the decrease in the obligations under the State Treasurer's Security Lending Collateral. Current liabilities consist primarily of trade payables to vendors, instant ticket prize liability, Powerball low-tier liability and obligations under State Treasurer's Lending Agreements. See Total Assets for an explanation of the State Treasurer's Security Lending Agreements. More detailed information can be found in Note 2D in the financial statements.

Noncurrent liabilities are Accrued Paid Time Off or Compensated Absences. A liability is recorded to reflect the balances for unpaid Paid Time Off (PTO) earned, which is provided to employees for use whenever vacation, sick leave, personal leave or bereavement leave is requested and approved. Current and noncurrent liability for Accrued Paid Time Off is shown below in thousands.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2008 and 2007

Activity for the year ended June 30, 2008:

<u>Beginning</u>	<u>Earned</u>	<u>Used</u>	<u>Ending</u>	<u>Current Liability</u>	<u>Noncurrent Portion</u>
\$ 864	\$ 1,839	\$ 1,551	\$ 1,152	\$ 57	\$ 1,095

Net Assets and Changes in Net Assets

As required in the Lottery Act, net revenues of the NCEL are transferred four times a year to the NC Education Lottery Fund at the Office of State Budget and Management. At year end, Net Revenues /Assets are zero for the NCEL. There are no changes in the Net Assets from year to year.

Condensed Statement of Net Assets (in thousands)	<u>2008</u>	<u>2007</u>
ASSETS		
Total Current Assets	\$ 79,443	\$ 118,760
Capital Assets, Depreciable (Net)	1,487	1,282
Total Assets	80,930	120,042
LIABILITIES		
Total Current Liabilities	79,835	119,258
Noncurrent Liabilities	1,095	784
Total Liabilities	80,930	120,042
NET ASSETS		
Invested in Capital Assets	1,487	1,282
Unrestricted Net Assets	(1,487)	(1,282)
Total Net Assets	\$ -	\$ -

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2008 and 2007

Current liabilities consist of "Due to Other Funds" in the amount of \$3.5 million which represents the amount of the "Net Revenues" for Fiscal Year 2008 not yet transferred to the NC Education Fund as of June 30, 2008, but will be transferred during Fiscal Year 2009. The remainder is due other state agencies for services provided to the NCEL. Additional information on the Due to Other Funds is found in NOTE 6C to the financial statements.

Revenues

Operating revenues consist of gross sales, fees and licenses.

Sales

Total gross lottery ticket sales for the fiscal year 2008 were approximately \$1.078 billion as compared to \$885.5 million in fiscal year 2007. This represents an increase of over \$192.5 million.

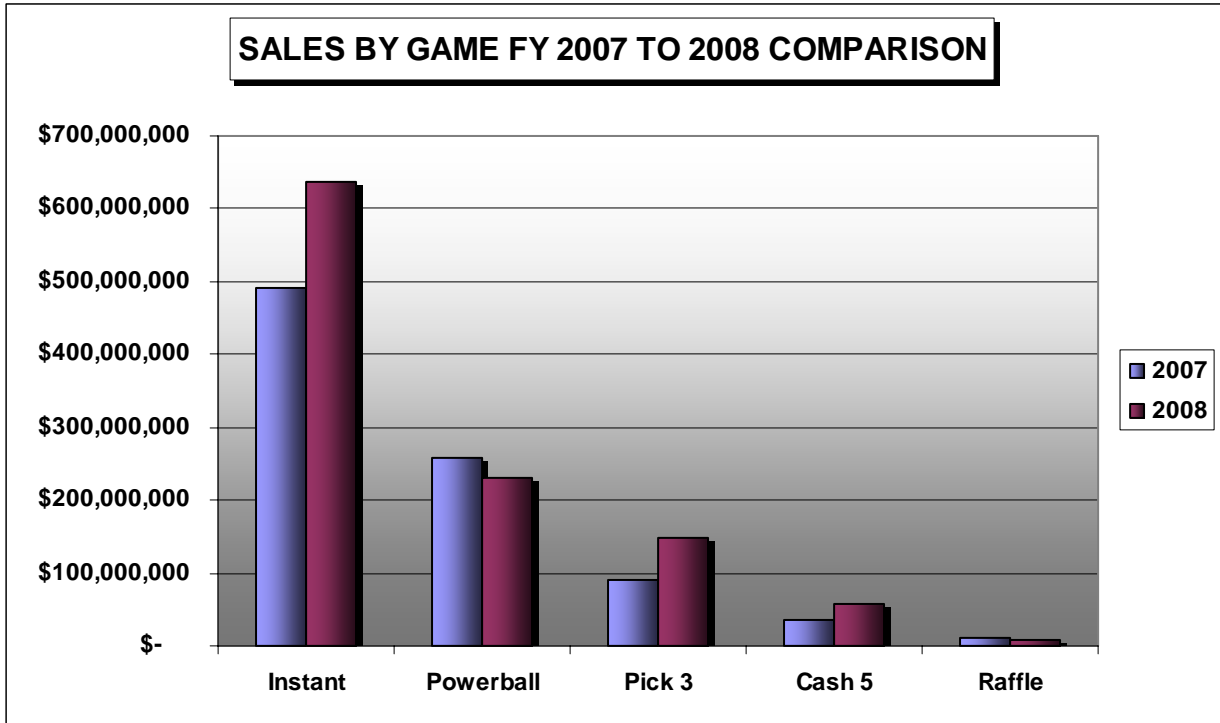
Gross instant ticket sales increased significantly during fiscal year 2008, up \$145 million over one year ago. The 30% increase is attributable to several factors. The NCEL launched its first \$10 Instant Scratch-off mega game, \$100 Million Cash Spectacular, with a 73% prize payout and ten \$1 million top prizes. This new game contributed to our first \$100 million month in total sales in February. The extremely successful merchandise game, Harley-Davidson Instant Scratch-Off, provided players the chance to win six Harley-Davidson Fat Boy Motorcycles, cash, and merchandise and was so well received the final drawing was moved up due to the game selling out faster than anticipated.

