

NORTH CAROLINA EDUCATION LOTTERY

Financial Statements

June 30, 2015

(With Report of Independent Auditor Thereon)

Financial Statement Audit Report of the
North Carolina Education Lottery
For the Period Ended June 30, 2015

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

NORTH CAROLINA EDUCATION LOTTERY

Table of Contents

| | <u>Page</u> |
|--|-------------|
| Report of Independent Auditor..... | 1 - 2 |
| Management's Discussion and Analysis..... | 3 - 12 |
| Statements of Net Position | 13 |
| Statements of Revenues, Expenses and Changes in Net Position | 14 |
| Statements of Cash Flows | 15 |
| Notes to Financial Statements | 16 - 37 |
| Required Supplementary Information – Schedule of the Proportionate Share of Net Pension Liability – Teachers' and State Employees' Retirement System | 38 |
| Required Supplementary Information – Schedule of Contributions – Teachers' and State Employees' Retirement System | 39 |
| Report of Independent Auditor 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..... | 40 - 41 |

Report of Independent Auditor

To the Commissioners
North Carolina Education Lottery
Raleigh, North Carolina

Report on the Financial Statements

We have audited the accompanying statements of net position of the North Carolina Education Lottery (“NCEL”), a major enterprise fund of the State of North Carolina, as of and for the years ended June 30, 2015 and 2014, and the related statements of revenues, expenses and changes in net position and cash flows, and the notes to the financial statements which collectively comprise the NCEL’s basic financial statements as listed in the table of contents.

Management’s Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor’s Responsibility

Our responsibility is to express opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall financial statement presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the NCEL as of June 30, 2015 and 2014, and the respective changes in financial position and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Emphasis of Matter

Nature of Reporting Entity

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, 2015 and 2014, and the changes in its financial position and its cash flows thereof for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Change in Accounting Principle

As discussed in Note 13 to the financial statements, the NCEL adopted the provisions of Governmental Accounting Standards Board ("GASB") Statement No. 68, Accounting and Financial Reporting for Pensions, and GASB Statement No. 71, Pension Transition for Contributions Made Subsequent to the Measurement Date, during fiscal year 2015. Our opinion is not modified with respect to this matter.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis and the Required Supplementary Information as listed in the table of contents be presented to supplement the basic financial statements. Such information, although not a required part of the basic financial statements, is required by GASB who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated October 21, 2015, on our consideration the NCEL's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants agreements, and other matters. The purpose of the report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the NCEL's internal control over financial reporting and compliance.

A handwritten signature in black ink that reads "Cheryl Bekart LLP". The signature is written in a cursive, flowing style.

Raleigh, North Carolina
October 21, 2015

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

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, 2015, 2014 and 2013 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 the fiscal years ended June 30, 2015, 2014 and 2013.

Financial Highlights

For fiscal year 2015, gross ticket sales totaled \$1.97 billion representing a \$133 million increase over fiscal year 2014. Total operating income was \$527 million, which represented an increase of \$23.6 million over fiscal year 2014. Other significant financial highlights included the following:

- North Carolina General Statute Section 18C-164 (a) requires the NCEL to transfer net proceeds from operations and any prior year surplus to the State of North Carolina at least four times a year. In fiscal year 2015, the sum total of these cash transfers was \$520.6 million. Total cash transfers for fiscal years 2014 and 2013 were \$525.8 million and \$461.4 million, respectively.
- Awarded \$1 million or more to an NCEL player for the 227th time.
- Provided customer service to our 6, 901 retailers on a regular basis.
- Released 50 new instant scratch-off games into the marketplace generating gross instant ticket sales of \$1.29 billion.

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 to determine 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.

Included in this report are the Statements of Net Position as of June 30, 2015 and 2014, the Statements of Revenues, Expenses, and Changes in Net Position for the periods ended June 30, 2015 and 2014, and the Statements of Cash Flows for the periods ended June 30, 2015 and 2014.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

The NCEL transfers its net revenues to the Office of State Budget and Management (OSBM) for credit to the Education Lottery Fund. Education Lottery funds are distributed by OSBM based on the budgeted distribution of lottery net revenue as recommended by the General Assembly.

