

NORTH CAROLINA EDUCATION LOTTERY

Financial Statements

June 30, 2010

(With Independent Auditors' Report Thereon)

Financial Statement Audit Report of the
North Carolina Education Lottery
For the Period Ended June 30, 2010

Performed under contract with the
North Carolina Office of the State Auditor
Beth A. Wood, CPA

NORTH CAROLINA EDUCATION LOTTERY

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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), a major enterprise fund of the State of North Carolina as of June 30, 2010 and 2009, 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.

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, 2010 and 2009, 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.

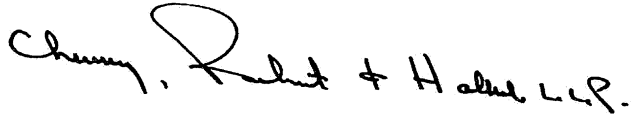
In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the NCEL as of June 30, 2010 and 2009, and the respective changes in its financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 9, 2010 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.

As discussed in the notes to the financial statements, management has recorded certain annuity contracts in the prior year in which management has determined that the legal liability for the pay out of those contracts still rests with the NCEL. Accordingly, assets and liabilities for the year ended June 30, 2009 have been restated to properly reflect the annuity contracts.

The management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. 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.

A handwritten signature in black ink that reads "Cherry, Bekaert & Holland L.L.P." in a cursive, stylized script.

Raleigh, North Carolina
November 9, 2010

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2010 and 2009

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, 2010, 2009 and 2008 and should be read in conjunction with the transmittal letter and 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, 2010, 2009 and 2008.

Financial Highlights

For fiscal year 2010, gross ticket sales again surpassed \$1 billion totaling \$1.421 billion representing a \$128.2 million increase over 2009. Total revenues earned for the state were \$431 million, which represented an increase of \$19 million over fiscal year 2009. Other significant financial highlights include the following:

- § 18C-164 (a) requires the NCEL to transfer net proceeds from operations and any prior year surplus to the State Education Lottery Fund four times a year. In fiscal year 2010 the sum total of these four cash transfers was \$419.5 million, the largest annual total for cash transfers in NCEL's history. Total cash transfers for fiscal years 2009 and 2008 were \$417.3 million and \$350.9 million respectively.
- We launched our second multi-state game, Mega Millions on January 31st.
- Awarded jackpots to two more North Carolinians in multi-state online games, bringing the total number of jackpot winners to four.
- Awarded \$1 million or more to a NCEL player for the 77th time.
- This year we increased the number of retailers to 6,267, representing a 4% increase over the prior year, and provided service to our retailers on a regular basis.
- We created 42 new instant scratch-off games and released them every two to four weeks.

Overview of the Financial Statements

This financial report is designed to inform the public and other interested parties of the financial results of the NCEL and show its accountability in meeting the legislated mandate to generate funds to further the goal of providing enhanced educational opportunities. 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 revenues 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 by contracted retailers to the general playing public. 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, 2010 and 2009

Included in this report are the Statements of Net Assets as of June 30, 2010 and 2009, the Statements of Revenues, Expenses, and Changes in Fund Net Assets for the periods ended June 30, 2010 and 2009, and the Statements of Cash Flows for the periods ended June 30, 2010 and 2009. 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 2010 were \$82 million compared to \$76 million at the end of fiscal year 2009, representing an increase of \$6 million.

Current assets decreased from \$62 million in 2009 to \$56 million in 2010, representing a decrease of \$6 million. This decline resulted from a decrease in the State Treasurer's Security Lending Collateral, more detailed information can be found in Note 2D in the financial statements. The decrease was partially offset by increases in accounts receivable in 2010 from 2009. This primarily represents amounts due from retailers for settlement of packs of tickets less commissions and prizes paid by the retailers. The increase is essentially 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 collect receivables weekly from retailer bank accounts that are set up in trust for the NCEL.

Current assets were also affected by a \$5.5 million increase in cash and cash equivalents and a \$1.05 million increase in investments in annuity contracts.

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 \$1.48 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.

The NCEL's investment in capital assets, net of accumulated depreciation in 2010 was \$1.2 million which is approximately \$71,000 lower than 2009. 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

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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 5E to the financial statements.

The activity for capital assets for the year ended June 30, 2010 was (in thousands):

<u>Category</u>	<u>Balance July 1, 2009</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2010</u>
Capital assets, depreciable				
Furniture	\$ 29	\$ -	\$ -	\$ 29
Equipment	2,606	529	(482)	2,653
Motorized equipment	67	-	-	67
Total capital assets, depreciable	<u>2,702</u>	<u>529</u>	<u>(482)</u>	<u>2,749</u>
Less accumulated depreciation for:				
Furniture	18	5	-	23
Equipment	1,336	564	(465)	1,435
Motorized equipment	38	14	-	52
Total accumulated depreciation	<u>1,392</u>	<u>583</u>	<u>(465)</u>	<u>1,510</u>
Total capital assets, depreciable, net	<u>1,310</u>	<u>(54)</u>	<u>(17)</u>	<u>1,239</u>
Capital assets, net	<u>\$ 1,310</u>	<u>\$ (54)</u>	<u>\$ (17)</u>	<u>\$ 1,239</u>

Total Liabilities

Total current liabilities for the NCEL were \$56 million in 2010 decreasing by \$6.1 million from 2009. The reduction in current liabilities mainly resulted from decreases in the State Treasurer's Security Lending Collateral. Current liabilities also consist of annuity installment prizes due to be paid in the next fiscal year, trade payables to vendors, prize awards payable, and other payables.

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.

<u>Beginning</u>	<u>Eamed</u>	<u>Used</u>	<u>Ending</u>	<u>Current Liability</u>	<u>Long Term Portion</u>
<u>\$ 1,274</u>	<u>\$ 1,135</u>	<u>\$ 1,316</u>	<u>\$ 1,093</u>	<u>\$ 65</u>	<u>\$ 1,028</u>

Noncurrent liabilities also includes the present value of the annuity contracts that fund the long term installment prizes that are due to NCEL annuity prize winners that will be paid after June 30, 2011.