On-line sales during fiscal year 2008 grew by \$47 million to \$442 million. Fiscal year 2007 on-line sales were \$395 million. On-line sales benefited from two big jackpots for Powerball during the year. The largest single sales day for Powerball was August 25, 2007 with sales of \$5,154,000. Carolina Pick 3's new additional daytime drawing began on March 31, 2008 and provided an immediate increase in sales that continued throughout the remainder of the fiscal year. Sales for Carolina Pick 3 increased 17% per day from the two months preceding to the two months following the additional drawing. The Carolina Cash 5 promotion "Mustang Madness" offered players the chance to win five Ford Mustangs and provided the NCEL a 13% increase in sales during the promotional window. The Carolina Cash 5 top prize reached a record of \$857 thousand in November, resulting in an increase of on-line sales.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2008 and 2007

The following chart depicts the distribution of sales by product for the fiscal years ending June 30, 2008 and 2007.



Nonoperating Revenues consist of investment earnings from the Short Term Investment Fund held at the State Treasurer's office, and Multi-State Lottery Association (MUSL) dividends received.

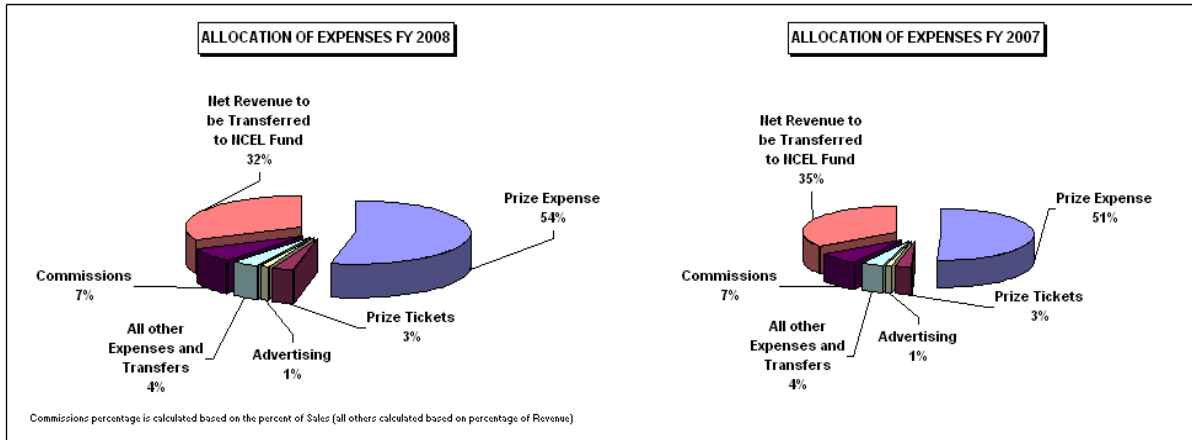
Expenses

Section 18C-162, NC General Statutes stipulates no more than 8% of the total annual revenues shall be allocated for payment of expenses of the Lottery. Advertising expenses shall not exceed 1% of the total annual revenues.

**NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS**

June 30, 2008 and 2007

The following chart shows the major components of NCEL operating expenses and transfers as a percentage of total revenues for the June 30, 2008 and 2007 fiscal years:



Prizes, retailer commissions and gaming vendor charges all directly relate to sales. As expected, as sales have increased and so have these expenses. In fiscal year 2008, prizes, commissions and gaming vendor charges increased to \$681 million from \$528 million in 2007. The other expenses, which consist of advertising, salary and benefits, professional fees, rent, maintenance, bad debt, depreciation and transfers, have remained stable at 5% of Total Annual Revenues over the past two years. Fiscal years 2008 and 2007 administrative expenses were \$50 million and \$47 million respectively.

Condensed Statement of Revenues and Expenses (in thousands)

	<u>2008</u>	<u>2007</u>
Operating Revenues		
Gross Sales	\$ 1,078,082	\$ 885,575
Less: Prize Tickets	(29,733)	(23,901)
Fees and Licenses	4,782	4,521
Total Operating Revenues	<u>1,053,131</u>	<u>866,195</u>
Operating Expenses		
Salaries, Wages, and Benefits	13,793	12,279
Lottery Prizes	588,485	451,792
Retailer Commissions	75,371	61,932
Gaming Systems Services	17,286	14,315
Advertising	8,619	7,810
Marketing	1,220	953
Other Services	2,576	3,038
Furniture, Fixtures, and Equipment	240	1,433
Depreciation	382	391
Other General and Administrative Expenses	1,674	1,490
Total Operating Expenses	<u>\$ 709,646</u>	<u>\$ 555,433</u>

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT’S DISCUSSION AND ANALYSIS
June 30, 2008 and 2007

	2008	2007
Operating Income	\$ 343,485	\$ 310,762
Nonoperating Revenue (Expense)		
Investment Earnings and Miscellaneous Revenue (Expense)	5,825	4,605
Income before Transfers	349,310	315,367
Transfers Out	(349,310)	(315,367)
Net Assets	\$ 0	\$ 0

Budget and Economic Outlook

On May 21, 2008, the Commission approved the Fiscal Year 2009 budget for the NCEL to provide a projected \$385.5 million to the State’s Education Lottery Fund. This projected budget is a 22% increase over the fiscal year 2008 budget of \$341.5 million for transfer to the State’s Education Lottery Fund. Actual transfer in 2008 was over \$348.3 million to education.