Total Assets

Total assets at the end of fiscal year 2015 were \$133 million compared to \$108 million at the end of fiscal year 2014, representing an increase of \$25 million.

Current assets increased from \$52 million in 2014 to \$74 million in 2015, representing an increase of \$22 million. This increase resulted from an increase in Pooled Cash due to fiscal year 2015 and 2014 surplus earnings held to be dispersed in the subsequent fiscal year. The increase was partially offset by a decrease in accounts receivable in 2015 from 2014. This primarily represents amounts due from retailers for ticket sales less commissions and prizes paid by the retailers. The decrease is essentially due to the timing of the end of the accounting week for billing and collections from our retailers at fiscal 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 \$2 million increase in the State Treasurer's Securities Lending Collateral and a \$532 thousand 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 \$408 thousand 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 2015 was \$1.8 million which is approximately \$502 thousand higher than 2014. 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 the Office of the State Controller's (OSC) policy. 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.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

The activity for capital assets for the year ended June 30, 2015 was (in thousands):

| <u>Category</u> | <u>Balance July 1, 2014</u> | <u>Increases</u> | <u>Decreases</u> | <u>Balance June 30, 2015</u> |
|--|---------------------------------|------------------|------------------|----------------------------------|
| Capital assets, depreciable | | | | |
| Furniture | \$ 46 | \$ - | \$ - | \$ 46 |
| Equipment | 4,376 | 111 | (778) | 3,709 |
| Motorized equipment | 67 | - | - | 67 |
| Computer software | - | 983 | - | 983 |
| Total capital assets, depreciable | <u>4,489</u> | <u>1,094</u> | <u>(778)</u> | <u>4,805</u> |
| Less accumulated depreciation for: | | | | |
| Furniture | 34 | 3 | - | 37 |
| Equipment | 3,056 | 563 | (753) | 2,866 |
| Motorized equipment | 68 | 1 | - | 69 |
| Computer software | - | - | - | - |
| Total accumulated depreciation | <u>3,158</u> | <u>567</u> | <u>(753)</u> | <u>2,972</u> |
| Total capital assets, depreciable, net | <u>1,331</u> | <u>527</u> | <u>(25)</u> | <u>1,833</u> |
| Capital assets, net | <u>\$ 1,331</u> | <u>\$ 527</u> | <u>\$ (25)</u> | <u>\$ 1,833</u> |

Deferred Outflows of Resources

The NCEL recognized deferred outflows of resources as related to pensions as per GASB 68 during fiscal year 2015. More information on deferred outflows can be found in Note 9 of the Notes to the financial statements.

Total Liabilities

Total current liabilities for the NCEL were \$70 million in 2015 increasing by \$17 million from 2014. The increase in current liabilities partially resulted from increases in transfers due to the state and in obligations under State Treasurer's security lending collateral agreements. The increased amount due to the State can be attributed to the timing of transactions encountered in the normal course of business. The increase in the obligations under State Treasurer's security lending collateral is directly related to the NCEL having more cash on hand at year-end. Current liabilities also increased over 2014 due to increases in prize awards payable, and other payables.

Noncurrent liabilities include 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>Earned</u> | <u>Used</u> | <u>Ending</u> | <u>Current Liability</u> | <u>Long Term Portion</u> |
|------------------|-----------------|-----------------|-----------------|------------------------------|------------------------------|
| <u>\$ 1,264</u> | <u>\$ 1,554</u> | <u>\$ 1,056</u> | <u>\$ 1,762</u> | <u>\$ 192</u> | <u>\$ 1,570</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, 2016.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

Deferred Inflows of Resources

The NCEL recognized deferred inflows of resources as related to pensions as per GASB 68 during fiscal year 2015. More information on deferred inflows can be found in Note 9 of the Notes to the financial statements.

Net Position and Changes in Net Position

As required in the North Carolina State 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 position is zero for the NCEL. There are no changes in the net position from year to year.