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Net Assets and Changes in Net Assets

As required in the Lottery Act, net revenues of the NCEL are transferred quarterly 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)

	2010	2009	2008
ASSETS			
Total Current Assets	\$ 55,881	\$ 62,068	\$ 79,843
Noncurrent Assets	26,246	13,728	5,864
Total Assets	<u>82,127</u>	<u>75,796</u>	<u>85,707</u>
LIABILITIES			
Total Current Liabilities	56,092	62,147	80,235
Noncurrent Liabilities	26,035	13,649	5,472
Total Liabilities	<u>82,127</u>	<u>75,796</u>	<u>85,707</u>
NET ASSETS			
Invested in Capital Assets	1,239	1,310	1,487
Unrestricted Net Assets	<u>(1,239)</u>	<u>(1,310)</u>	<u>(1,487)</u>
Total Net Assets	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>	<u><u>\$ -</u></u>

Current liabilities consist of "Due to Other Funds" in the amount of \$18.1 million. This amount represents the remaining amount of the "Net Revenues" for Fiscal Year 2010 not yet transferred to the State of North Carolina as of June 30, 2010, but will be transferred to the state during Fiscal Year 2011. Also included, \$45 thousand due other state agencies for services provided to the NCEL. Additional information on the Due to Other Funds is found in Note 6D to the financial statements.

Revenues

Operating revenues consist of gross sales, fees and licenses.

Sales

Total gross lottery ticket sales for the fiscal year 2010 were approximately \$1.421 billion as compared to \$1.293 billion in fiscal year 2009. This represents an increase of over \$128 million from 2009 and \$343 million over 2008.

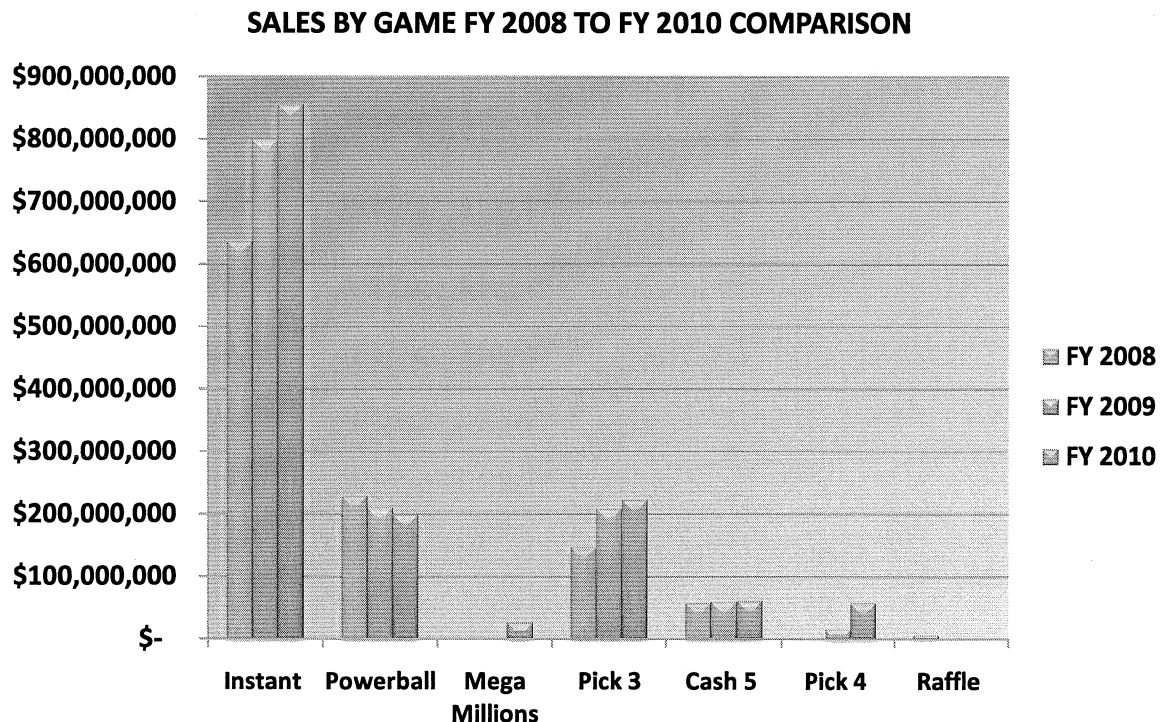
Gross instant ticket sales increased significantly during fiscal year 2010 to \$855.6 million, up \$56.9 million over fiscal year 2009 and \$217.7 million over fiscal year 2008. The 7.1% increase over fiscal year 2009 realized in fiscal year 2010 is attributable to several factors. The NCEL launched its first \$20 Instant

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Scratch-off mega game; \$200 Million Extravaganza, with a prize payout of 75% which generated over \$150 million in sales during fiscal year 2010. The NCEL released several very successful licensed games during the year. The World Series of Poker Instant Scratch-Off was introduced and provided players the chance to win a grand prize trip package including a seat at the 2010 WSOP® Main Event. The NCEL launched its Price is Right Instant Scratch-Off licensed game, which awarded players the opportunity to travel to Las Vegas and play in an un-televised version of the popular game show. In addition, the NCEL partnered with former professional wrestler and North Carolina icon Ric Flair to release the "Woool!" Instant Scratch-Off game, which proved to be a great success.

On-line sales during fiscal year 2010 grew to \$566 million, a \$71.3 million increase over fiscal year 2009 and a \$123.4 million increase over fiscal year 2008. On-line sales benefited from four jackpots over \$200 million for Powerball during the year. The largest single sales day for Powerball was August 19, 2009 with sales of \$3.8 million. The NCEL also commenced selling Mega Million tickets on January 31, 2010, with total sales of \$25.9 million during 2010. The Carolina Cash 5 top prize exceeded \$1 million for the first time in March, resulting in an increase in on-line sales. The NCEL launched its newest daily online game, Carolina Pick 4 last year, which had sales of \$15.8 million to the end of the fiscal year. With Carolina Pick 4 in place for the entire year in 2010 its sales increased to \$57.3 million.

The following chart depicts the distribution of sales by product for the fiscal years ending June 30, 2010, 2009 and 2008.



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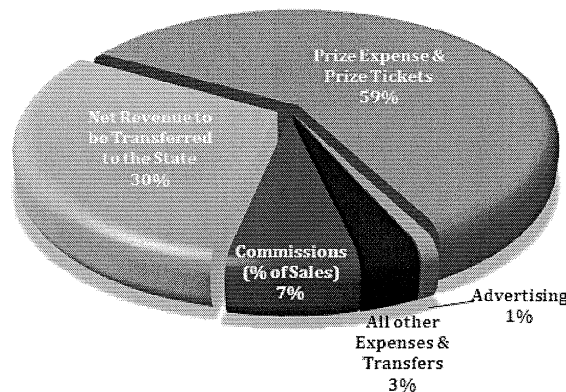
Nonoperating Revenues consist of investment earnings from the Short Term Investment Fund held at the State Treasurer's Office, Multi-State Lottery Association (MUSL) dividends received, and proceeds from the sale of start-up and other marketing materials to other state lotteries.