A focus of the Commission at start up was to ensure sound operations. This focus continues today and is apparent in audits conducted by outside firms. The Commission has undergone several audits this fiscal year. Delehanty Consulting LLC, an independent security organization, conducted our second security audit and determined that the controls designed by the North Carolina Education Lottery are adequate and operating as intended.

The Office of the State Auditor spent several months conducting a performance audit to answer three questions: (1) whether NCEL uses performance management best practices; (2) whether management compensation is comparable to lotteries in other states; and (3) whether NCEL employee and vendor ethnic diversity reflects the ethnic diversity of North Carolina’s population. The performance audit noted that the NCEL has exceeded the Lottery Act minority participation requirements.

Since inception, the NCEL has not had a formal documented revenue forecasting methodology due to a lack of sales history. For the fiscal year 2009 budget, the NCEL applied a more formal approach to forecasting revenues utilizing two years of history. At start-up, the focus was on getting the organization up and running as quickly as possible with the greatest offering of game choices available to players in order to maximize the amount of money raised for education. The NCEL began writing a strategic plan in fiscal year 2008 which will benefit the organization in fiscal year 2009 and beyond.

For the third consecutive year, the State Auditor contracted with an outside CPA firm to conduct the fiscal year financial audit, which resulted in an unqualified opinion.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2008 and 2007

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 (in thousands)

June 30, 2008 and 2007

	2008	2007
ASSETS		
Current Assets:		
Cash and Cash Equivalents:		
Cash	\$ 75	\$ 62
Pooled Cash	38,680	49,503
Receivables:		
Accounts Receivable	13,728	11,054
Interest Receivable	418	406
Inventory	910	795
State Treasurer's Security Lending Collateral	25,632	56,940
Total Current Assets	79,443	118,760
Capital Assets, Depreciable (Net):		
Machinery and Equipment	2,335	1,748
Accumulated Depreciation	(848)	(466)
Total Capital Assets, Depreciable (Net)	1,487	1,282
Total Assets	80,930	120,042
LIABILITIES		
Current Liabilities:		
Accounts Payable	48,221	56,308
Accrued Payroll	405	16
Other Payables	1,956	3,333
Accrued Paid Time Off - Current	57	80
Due to Other Funds	3,564	2,581
Obligations Under State Treasurer's Security Lending Agreements	25,632	56,940
Total Current Liabilities	79,835	119,258
Noncurrent Liabilities:		
Accrued Paid Time Off	1,095	784
Total Liabilities	80,930	120,042
NET ASSETS		
Invested in Capital Assets	1,487	1,282
Unrestricted Net Assets	(1,487)	(1,282)
Total Net Assets	\$ -	\$ -

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY

Statement of Revenues, Expenses and Changes in Fund Net Assets (in thousands)
Years Ended June 30, 2008 and 2007

	2008	2007
Operating Revenues:		
Gross Sales:	\$ 1,078,082	\$ 885,575
Less: Prize Tickets	(29,733)	(23,901)
Fees and Licenses	4,782	4,521
Total Operating Revenues	1,053,131	866,195
Operating Expenses:		
Salaries, Wages, and Benefits	13,793	12,279
Lottery Prizes	588,485	451,792
Retailer Commissions	75,371	61,932
Gaming Systems Services	17,286	14,315
Advertising	8,619	7,810
Marketing	1,220	953
Other Services	2,576	3,038
Furniture, Fixtures, and Equipment (See Note 4A4)	240	1,433
Depreciation	382	391
Other General and Administrative Expenses	1,674	1,490
Total Operating Expenses	709,646	555,433
Operating Income	343,485	310,762
Nonoperating Revenues (Expenses):		
Investment Earnings and Other Miscellaneous Revenue	8,897	8,544
Miscellaneous Nonoperating Expenses	(3,072)	(3,939)
Income Before Transfers	349,310	315,367
Transfers Out	(349,310)	(315,367)
Change in Net Assets	-	-
Net Assets Beginning, July 1	-	-
Net Assets Ending, June 30	\$ -	\$ -