Expenses

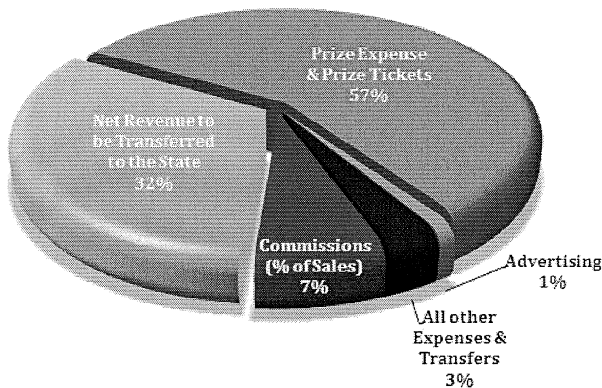
Section 18C-162, NC General Statutes stipulates no more than 8% of the total annual revenues shall be allocated for payment of expenses of the Lottery. Advertising expenses shall not exceed 1% of the total annual revenues.

The following charts show the major components of NCEL operating expenses and transfers as a percentage of total revenues for the June 30, 2010, 2009 and 2008 fiscal years:

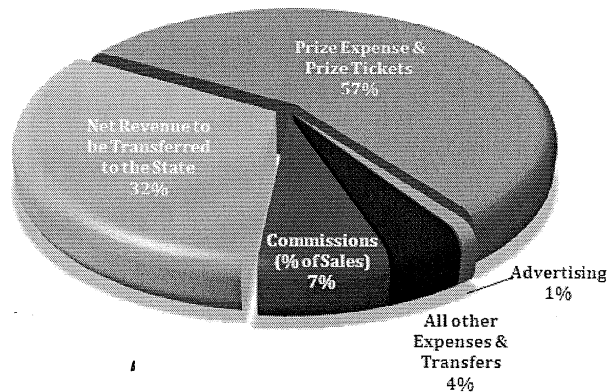
ALLOCATION OF EXPENSES FY 2010



ALLOCATION OF EXPENSES FY 2009



ALLOCATION OF EXPENSES FY 2008



Note: Commissions percentage is calculated based on the percent of Sales (all others calculated based on percentage of Total Revenue) per G.S. 18c; therefore may not equal 100%.

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MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2010 and 2009

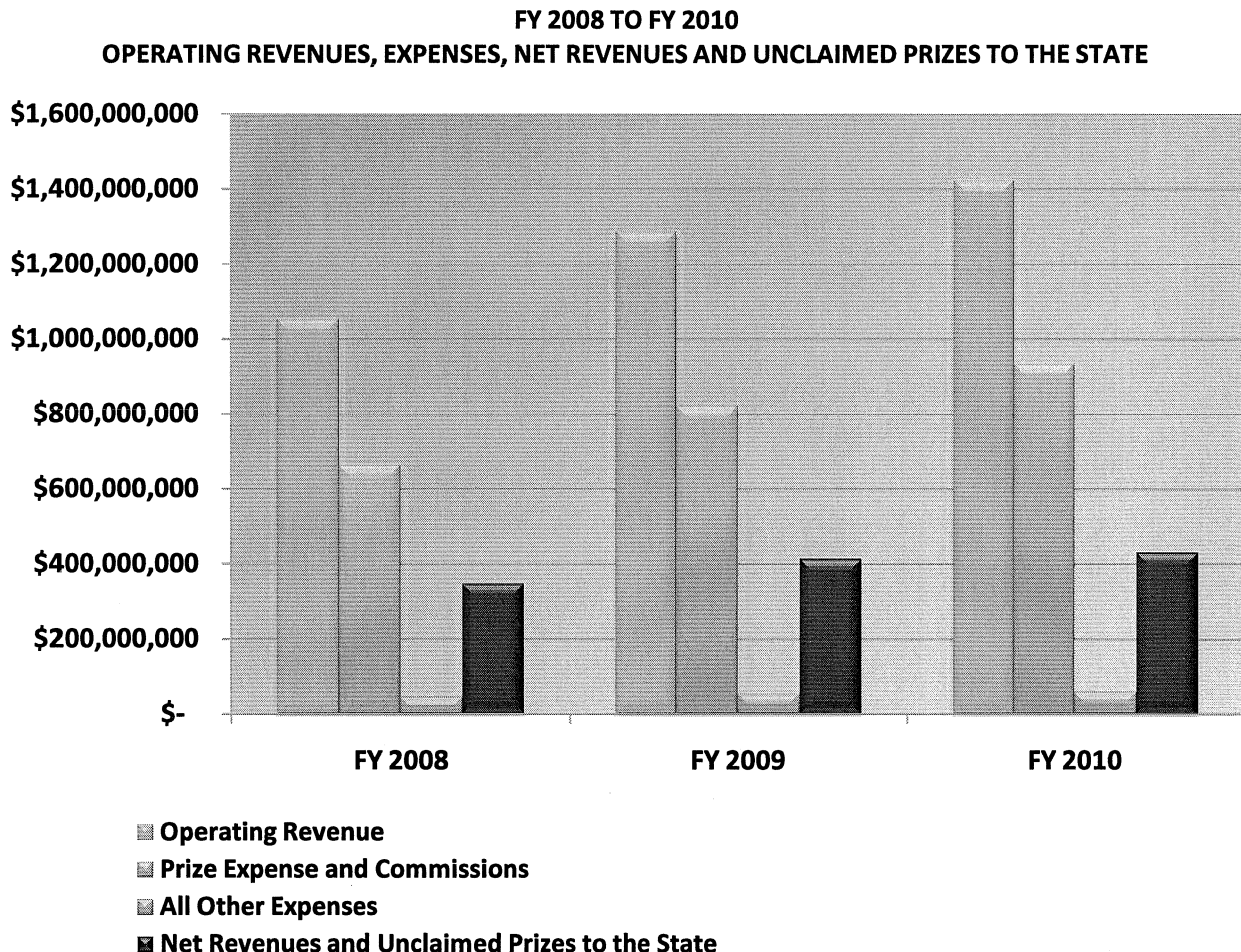
Prizes, commissions and gaming vendor charges all directly relate to sales. As expected, as sales have increased so have these expenses. In fiscal year 2010 total gaming expenses which consist of prizes, retailer commissions and gaming vendor charges (gaming system services) totaled \$957 million as compared to \$843 million and \$681 million in fiscal years 2009 and 2008 respectively. Other operating expenses, which consist of advertising and marketing, salary and benefits, professional fees, rent, maintenance, bad debt, depreciation and general administrative expenses increased to \$36.6 million in fiscal year 2010 as compared to \$34.1 million and \$28.5 million in fiscal year 2009 and 2008 respectively. Other operating expenses represented 2.6%, 2.7% and 2.7% of total operating revenues in fiscal years 2010, 2009 and 2008 respectively.

Condensed Statement of Revenues and Expenses (in thousands)

	2010	2009	2008
Operating Revenues:			
Gross Sales:	\$ 1,421,313	\$ 1,293,111	\$ 1,078,179
Less: Prize Tickets	(1,309)	(9,580)	(29,733)
Less: Sales/Service Bad Debt	(405)	(91)	(97)
Fees and Licenses	4,859	4,663	4,782
Total Operating Revenues	<u>1,424,458</u>	<u>1,288,103</u>	<u>1,053,131</u>
Operating Expenses:			
Gaming Expenses:			
Lottery Prizes	835,302	731,690	588,485
Retailer Commissions	99,340	90,366	75,371
Gaming Systems Services	22,639	20,599	17,286
Total Gaming Expenses	<u>957,281</u>	<u>842,655</u>	<u>681,142</u>
Other Operating Expenses	36,608	34,135	28,504
Total Operating Expenses	<u>993,889</u>	<u>876,790</u>	<u>709,646</u>
Operating Income	430,569	411,313	343,485
Nonoperating Revenues (Expenses):			
Investment Earnings, Nonoperating Revenue (Expense)			
and Compulsive Gambling Contribution	1,636	2,616	4,825
Net Revenues and Unclaimed prizes to the State	(432,205)	(413,929)	(348,310)
Total Nonoperating Revenue (Expenses)	<u>(430,569)</u>	<u>(411,313)</u>	<u>(343,485)</u>
Net Income	<u>-</u>	<u>-</u>	<u>-</u>
Net Assets	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

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MANAGEMENT'S DISCUSSION AND ANALYSIS
June 30, 2010 and 2009

From fiscal year 2008 to fiscal year 2010, the NCEL has achieved year over year increases in revenues and transfers to the State. The following graph depicts these trends.



Budget and Economic Outlook

On June 16, 2010, the Commission approved the Fiscal Year 2011 budget for the NCEL to provide a projected \$441 million to the State's Education Lottery Fund. This projected budget is a 5% increase over the fiscal year 2009 budget of \$419 million for transfer to the State's Education Lottery Fund. The NCEL will continue to monitor the current economic conditions in the State of North Carolina, and its impact on lottery ticket sales. As per the General Assembly Fiscal Research Division: "The nation is coming out of the longest, sustained period of economic contraction since the depression of the 1930's. Given the length and severity of the recession, one might expect a robust recovery similar to what occurred coming out of the 81-82 recession (6% growth). We are unlikely to see that type of robust expansion anytime soon because of the structural problems that sent us into a recession; housing and financial, take much

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longer to correct and are historically followed by a much slower, prolonged recovery phases.” Also “A quarter-over-quarter improvement in the economy is expected, albeit at a slow rate. During this phase of the recovery the capacity of the economy to absorb any new shocks regardless of the origin could cause the growth to stall and possibly lead to another contraction.” Therefore, the NCEL has constructed a conservative budget and sales forecast for the upcoming fiscal year.

A focus of the Commission is to ensure sound operations, 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 third security audit and determined that the controls designed by the North Carolina Education Lottery are adequate and operating as intended.

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

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

Statements of Net Assets (in thousands) June 30, 2010 and 2009

	2010	Restated 2009
ASSETS		
Current Assets:		
Cash and Cash Equivalents:		
Cash	\$ 96	\$ 119
Pooled Cash	38,664	33,124
Receivables:		
Accounts Receivable	6,648	4,919
Interest Receivable	110	138
Investment in Annuity Contracts	2,150	1,100
Inventory	209	293
Prepaid Items and Deferred Charges	198	-
State Treasurer's Security Lending Collateral	7,806	22,375
Total Current Assets	55,881	62,068
Noncurrent Assets:		
Investment in Annuity Contracts	25,007	12,418
Capital Assets, Depreciable (Net):		
Furniture and Equipment	2,749	2,702
Accumulated Depreciation	(1,510)	(1,392)
Total Capital Assets, Depreciable (Net)	1,239	1,310
Total Assets	82,127	75,796
LIABILITIES		
Current Liabilities:		
Accounts Payable	26,161	29,406
Accrued Payroll	379	332
Other Payables	1,321	2,266
Annuity Prize Award Payable	2,150	1,100
Accrued Paid Time Off - Current	65	43
Due to Other Funds	18,127	6,625
Obligations Under State Treasurer's Security Lending Agreements	7,889	22,375
Total Current Liabilities	56,092	62,147
Noncurrent Liabilities:		
Annuity Prize Award Payable	25,007	12,418
Accrued Paid Time Off	1,028	1,231
Total Liabilities	82,127	75,796
NET ASSETS		
Invested in Capital Assets	1,239	1,310
Unrestricted Net Assets	(1,239)	(1,310)
Total Net Assets	\$ -	\$ -

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY

Statements of Revenues, Expenses and Changes in Fund Net Assets (in thousands) Years Ended June 30, 2010 and 2009