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY

Statement of Cash Flows (in thousands)
Years Ended June 30, 2008 and 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from Customers	\$ 975,093	\$ 803,256
Payments to Employees and Fringe Benefits	(13,117)	(11,924)
Payments for Prizes, Benefits and Claims	(598,203)	(406,235)
Payments to Vendors and Suppliers	(31,484)	(30,964)
Other Receipts/Payments	548	569
	<u>332,837</u>	<u>354,702</u>
Net Cash Flows Provided by Operating Activities		
CASH USED FOR NONCAPITAL FINANCING ACTIVITIES		
Transfers to State Education Fund	(347,327)	(325,397)
Transfers to Other State Agencies	(1,000)	(1,013)
	<u>(348,327)</u>	<u>(326,410)</u>
Total Cash Used for Noncapital Financing Activities		
CASH USED FOR CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition and Construction of Capital Assets	(587)	(1,059)
Proceeds from Sale of Capital Assets	-	10
	<u>(587)</u>	<u>(1,049)</u>
Total Cash Used for Capital and Related Financing Activities		
CASH PROVIDED FROM INVESTING ACTIVITIES		
Investment Earnings	5,267	3,822
	<u>5,267</u>	<u>3,822</u>
Total Cash Provided from Investing Activities		
Net Increase/(Decrease) in Cash and Cash Equivalents	(10,810)	31,065
Cash and Cash Equivalents at Beginning of Year	49,565	18,500
Cash and Cash Equivalents at End of Year	<u>\$ 38,755</u>	<u>\$ 49,565</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating Income	\$ 343,485	\$ 310,762
Adjustments to Reconcile Operating Income to Cash Provided by Operating Activities:		
Depreciation Expense	382	391
Nonoperating Income - MUSL Dividend	544	554
Other Nonoperating Income	2	6
(Increase) Decrease in Assets:		
Accounts Receivable	(2,674)	(1,007)
Inventories	(115)	(795)
Increase (Decrease) in Liabilities:		
Accounts Payable	(9,481)	44,436
Accrued Payroll and Related Liabilities	677	355
Other Liabilities	17	-
	<u>\$ 332,837</u>	<u>\$ 354,702</u>
Total Cash Provided by Operating Activities		
NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES		
Assets Acquired through the Assumption of a Liability	<u>\$ 25,632</u>	<u>\$ 56,940</u>

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2008 and 2007

NOTE 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 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. Carolina Pick 3 online game sales began on October 6, 2006, and Carolina Cash 5 online game sales began on October 27, 2006. A second daily (Monday through Saturday) Carolina Pick 3 drawing was added on March 31, 2008. Sales for the NCEL's second online raffle ran from November 14, 2007 through December 26, 2007.

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.

NOTE 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 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

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)

June 30, 2008 and 2007

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 statement of net assets, and its operating statement includes all revenues (increases) and expenses (decreases) in total assets. The NCEL distinguishes operating from non-operating 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 non-operating. The principal operating revenues of the NCEL are charges to retailers for sales of lottery products. The significant operating expenses include the cost of prizes, commissions, gaming system vendor charges, personnel, and other administrative expenses.

- C. Cash and Cash Equivalents** - Cash and cash equivalents include regional office deposited operating funds, imprest funds, and deposits held 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. 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.” The NCEL’s allocable share of these assets and liabilities is based on the NCEL’s year end deposit balance per the State Treasurer’s records.

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

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collateral. The Treasurer’s custodian is permitted to receive cash, U.S. government and agency securities, or irrevocable letters of credit as collateral for the securities lent.

The collateral is initially pledged at 102 percent of the market value of the securities lent, and additional collateral is required if its value falls to less than 100 percent 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.

- E. 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, 2008 and 2007.
- F. 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:

Category	Years
Equipment	5-7
Furniture	5
Computers and Software	3-5

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- G. Game Revenue Recognition** - For the NCEL's on-line games, POWERBALL, Carolina Cash 5, Carolina Pick 3, and raffles offered, 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 (SEE NOTE 3A(1) – Game Revenue).
- H. Lottery Prize Expense Recognition** - For POWERBALL, Carolina Cash 5, Carolina Pick 3, and for raffles, prize expense is recorded at approximately 50 percent 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 (prize tickets) which entitle the holder to exchange one instant ticket for another of equal value. For the instant games with prize tickets, the final prize structure percentage used is adjusted to eliminate the value of the prize tickets.
- I. 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. Actual results could differ from those estimates.

NOTE 3 - REVENUE

A. Operating Revenue

- 1. 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.

<u>Gross Revenue</u>	<u>2008</u>	<u>2007</u>
Instant	\$ 635,880	\$ 490,564
On-line	442,299	395,011
Bad Debt Write Off	(89)	-
Damaged Tickets	(8)	-
Total	<u>\$ 1,078,082</u>	<u>\$ 885,575</u>

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2. 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 interest earned on these balances is recorded as nonoperating revenue, and is \$5,278 and \$4,044 for the years ended 2008 and 2007, respectively. Earnings on the accounts are credited on a monthly basis. The allocable share of the revenue arising from the State Treasurer's Securities Lending Collateral program is included as investment earnings. This also reflects a dividend from MUSL of \$544 and \$554 for the years ended 2008 and 2007, respectively. The remaining \$3 and \$7 for the years ended June 30, 2008 and 2007, respectively, is composed of miscellaneous items.

NOTE 4 - EXPENSES

A. Operating Expenses

1. Lottery Prize Expense

Prize Expense	<u>2008</u>	<u>2007</u>
Instant	\$ 350,165	\$ 257,460
On-line	221,531	194,332
50% of Unclaimed Prizes	<u>16,789</u>	<u>-</u>
Total	<u><u>\$ 588,485</u></u>	<u><u>\$ 451,792</u></u>

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2. Retailer Commissions

Commissions	2008	2007
Instant	\$ 44,441	\$ 34,308
On-line	30,930	27,624
Total	\$ 75,371	\$ 61,932

3. Other Services - The principal expenses included are: security services, background checks, communications, legal services, travel, financial audit services, network support, and costs for temporary employees.