	2010	2009
Operating Revenues:		
Gross Sales	\$ 1,421,313	\$ 1,293,111
Less: Prize Tickets	(1,309)	(9,580)
Sales/Service Bad Debt	(405)	(91)
Fees and Licenses	4,859	4,663
Total Operating Revenues	<u>1,424,458</u>	<u>1,288,103</u>
Operating Expenses:		
Salaries, Wages, and Benefits	15,299	14,694
Lottery Prizes	835,302	731,690
Retailer Commissions	99,340	90,366
Retailer Incentive	394	-
Gaming Systems Services	22,639	20,599
Advertising	11,792	11,172
Marketing	2,239	1,751
Other Services	3,555	2,975
Furniture, Fixtures, and Equipment	376	249
Depreciation	583	544
Other General and Administrative Expenses	2,370	2,750
Total Operating Expenses	<u>993,889</u>	<u>876,790</u>
Operating Income	<u>430,569</u>	<u>411,313</u>
Nonoperating Revenues (Expenses):		
Investment Earnings and Other Miscellaneous Revenue	2,699	4,251
Compulsive Gambling Contribution	(1,000)	(1,000)
Unclaimed Prizes to NC Education Lottery Fund	(14,894)	(19,901)
Net Revenues to the State of NC	(417,311)	(394,028)
Miscellaneous Nonoperating Expenses	(63)	(635)
Total Nonoperating Revenues (Expense)	<u>(430,569)</u>	<u>(411,313)</u>
Net Income	-	-
Change in Net Assets	-	-
Net Assets Beginning, July 1	-	-
Net Assets Ending, June 30	<u>\$ -</u>	<u>\$ -</u>

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY

Statements of Cash Flows (in thousands)
Years Ended June 30, 2010 and 2009

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from Customers	\$ 1,323,356	\$ 1,206,591
Payments to Employees and Fringe Benefits	(15,432)	(14,644)
Payments for Prizes, Benefits and Claims	(839,959)	(751,430)
Payments to Vendors and Suppliers	(42,980)	(37,688)
Other Receipts/Payments	13	8
Net Cash Flows Provided by Operating Activities	<u>424,998</u>	<u>402,837</u>
CASH USED FOR NONCAPITAL FINANCING ACTIVITIES		
Transfers to State Education Fund	(419,465)	(410,868)
Transfers to Other State Agencies	(1,000)	(1,000)
Total Cash Used for Noncapital Financing Activities	<u>(420,465)</u>	<u>(411,868)</u>
CASH USED FOR CAPITAL AND RELATED FINANCING ACTIVITIES		
Acquisition and Construction of Capital Assets	(529)	(367)
Proceeds from Sale of Capital Assets	1	-
Total Cash Used for Capital and Related Financing Activities	<u>(528)</u>	<u>(367)</u>
CASH PROVIDED FROM INVESTING ACTIVITIES		
Investment Earnings	<u>1,512</u>	<u>3,886</u>
Total Cash Provided from Investing Activities	<u>1,512</u>	<u>3,886</u>
Net Increase/(Decrease) in Cash and Cash Equivalents	5,517	(5,512)
Cash and Cash Equivalents at Beginning of Year	<u>33,243</u>	<u>38,755</u>
Cash and Cash Equivalents at End of Year	<u><u>\$ 38,760</u></u>	<u><u>\$ 33,243</u></u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES		
Operating Income	\$ 430,569	\$ 411,313
Adjustments to Reconcile Operating Income to Cash Provided by Operating Activities:		
Depreciation Expense	583	545
Nonoperating Income - MUSL Dividend	29	7
Other Nonoperating Income	(16)	1
(Increase) Decrease in Assets:		
Accounts Receivable	(1,729)	8,809
Inventories	84	617
Prepaid Items	(198)	-
Increase (Decrease) in Liabilities:		
Accounts Payable	(4,157)	(18,549)
Accrued Payroll and Related Liabilities	(134)	50
Other Liabilities	(33)	44
Total Cash Provided by Operating Activities	<u><u>\$ 424,998</u></u>	<u><u>\$ 402,837</u></u>
NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES		
Assets Acquired through the Assumption of a Liability	\$ 34,964	\$ 35,893

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

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. Additional on-line games were introduced as follows:

- Carolina Pick 3 on October 6, 2006.
- Carolina Cash 5 on October 27, 2006.
- Carolina Pick 3 second daily draw (Monday through Saturday) on March 31, 2008.
- Carolina Pick 4 on April 17, 2009.
- Mega Millions on January 31, 2010.

The purpose of the NCEL is to generate funds to further the goal of providing enhanced educational opportunities, support school construction, and 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 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.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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 securities custodian manages the securities lending program. 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 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.

The NCEL was informed by the North Carolina Office of State Controller that an adjustment was needed to investment earnings as a result of unrealized losses in securities lending collateral. Securities lending disclosures are determined by GASB Statement 28. During fiscal year 2009, with the investment markets downturn, situations occurred related to securities lending investment activity that resulted in the State experiencing unrealized losses on the investment of cash collateral received for securities lent. This situation had never occurred prior to fiscal year 2009. Participants in State investment pools bear the risk of loss. Therefore, each participant has been allocated a share of the fiscal year 2009 unrealized loss, and a share of current fiscal year 2010 unrealized loss. The overall net effect of the transactions was recorded as an adjustment to Net Revenues to the State of North Carolina in the amount of \$82.

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.nc.gov/> 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, 2010 and 2009.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

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:

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

G. Game Revenue Recognition:

For the NCEL's on-line games, POWERBALL, Mega Millions, Carolina Cash 5, Carolina Pick 4, 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, Mega Millions, Carolina Cash 5, Carolina Pick 4, Carolina Pick 3, and for raffles, prize expense is recorded at 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. Prize expense for merchandise prizes is recognized as prizes are fulfilled.

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 using the following methodology:

- Manually by the retailer initiating a settlement transaction via the gaming terminal.
- Automatically by the gaming system - twenty one (21) days after pack activation.
- Automatically by the gaming system - once the fifth (5th) pack in a specific game is activated by a retailer, the oldest active pack is settled.

Operating revenues are reduced by the value of prize tickets validated during a period.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 3 – REVENUE (continued)

Game Revenue	2010	2009
Instant	\$ 855,566	\$ 798,676
Less Prize Tickets	(1,309)	(9,580)
On-line	565,747	494,435
Bad debt write off	(396)	(86)
Damaged tickets, Sales services	(9)	(5)
Total	<u>\$ 1,419,599</u>	<u>\$ 1,283,440</u>

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. Total Fees and Licenses for 2010 and 2009 were \$4,859 and \$4,663 respectively.

B. Non-operating 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 non-operating revenue, and is \$1,484, and \$3,608 for the years ended June 30, 2010 and 2009, respectively. 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 \$29, and \$7 for the years ended June 30, 2010 and 2009, respectively. The remaining \$184, for the year ended June 30, 2010 is predominately comprised of sales of marketing and start up materials to other lotteries. The remaining \$1 for the year ended June 30, 2009 is composed of miscellaneous items. Non-operating revenues are netted against non-operating expenses, with the exception of securities lending collateral program transactions on the financial statements.

NOTE 4 – EXPENSES

A. Operating Expenses:

1. Lottery Prize Expense:

Prize Expense	2010	2009
Instant	\$ 546,911	\$ 474,111
On-line	273,497	237,678
50% of unclaimed prizes	14,894	19,901
Total	<u>\$ 835,302</u>	<u>\$ 731,690</u>

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 4 – EXPENSES (continued)

2. Retailer Commissions:

Commissions	2010	2009
Instant	\$ 59,777	\$ 55,788
On-line	39,563	34,578
Total	<u>\$ 99,340</u>	<u>\$ 90,366</u>

3. Retailer Incentives

In fiscal year 2010, the Lottery Commission approved a retailer incentive program where retailers would receive compensation for selling a top tier prize or second tier prize in the Multi-State games POWERBALL and Mega Millions and a top tier prize in Carolina Cash 5. The total paid in the retailer incentive program in fiscal year 2010 was \$394.

4. 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.

	2010	2009
Security services	\$ 11	\$ 10
Background checks	797	849
Communications, including wiring	1,328	1,032
Legal services	42	14
Travel	79	104
Other	1,298	966
	<u>\$ 3,555</u>	<u>\$ 2,975</u>

5. Furniture, Fixtures, and Equipment:

To operate a lottery, numerous items of equipment, furniture, and ticket dispensers are 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 5E – Capital Assets) and therefore expensed. The total for these expenses was \$376 in fiscal year 2010 and \$249 in fiscal year 2009.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 4 – EXPENSES (continued)

6. Leases – Buildings, Offices and Other Equipment:

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>Year Ending</u>	<u>Amount</u>
2011	\$ 1,065
2012	682
2013	699
2014	702
2015	713
2016-2020	751
Total	<u>\$ 4,612</u>

The total space rental costs for the year ended June 30, 2010 was \$1,034 and \$858 for the year ended June 30, 2009 respectively. The NCEL also has several contracts for various equipment leases.

B. Non-operating Expenses:

The allocable share of the expenses arising from State Treasurer's Securities Lending Collateral program transactions, totaling \$63 and \$635 for the years ended June 30, 2010 and 2009 respectively, are also included as non-operating expense. In addition, for year ended June 30, 2010 the NCEL incurred an expense of \$200 to the Internal Revenue Service (IRS) for an assessment made under IRC Section 6651 for the late deposit of withheld federal income tax. This non-operating expense resulted from an accounting processing change made in early 2008 that resulted in a short delay in remitting withheld income tax to the IRS. The NCEL is currently appealing this charge. For the year ended June 30, 2010, the remaining \$16 non-operating expense resulted from a loss on a sale of property and equipment.

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 for years ended June 30, 2010 and 2009 (Note 7D).

The second transfer is \$14,894 and \$19,901 for the years ended June 30, 2010 and 2009, 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 7C).

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 \$417,311 and \$394,028 of June 30, 2010 and 2009 "Net Revenues" (see Note 12), respectively, \$398,015 and \$387,474 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 \$18,059 and \$6,554 for the years ended June 30, 2010 and 2009, 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."

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 5 – ASSETS

A. Cash:

The cash and cash equivalents balances at June 30, 2010 and 2009 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, 2010 and 2009, respectively, \$38,664 and \$33,124 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 1.6 and 1.8 years as of June 30, 2010 and 2009 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.osc.nc.gov/> 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 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, 2010 was \$209, and \$293 as of June 30, 2009, respectively.

D. Investment in Annuity Contracts:

Investments in Annuity Contracts represent the present value of the contracts that fund the long term installment prizes contracted through insurance company annuities (See Note 7B). The current and long term balances are \$2,150 and \$25,007 for fiscal year 2010 and \$1,100 and \$12,418 for fiscal year 2009 respectively.

E. Capital Assets:

The activity for capital assets for the year ended June 30, 2010 was:

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 5 – ASSETS (continued)

<u>Category</u>	<u>Balance July 1, 2009</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2010</u>
Capital assets, depreciable				
Furniture	\$ 29	\$ -	\$ -	\$ 29
Equipment	2,606	529	(482)	2,653
Motorized equipment	67	-	-	67
Total capital assets, depreciable	<u>2,702</u>	<u>529</u>	<u>(482)</u>	<u>2,749</u>
Less accumulated depreciation for:				
Furniture	18	5	-	23
Equipment	1,336	564	(465)	1,435
Motorized equipment	38	14	-	52
Total accumulated depreciation	<u>1,392</u>	<u>583</u>	<u>(465)</u>	<u>1,510</u>
Total capital assets, depreciable, net	<u>1,310</u>	<u>(54)</u>	<u>(17)</u>	<u>1,239</u>
Capital assets, net	<u>\$ 1,310</u>	<u>\$ (54)</u>	<u>\$ (17)</u>	<u>\$ 1,239</u>

The activity for capital assets for the year ended June 30, 2009 was:

<u>Category</u>	<u>Balance July 1, 2008</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance June 30, 2009</u>
Capital assets, depreciable				
Furniture	\$ 29	\$ -	\$ -	\$ 29
Equipment	2,239	367	-	2,606
Motorized equipment	67	-	-	67
Total capital assets, depreciable	<u>2,335</u>	<u>367</u>	<u>-</u>	<u>2,702</u>
Less accumulated depreciation for:				
Furniture	11	7	-	18
Equipment	813	523	-	1,336
Motorized equipment	24	14	-	38
Total accumulated depreciation	<u>848</u>	<u>544</u>	<u>-</u>	<u>1,392</u>
Total capital assets, depreciable, net	<u>1,487</u>	<u>(177)</u>	<u>-</u>	<u>1,310</u>
Capital assets, net	<u>\$ 1,487</u>	<u>\$ (177)</u>	<u>\$ -</u>	<u>\$ 1,310</u>

Equipment expenditures for 2010 include fire suppression systems, three random number generators and an upgraded telephone system in the regional offices. Equipment expenditures for 2009 include Carolina Pick 4 draw machines and an upgraded telephone system.