	2008	2007
Security Services	\$ 17	\$ 407
Background Checks	699	701
Communications, Including Wiring	708	769
Legal Services	79	139
Travel	92	102
Other	981	920
	\$ 2,576	\$ 3,038

4. Furniture, Fixtures, and Equipment - While establishing our new lottery, numerous initial items of equipment, furniture, and ticket dispensers were required. Most of these items were one time purchases during fiscal year 2007, but will be replaced as needed. These items were below our threshold for capitalization (see NOTE 2F – Capital Assets) and therefore expensed. The total for these expenses was \$240 in Fiscal Year 2008 and \$1,433 in Fiscal Year 2007.

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5. 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:

Year Ending (June 30)	Amount
2009	\$ 854
2010	868
2011	881
2012	638
2013	639
2014-2018	2,094
Total	\$ 5,974

The total space rental costs for the year ended June 30, 2008 was \$838 and was \$836 for the year ended June 30, 2007.

- B. Nonoperating Expenses** - The allocable share of the expenses arising from State Treasurer’s Securities Lending Collateral program transactions, totaling \$3,072 and \$3,939 for the years ended June 30, 2008 and 2007, respectively, are also included as nonoperating expense.
- C. Transfers Out** - There were three significant transfers out of the NCEL. \$1,000 was transferred to the NC Department of Health and Human Services for a gambling addiction education and treatment program as stipulated in the North Carolina Lottery Act (Note 7C) for both years ended June 30, 2008 and 2007.

The second transfer is \$16,789 and \$8,037 for the years ended June 30, 2008 and 2007, respectively, from unclaimed prizes during the year. The North Carolina State Lottery Act requires the NCEL to transfer “Fifty percent (50%)” of unclaimed prizes to the NC Education Lottery Fund each year (Note 7B).

The third 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 NC Education Lottery Fund for the educational purposes set forth in the legislation. Of the \$331,521 and \$306,317 of June 30, 2008 and 2007 “Net Revenues,” respectively, (see Note 12), \$328,020 and \$303,774,

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respectively, was actually transferred to the NC Education Lottery Fund. The remaining was recorded as a payable to the State, but remained in the NCEL. The remaining \$3,501 and \$2,543 for the years ended June 30, 2008 and 2007, respectively, were transferred subsequent to year-end. 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."

NOTE 5 - ASSETS

- A. Cash** - The cash and cash equivalents balances at June 30, 2008 and 2007 include no undeposited receipts on hand.

Unless specifically exempt, the NCEL is required by North Carolina General Statute 147-77 to deposit moneys received with the State Treasurer or with a depository institution in the name of the State Treasurer. Except as noted above, all NCEL funds are deposited with the State Treasurer. The NCEL has no deposit policy concerning credit risk, as all deposits are held by the State Treasurer.

At June 30, 2008 and 2007, respectively, \$38,680 and \$49,503 of the amount shown on the Statement of Net Assets as cash and cash equivalents represents the NCEL's equity position in the State Treasurer's Short-Term Investment Fund. The Short-Term Investment Fund (a portfolio within the State Treasurer's Investment Pool, an external investment pool that is not registered with the Securities and Exchange Commission and does not have a credit rating) had a weighted average maturity of 2.9 and 1.6 years as of June 30, 2008 and 2007, respectively. Assets and shares of the Short-Term Investment Fund are valued at amortized cost, which approximates fair value. Deposit and investment risks associated with the State Treasurer's Investment Pool (which includes the State Treasurer's Short-Term Investment Fund) 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.ncosc.net/> and clicking on "Financial Reports" or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

- 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

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used to collect receivables weekly from retailer bank accounts that were set up in trust for the NCEL.

C. Inventory - Inventory for the NCEL consists of all merchandise prizes that are paid for before distribution, inventory is reduced as prizes are fulfilled. Inventory as of June 30, 2008 was \$910 and \$795 as of June 30, 2007.

D. Capital Assets - The activity for capital assets for the year ended June 30, 2008 was:

<u>Category</u>	<u>Balance July 1, 2007</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2008</u>
Capital Assets, Depreciable				
Furniture	\$ 29	\$ -	\$ -	\$ 29
Equipment	1,652	587	-	2,239
Motorized Equipment	67	-	-	67
Total Capital Assets, Depreciable	<u>1,748</u>	<u>587</u>	<u>-</u>	<u>2,335</u>
Less Accumulated Depreciation for:				
Furniture	4	7	-	11
Equipment	450	363	-	813
Motorized Equipment	12	12	-	24
Total Accumulated Depreciation	<u>466</u>	<u>382</u>	<u>-</u>	<u>848</u>
Total Capital Assets, Depreciable, Net	<u>1,282</u>	<u>205</u>	<u>-</u>	<u>1,487</u>
Capital Assets, Net	<u>\$ 1,282</u>	<u>\$ 205</u>	<u>\$ -</u>	<u>\$ 1,487</u>

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The activity for capital assets for the year ended June 30, 2007 was:

<u>Category</u>	<u>Balance July 1, 2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2007</u>
Capital Assets, Nondepreciable				
Improvements in Progress	\$ 194	\$ -	\$ 194	\$ -
Total Capital Assets, Nondepreciable	<u>194</u>	<u>-</u>	<u>194</u>	<u>-</u>
Capital Assets, Depreciable				
Furniture	-	29	-	29
Equipment	484	1,179	11	1,652
Motorized Equipment	<u>22</u>	<u>45</u>	<u>-</u>	<u>67</u>
Total Capital Assets, Depreciable	<u>506</u>	<u>1,253</u>	<u>11</u>	<u>1,748</u>
Less Accumulated Depreciation for:				
Furniture	-	4	-	4
Equipment	74	377	1	450
Motorized Equipment	<u>2</u>	<u>10</u>	<u>-</u>	<u>12</u>
Total Accumulated Depreciation	<u>76</u>	<u>391</u>	<u>1</u>	<u>466</u>
Total Capital Assets, Depreciable, Net	<u>430</u>	<u>862</u>	<u>10</u>	<u>1,282</u>
Capital Assets, Net	<u>\$ 624</u>	<u>\$ 862</u>	<u>\$ 204</u>	<u>\$ 1,282</u>

Equipment expenditures for 2008 include storage area networks (SAN) in Greensboro and Raleigh offices for disaster recovery and improvement of network efficiency.

NOTE 6 - LIABILITIES

A. Accounts Payable - This primarily represents trade payables to vendors, prize liabilities, and Powerball low-tier liability. At year end, June 30, 2008 and 2007, the balances were:

<u>Type Account</u>	<u>2008</u>	<u>2007</u>
Trade Payables to Vendors	\$ 3,413	\$ 3,109
Instant Prize Liability	25,434	35,633
Prize Liability- Unused Unclaimed Prizes	9,279	8,037
POWERBALL Low-Tier Liability	5,318	4,563
Prize Liability – Breakage	4,742	4,943
Other	<u>35</u>	<u>23</u>
Total Accounts Payable	<u>\$ 48,221</u>	<u>\$ 56,308</u>

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- B. Other Payables** - This represents amounts due to MUSL of \$1,846 and \$3,255 for the years ended June 30, 2008 and 2007, respectively for the NCEL's share of POWERBALL jackpot prizes. The remainder resulted from federal and state withholding on prize payments, and various clearing accounts.
- C. Due to Other Funds** - As explained in NOTE 4C, \$3,501 and \$2,543 for the years ended June 30, 2008 and 2007, respectively, represents the amounts of the "Net Revenues" for the year not yet transferred to the NC Education Fund as of June 30, but will be transferred subsequent to year-end. 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.

Activity for the year ended June 30, 2008:

<u>Beginning</u>	<u>Earned</u>	<u>Used</u>	<u>Ending</u>	<u>Current Liability</u>	<u>Long Term Portion</u>
\$ 864	\$ 1,839	\$ 1,551	\$ 1,152	\$ 57	\$ 1,095

Activity for the year ended June 30, 2007:

<u>Beginning</u>	<u>Earned</u>	<u>Used</u>	<u>Ending</u>	<u>Current Liability</u>	<u>Long Term Portion</u>
\$ 524	\$ 943	\$ 603	\$ 864	\$ 80	\$ 784

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NOTE 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. Through June 30, 2008, MUSL 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 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, 2008 and 2007, respectively, the NCEL had been credited with \$4,505 and \$2,369 in the MUSL prize reserve funds.

B. Unclaimed Prizes - As of June 30, 2008 and 2007, the NCEL had unclaimed prizes from both online and instant games. The first POWERBALL draw after the NCEL started selling tickets was on May 31, 2006, and therefore, the NCEL began recognizing unclaimed prizes on November 27, 2006 (180 days after the first draw). The first Carolina Pick 3 unclaimed prizes were recorded on April 4, 2007 and the first unclaimed prizes for Carolina Cash 5 were recorded on April 25, 2007. The NCEL closed forty three instant games during the 2008 fiscal year resulting in approximately \$22.8 million in unclaimed prizes. Amounts shown below are in thousands.

<u>Type Game</u>	<u>2008</u>	<u>2007</u>
Instant	\$ 22,792	\$ 9,586
POWERBALL	7,598	5,748
Carolina Cash 5	1,892	333
Carolina Pick 3	1,150	408
Raffle	73	-
Total Unclaimed Prizes	<u>\$ 33,505</u>	<u>\$ 16,075</u>

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- C. Compulsive Gambling Contribution** - By North Carolina General Statute the NCEL must make “a transfer of \$1,000 annually to the Department of Health and Human Services (DHHS) for gambling addiction education and treatment programs.” (Note 4C)
- D. Limitations on Operating and Advertising Expenses** - As established in North Carolina General Statute 18C-162(a)(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.” The one percent for advertising expenses is included in the eight percent maximum for Lottery expenses. Total annual revenues include proceeds from the sale of lottery tickets, interest earned by the NCEL, and all other funds credited to the Lottery from any source.

NOTE 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 year ended June 30, 2008.

The types of coverage, limits, and deductibles as of June 30, 2008 are described below (the following chart is not shown in thousands).

Type Coverage	Limits (\$)	Deductible (\$)	Comments
Public Officers and Employee Liability	1,000,000/ 5,000,000	-	State is self-insured up to \$1,000,000; excess up to \$5,000,000 is with a private insurer.
All Risk- Property Contents	3,006,000	500	Except for theft, then \$1,000 per occurrence
Auto- Bodily Injury and Property Damage	500,000/ 5,000,000	50 100	Comp. deductible Collision deductible
Theft, Disappearance, Destruction	250,000	2,500	Inside premises
Theft, Disappearance, Destruction	50,000	2,500	Outside premises
Computer Fraud	5,000,000	75,000	+10% over \$75,000
Employee Dishonesty	5,000,000	75,000	+10% over \$75,000
Forgery and Alteration	100,000	2,500	
Robbery and Safe Burglary- Money/Securities	500,000	1,000	

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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. Term life insurance of \$25,000 to \$50,000 is provided to eligible employees. This self-insured death benefit program is administered by the Department of the State Treasurer and funded via employer contributions.

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

NOTE 9 - PENSION AND DEFERRED COMPENSATION PLANS

A. Retirement Plan - Each permanent full-time employee, as a condition of employment, is a member of the Teachers' and State Employees' Retirement System (TSERS) and is automatically enrolled in the Teachers' and State Employees' Retirement System.

The Teachers' and State Employees' Retirement System is a cost sharing multiple-employer defined benefit pension plan established by the State to provide pension benefits for employees of the State, its component units and local boards of education. The plan is administered by the North Carolina State Treasurer.

Benefit and contribution provisions for the Teachers' and State Employees' Retirement System are established by *North Carolina General Statutes* 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.

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For the years ending June 30, 2008 and 2007, respectively, the NCEL had a total payroll of \$10,862 and \$9,720, of which \$10,340 and \$9,677 was covered under the Teachers' and State Employees' Retirement System. Total employer and employee contributions for pension benefits for the year were \$805 and \$621, respectively. Required employer contribution rates for the years ended June 30, 2008, 2007 and 2006, were 3.05%, 2.66% and 2.34%, respectively, while employee contributions were 6% each year. The NCEL made 100% of its annual required contributions for the years ended June 30, 2008, 2007 and 2006, which were \$313, \$257 and \$262, respectively.

The Teachers' and State Employees' Retirement System's financial information is 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.ncosc.net/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

- 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. The voluntary contributions by employees amounted to \$194 and \$115 for the years ended June 30, 2008 and 2007, respectively.**

- 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 State Treasurer, 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**

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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. The voluntary contributions by employees amounted to \$67 and \$50 for the years ended June 30, 2008 and 2007, respectively.

NOTE 10 - OTHER POSTEMPLOYMENT BENEFITS

- A. Health Care for Long-Term Disability Beneficiaries and Retirees** - The NCEL participates in the Comprehensive Major Medical Plan (the Plan), a cost-sharing, multiple-employer defined benefit health care plan that provides postemployment 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 System. Coverage eligibility varies depending on years of contributory membership service in the retirement system prior to disability or retirement.

The Plan's benefit and contribution provisions are established by Chapter 135-7, Article 1, and Chapter 135, Article 3, of the General Statutes and may be amended only by the North Carolina General Assembly. The Plan does not provide for automatic post-retirement benefit increases.

By General Statute, a Retiree Health Benefit Fund (the Fund) has been established as a fund in which accumulated contributions from employers and any earnings on those contributions shall be used to provide health benefits to retired and disabled employees and applicable beneficiaries. By statute, the Fund is administered by the Board of Trustees Teachers' and State Employees' Retirement System and contributions to the fund are irrevocable. Also by law, Fund assets are dedicated to providing benefits to retired and disabled employees and applicable beneficiaries and are not subject to the claims of creditors of the employers making contributions to the Fund. Contribution rates to the Fund, which are intended to finance benefits and administrative expenses on a pay-as-you-go basis, are determined by the General Assembly in the Appropriations Bill.

For the current fiscal year the NCEL contributed 4.1% of the covered payroll under the Teachers' and State Employees' Retirement System. Required contribution rates for the years ended June 30, 2008, 2007 and 2006, were 4.1%, 3.8% and 3.8%, respectively. The NCEL made 100% of its annual required contributions to the Plan for the years ended June 30, 2008, 2007 and 2006, which were \$421, \$368 and \$144,

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respectively. 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 can be located 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.ncosc.net/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

- B. Long-Term Disability** - The NCEL participates in the Disability Income Plan of North Carolina (DIPNC), a cost-sharing, multiple-employer defined benefit plan, to provide short-term and long-term disability benefits to eligible members of the Teachers' and State Employees' Retirement System. Benefit and contribution provisions are established by Chapter 135, Article 6, of the General Statutes, and may be amended only by the North Carolina General Assembly. The plan does not provide for automatic post-retirement benefit increases.

Disability income benefits are funded by actuarially determined employer contributions that are established in the Appropriations Bill by the General Assembly. For the fiscal year ended June 30, 2008 and 2007, the NCEL made a statutory contribution of .52% of covered payroll under the Teachers' and State Employees' Retirement System. Required contribution rates for the years ended June 30, 2008, 2007 and 2006, were .52%, .52% and .52%, respectively. The NCEL made 100% of its annual required contributions to the DIPNC for the years ended June 30, 2008, 2007 and 2006, which were \$54, \$50 and \$20, respectively. The NCEL assumes no liability for long-term disability benefits under the Plan other than its contribution.

Additional detailed information about the DIPNC is disclosed in the State of North Carolina's *Comprehensive Annual Financial Report*.