NOTE 6 – LIABILITIES

A. Accounts Payable:

This primarily represents trade payables to vendors, prize liabilities, and multi state game low-tier liability. At year end, June 30, 2010 and 2009, the balances were:

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 6 – LIABILITIES (continued)

<u>Type Account</u>	<u>2010</u>	<u>2009</u>
Trade payables to vendors	\$ 5,103	\$ 4,607
Instant prize liability	4,278	8,987
Prize liability- unused unclaimed prizes	8,175	7,294
Multi state games low-tier liability	4,098	3,449
Prize liability – breakage	4,371	5,068
Prize liability – rollover	133	-
Other	3	1
Total accounts payable	<u>\$ 26,161</u>	<u>\$ 29,406</u>

B. Other Payables:

This represents amounts due to MUSL of \$1,181 and \$2,108 for the years ended June 30, 2010 and 2009, respectively for the NCEL's share of POWERBALL and Mega Millions jackpot prizes. The remainder resulted from federal and state withholding on prize payments, and various clearing accounts.

C. Annuity Prize Awards Payable:

Annuity Prize awards payable represent the present value of the contracts that fund the long term installment prizes that are due to NCEL annuity prize winners (See Note 7B). The current and long term balances are \$2,150 and \$25,007 for fiscal year 2010 and \$1,100 and \$12,418 for fiscal year 2009 respectively. Annuity activity for both short and long term accounts during fiscal year 2010 are as follows:

	<u>Beginning Balance 7/1/2009</u>	<u>Purchases</u>	<u>Annuity Appreciation</u>	<u>Annuity Disbursements</u>	<u>Reclass to Short Term</u>	<u>Ending Balance 6/30/2010</u>
Short Term	\$ 1,100	\$ -	\$ -	\$ (1,100)	\$ 2,150	\$ 2,150
Long Term	12,418	13,726	1,013	-	(2,150)	25,007
Total Annuities	<u>\$ 13,518</u>	<u>\$ 13,726</u>	<u>\$ 1,013</u>	<u>\$ (1,100)</u>	<u>\$ -</u>	<u>\$ 27,157</u>

D. Due to Other Funds:

As explained in Note 4C, \$18,059 and \$6,554 for the years ended June 30, 2010 and 2009, respectively, represents the amounts of the "Net Revenues" and "50% of Unclaimed Prizes" for the year not yet transferred to the State as of June 30, but will be transferred to the State subsequent to year-end. The remainder is due to other state agencies for services provided to the NCEL.

E. 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.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 6 – LIABILITIES (continued)

Activity for the year ended June 30, 2010:

<u>Beginning</u>	<u>Earned</u>	<u>Used</u>	<u>Ending</u>	<u>Current Liability</u>	<u>Long Term Portion</u>
\$ 1,274	\$ 1,135	\$ 1,316	\$ 1,093	\$ 65	\$ 1,028

Activity for the year ended June 30, 2009:

<u>Beginning</u>	<u>Earned</u>	<u>Used</u>	<u>Ending</u>	<u>Current Liability</u>	<u>Long Term Portion</u>
\$ 1,152	\$ 1,112	\$ 990	\$ 1,274	\$ 43	\$ 1,231

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 and Mega Millions. Through June 30, 2010, MUSL includes 31 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 and Mega Millions 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's 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, 2010 and 2009, the NCEL had been credited with \$7,921 and \$6,906 in the MUSL prize reserve funds.

B. Annuity Installment Prizes:

The NCEL funds long term installment prizes through the purchase of insurance company annuities. The contract holders will fund the future value of the installment prize awards over the life of the prize awarded to the player. The NCEL currently holds contracts with Met Life Insurance Company and Prudential Life Insurance Company to provide these future prize installment payments. The future value of the annuity prizes awarded as of June 30, 2010 is \$39,300 and \$21,450 as of June 30, 2009.

C. Unclaimed Prizes:

As of June 30, 2010 and 2009, 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. Unclaimed prizes for Carolina Pick 4 were recorded on November 14, 2009. Unclaimed prizes for Mega Millions were not recorded, since the end of the fiscal year was less than 180 days after the first draw on February 2, 2010. The NCEL closed forty-six instant games during the 2010 fiscal year resulting in \$20,088 in unclaimed prizes.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 7 – OTHER IMPORTANT ITEMS (continued)

<u>Game Type</u>	2010	2009
Instant	\$ 20,088	\$ 29,953
Powerball	5,066	5,594
Carolina Cash 5	1,917	2,322
Carolina Pick 4	668	-
Carolina Pick 3	2,049	1,933
Raffle	-	-
Total unclaimed prizes	\$ 29,788	\$ 39,802

D. 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.” (See Note 4C)

E. 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, 2010.

The types of coverage, limits, and deductibles as of June 30, 2010 are described below (the following chart is not shown in thousands).

Type Coverage	Limits (\$)	Deductible (\$)	Comments
Public officers and employee liability	1,000,000 /10,000,000	The first 150,000 /1,000,000 per person is paid by the Commission.	State is self-insured up to \$1,000,000; excess up to \$10,000,000 is with a private insurer.
All risk – property contents	4,244,182	5,000	
Auto – liability	1,000,000 per person/ 10,000,000 per accident		
Auto – comp/collision	29,470	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	

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 8 – RISK MANAGEMENT (continued)

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 to \$50 is provided to eligible employees. This self-insured death benefit program is administered by the North Carolina Department of the State Treasurer and funded via employer contributions. The employer contribution rate was .16% for the current fiscal year.

Additional details on State-administered risk management programs are disclosed 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.nc.gov/> and clicking on "Financial Reports" or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

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.

For the years ending June 30, 2010, 2009 and 2008, respectively, the NCEL had a total payroll of \$11,968, \$11,696, and \$10,862 of which \$11,968, \$11,240 and \$10,340 was covered under the Teachers' and State Employees' Retirement System. Total employer and employee contributions for pension benefits for the year ended June 30, 2010, 2009 and 2008 were \$1,143, \$1,052 and \$805, respectively. Required employer contribution rates for the years ended June 30, 2010, 2009 and 2008, were 3.57%, 3.36% and 3.05%, respectively, while employee contributions were 6% each year. The NCEL made 100% of its annual required contributions for the years ended June 30, 2010, 2009, and 2008, which were \$425, \$378 and \$313, 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.osc.nc.gov/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 9 – PENSION AND DEFERRED COMPENSATION PLANS (continued)

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 \$203, \$206 and \$194 for the years ended June 30, 2010, 2009 and 2008, 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 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 \$134, \$80 and \$67 for the years ended June 30, 2010, 2009 and 2008.