NOTE 11 - LITIGATION

As of June 30, 2008, the NCEL is not, nor anticipates being, a party to any litigation.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2008 and 2007

NOTE 12 - ALLOCATION OF TOTAL ANNUAL REVENUES/TRANSFERS TO NC EDUCATION LOTTERY FUND

	<u>2008</u>		
Lottery Ticket Sales	\$ 1,078,082		
Fees and Licenses	4,782		
Investment Earnings and Other Revenues	<u>8,897</u>		
Total Annual Revenue	1,091,761		
Less Prize Tickets	<u>(29,733)</u>	3%	of Total Annual Revenue
Total Net Revenue	<u>1,062,028</u>		
Prize Expense	(588,485)	54%	of Total Annual Revenue
Advertising	(8,619)	1%	of Total Annual Revenue
All Other Expenses and Transfers	<u>(41,243)</u>		
Total Section 18C-162.a.3	<u>(49,862)</u>	5%	of Total Annual Revenue
Commissions (Per 18C-142)	(75,371)	7%	of Lottery Ticket Sales
Unclaimed Prizes to NC Education Lottery Fund	16,789		
Net Revenues To NC Education Lottery Fund	<u>331,521</u>		
Total Revenues to NC Education Fund	<u>\$ 348,310</u>	32%	of Total Annual Revenue
	<u>2007</u>		
Lottery Ticket Sales	\$ 885,575		
Fees and Licenses	4,521		
Investment Earnings and Other Revenues	<u>8,544</u>		
Total Annual Revenue	898,640		
Less Prize Tickets	<u>(23,901)</u>	3%	of Total Annual Revenue
Total Net Revenue	<u>874,739</u>		
Prize Expense	(451,792)	50%	of Total Annual Revenue
Advertising	(7,810)	1%	of Total Annual Revenue
All Other Expenses and Transfers	<u>(38,851)</u>		
Total Section 18C-162.a.3	<u>(46,661)</u>	5%	of Total Annual Revenue
Commissions (Per 18C-142)	(61,932)	7%	of Lottery Ticket Sales
Unclaimed Prizes to NC Education Lottery Fund	8,037		
Net Revenues To NC Education Lottery Fund	<u>306,317</u>		
Total Revenues to NC Education Fund	<u>\$ 314,354</u>	35%	of Total Annual Revenue

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2008 and 2007

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

- (a) The Commission shall allocate revenues to the North Carolina State Lottery Fund in order to increase and maximize the available revenues for education purposes, and to the extent practicable, shall adhere to the following guidelines:
- (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.

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.”

§ 18C-161. Types of income to 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 provide by the State.
- (3) All other funds credited or appropriated to the Commission from any sources.
- (4) Interest earned by the North Carolina Lottery Fund.

As of September 30, 2008 the NCEL transferred \$344,809 and \$311,811 for the years ended June 30, 2008 and 2007, respectively to the NC Education Lottery Fund. As explained in NOTE 4C, \$3,501 and \$2,543 for the years ended June 30, 2008 and 2007, respectively, is the amount of the “Net Revenues” for the year not yet transferred to the NC Education Fund as of June 30, but will be transferred during the subsequent fiscal year.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2008 and 2007

NOTE 13 - CHANGES IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2008, the NCEL implemented the following pronouncements issued by the Governmental Accounting Standards Board (GASB):

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

GASB Statement No. 50, *Pension Disclosures*.

GASB Statement No. 45 requires cost-sharing employers to recognize OPEB expense for their contractually required contributions to the plan generally consistent with the approach adopted in GASB Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers, with modifications to reflect differences between pension benefits and OPEB*.

GASB Statement No. 50 aligns the financial reporting requirements for pensions with those of other postemployment benefits, to conform with GASB Statement No. 45. This Statement amends GASB Statement 27 to require note disclosure of the employer contribution rates and percentage of the amount contributed for the current and preceding two years and to disclose how the required contribution rates are established.

NOTE 14 - RECLASSIFICATIONS

Certain reclassifications have been made to the 2007 financial statements to conform to the current year presentation.



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

To the Commissioners
North Carolina Education Lottery
Raleigh, North Carolina

We have audited the accompanying statements of net assets of the North Carolina Education Lottery (NCEL) as of June 30, 2008 and 2007, and the related statements of revenues, expenses, and changes in fund net assets and cash flows for the years then ended, and have issued our report thereon dated October 15, 2008. 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.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the NCEL's internal control over financial reporting as a basis for designing our audit procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the NCEL's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the NCEL's internal control over financial reporting.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the NCEL's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the NCEL's financial statements is more than inconsequential will not be prevented or detected by the NCEL's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the NCEL's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not

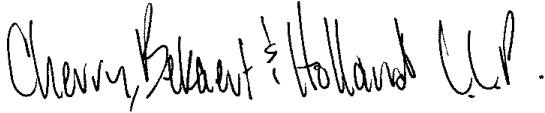
identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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*.

This report is intended solely for the information and use of management, the Commissioners, others within the organization, and the State of North Carolina and is not intended to be and should not be used by anyone other than these specified parties.

CHERRY, BEKAERT & HOLLAND, L.L.P.

A handwritten signature in cursive script that reads "Cherry, Bekaert & Holland LLP." The signature is written in black ink and is positioned below the printed name of the firm.

Raleigh, North Carolina
October 15, 2008

ORDERING INFORMATION

Audit reports issued by the Office of the State Auditor can be obtained from the web site at www.ncauditor.net. Also, parties may register on the web site to receive automatic email notification whenever reports of interest are issued. Otherwise, copies of audit reports may be obtained by contacting the:

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