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 4.5% of the covered payroll under the Teachers' and State Employees' Retirement System. Required contribution rates for the years ended June 30, 2009 and 2008, were 4.5% and 4.1%, respectively. The NCEL made 100% of its annual required contributions to the Plan for the years ended June 30, 2010, 2009, and 2008, which were \$539, \$461, and \$421, respectively.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 10 – OTHER POSTEMPLOYMENT BENEFITS (continued)

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.osc.nc.gov/> 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, 2010, the NCEL made a statutory contribution of .52% of covered payroll under the Teachers' and State Employees' Retirement System and the Optional Retirement Program to the DIPNC. Required contribution rates for the years ended June 30, 2010, 2009 and 2008 were .52%, .52% and .52%, respectively. The NCEL made 100% of its annual required contributions to the DIPNC for the years ended June 30, 2010, 2009, and 2008, which were \$62, \$58, and \$54, 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*. 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.nc.gov/> and clicking on "Financial Reports", or by calling the State Controller's Financial Reporting Section at (919) 981-5454.

NOTE 11 – LITIGATION

As of June 30, 2010, the NCEL is not, nor anticipates being, a party to any litigation.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

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

	<u>2010</u>		
Lottery Ticket Sales	\$ 1,420,908		
Fees and Licenses	4,859		
Investment Earnings and Other Revenues	2,699		
Total Annual Revenue	<u>1,428,466</u>		
Less Prize Tickets	(1,309)	0%	Of Total Annual Revenue
Total Net Revenue	<u>1,427,157</u>		
Prize Expense	(835,302)	59%	Of Total Annual Revenue
Advertising	(11,792)	1%	Of Total Annual Revenue
All Other Expenses and Transfers	(48,518)		
Total Section 18C-162.a.3	<u>(60,310)</u>	4%	Of Total Annual Revenue
Commissions (per 18C-142)	(99,340)	7%	Of Lottery Ticket Sales
Unclaimed Prizes to The State of North Carolina	14,894		
Net Revenues to The State of North Carolina	417,311		
Total Revenues to The State of North Carolina	<u>\$ 432,205</u>	30%	Of Total Annual Revenue
	<u>2009</u>		
Lottery Ticket Sales	\$ 1,293,020		
Fees and Licenses	4,663		
Investment Earnings and Other Revenues	4,251		
Total Annual Revenue	<u>1,301,934</u>		
Less Prize Tickets	(9,580)	1%	Of Total Annual Revenue
Total Net Revenue	<u>1,292,354</u>		
Prize Expense	(731,690)	56%	Of Total Annual Revenue
Advertising	(11,172)	1%	Of Total Annual Revenue
All Other Expenses and Transfers	(45,197)		
Total Section 18C-162.a.3	<u>(56,369)</u>	4%	Of Total Annual Revenue
Commissions (per 18C-142)	(90,366)	7%	Of Lottery Ticket Sales
Unclaimed Prizes to The State of North Carolina	19,901		
Net Revenues to The State of North Carolina	394,028		
Total Revenues to The State of North Carolina	<u>\$ 413,929</u>	32%	Of Total Annual Revenue

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

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

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.
- (b) To the extent that the expenses of the Commission are less than eight percent (8%) of total annual revenues, the Commission may allocate any surplus funds:
 - (1) To increase prize payments; or
 - (2) To the benefit of the public purposes as described in this chapter.
- (c) Unclaimed prize money shall be held separate and apart from the other revenues and allocated as follows:
 - (1) Fifty (50%) to enhance prizes under subdivision (a)(1) of this section.
 - (2) Fifty (50%) to the Education Lottery Fund to be allocated in accordance with G.S. 18C-164(c).(2005-344, s. 1; 2005-276, s. 31.1(r); 2007-323, s.5.2(c).)

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 provided 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, 2010 the NCEL transferred \$419.5 million, \$407.4 million and \$344.8 million for the years ended June 30, 2010, 2009 and 2008, respectively, to the NC Education Lottery Fund. As explained in Note 4C, \$18.0 million, \$6.5 million and \$3.5 for the years ended June 30, 2010, 2009 and 2008, respectively, is the amount of the "Net Revenues" and "50% of Unclaimed Prizes" for the year not yet transferred to the state as of June 30, but will be transferred during the subsequent fiscal year.

NOTE 13 – CHANGES IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2010, the NCEL implemented the following pronouncement issued by the Governmental Accounting Standards Board (GASB):

GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*.

GASB Statement No. 51 provides needed guidance regarding how to identify, account for, and report intangible assets. This Statement requires that all intangible assets not specifically excluded by its scope provisions be classified as capital assets. Accordingly, existing authoritative guidance related to the accounting and financial reporting for capital assets should be applied to these intangible assets, as applicable. This pronouncement provides additional guidance that specifically addresses the unique nature of intangible assets, including 1) establishing a specified conditions approach to recognizing intangible assets that are internally generated,

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2010 and 2009

NOTE 13 – CHANGES IN FINANCIAL ACCOUNTING AND REPORTING (continued)

2) providing guidance on recognizing internally generated computer software, and 3) establishing specific guidance for the amortization of intangible assets.

NOTE 14 – RECLASSIFICATIONS AND RESTATEMENTS

During fiscal year 2010 the NCEL began reporting a liability for long term annuity winners. The liability for the prizes is offset by investments in annuity contracts, which fund the long term installment prizes. Restatements of assets and liabilities for year ended June 30, 2009 was completed to provide the same information. Additional information on the long term prize liability and investments can be found in Notes 5D, 6C, and 7B.

NOTE 15 – SUBSEQUENT EVENTS

The Commission NCEL has evaluated all subsequent events for potential recognition and disclosure through November 1, 2010 the date these financial statements were available to be issued.



**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 statements of net assets of the North Carolina Education Lottery (NCEL), a major enterprise fund of the State of North Carolina as of June 30, 2010 and 2009, 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 November 9, 2010. 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.

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, 2010 and 2009, 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.

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 deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

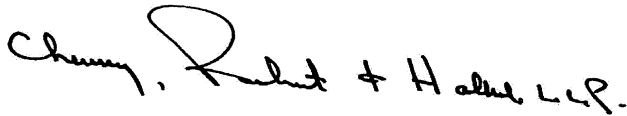
Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material 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 black ink that reads "Cherry, Bekaert & Holland, L.L.P." in a cursive, flowing script.

Raleigh, North Carolina
November 9, 2010