Condensed Statement of Net Position (in thousands)

| | 2015 | 2014 | 2013 |
|-----------------------------------|----------------|----------------|----------------|
| ASSETS | | | |
| Total Current Assets | \$ 73,811 | \$ 51,543 | \$ 59,643 |
| Noncurrent Assets | 57,373 | 55,020 | 50,708 |
| Capital Assets, Depreciable (Net) | 1,833 | 1,331 | 897 |
| Total Assets | <u>133,017</u> | <u>107,894</u> | <u>111,248</u> |
| Deferred Outflows of Resources | <u>1,471</u> | <u>-</u> | <u>-</u> |
| Liabilities | | | |
| Total Current Liabilities | 70,200 | 53,210 | 60,525 |
| Noncurrent Liabilities | 59,589 | 54,684 | 50,723 |
| Total Liabilities | <u>129,789</u> | <u>107,894</u> | <u>111,248</u> |
| Deferred Inflows of Resources | <u>4,699</u> | <u>-</u> | <u>-</u> |
| Net Position | | | |
| Net Investment in Capital Assets | 1,833 | 1,331 | 897 |
| Unrestricted | <u>(1,833)</u> | <u>(1,331)</u> | <u>(897)</u> |
| Total Net Position | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |

Current liabilities consist of "Due to the State" in the amount of \$10.404 million. Of this amount, \$10.350 million represents the remaining amount of the "Net Revenues" and "50% of Unclaimed Prizes" for Fiscal Year 2015 not yet transferred to the State of North Carolina as of June 30, 2015. These funds will be transferred to the State during Fiscal Year 2016. The remainder is due to other state agencies for services provided to the NCEL. Additional information on "Due to the State" is found in Note 6C to the financial statements.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

Revenues

Operating revenues consist of gross sales (net of bad debt), fees and licenses.

Sales

The gross lottery ticket sales for fiscal year 2015 totaled \$1.972 billion as compared to \$1.839 billion for fiscal year 2014 and \$1.69 billion in fiscal year 2013. This represents an increase of \$133 million from 2014 and \$282 million from 2013.

Gross instant ticket sales were \$1.294 billion for fiscal year 2015 compared with \$1.17 billion for fiscal year 2014 and \$1.01 billion in fiscal year 2013, an increase of approximately \$124 million from fiscal year 2014 and approximately \$284 million from fiscal year 2013. The increase realized during fiscal year 2015 is attributable to several factors. The NCEL saw continued strong performance of games featuring "Back Scratch", an additional play area on the back of the ticket, with the launch of the \$5 Break the Bank and \$5 Trucks and Bucks games. Break the Bank was one of the highest performing \$5 games of the year with nearly \$30 Million in sales. Trucks & Bucks also featured "Back Scratch", as well as, the opportunity for players to win one of three four wheel drive trucks in a second chance drawing. Each winner had a choice of a Chevrolet Silverado, Ford F-150 or Dodge Ram. The game was very popular amongst players because of this one-of-a-kind prize opportunity. The NCEL also expanded the "Bucks" family of games to include all of the Holiday themed tickets this past year which included \$1 – Jingle Bucks, \$2 – Jolly Jingle Bucks, \$3 – Jingle Bingo Bucks, \$5 – Jumbo Jingle Bucks and \$10 – Millionaire Jingle Bucks Collectively, these holiday themed "Bucks" tickets became the best-selling holiday tickets ever for the NCEL.

Draw game sales were \$678 million for fiscal year 2015 compared to \$669 million for fiscal year 2014 and \$678 for fiscal year 2013, representing a \$9 million increase over fiscal year 2014 and no change from fiscal year 2013. Draw game sales suffered from a lack of high jackpots in the multi-state game Powerball. Since surpassing \$500 million twice in fiscal year 2013, the Powerball jackpot has broken the mark only once. This led to sales of \$130 million for fiscal year 2015, a decrease of \$19 million from fiscal year 2014 and of \$67 million from 2013. After reaching a top jackpot of \$636 million in fiscal year 2014, the NCEL's other multi-state game, Mega Millions, reached a top jackpot amount for fiscal year 2015 of \$321 million. This resulted in sales of \$61 million, a decrease of \$13 million from sales of \$74 million in fiscal year 2014.

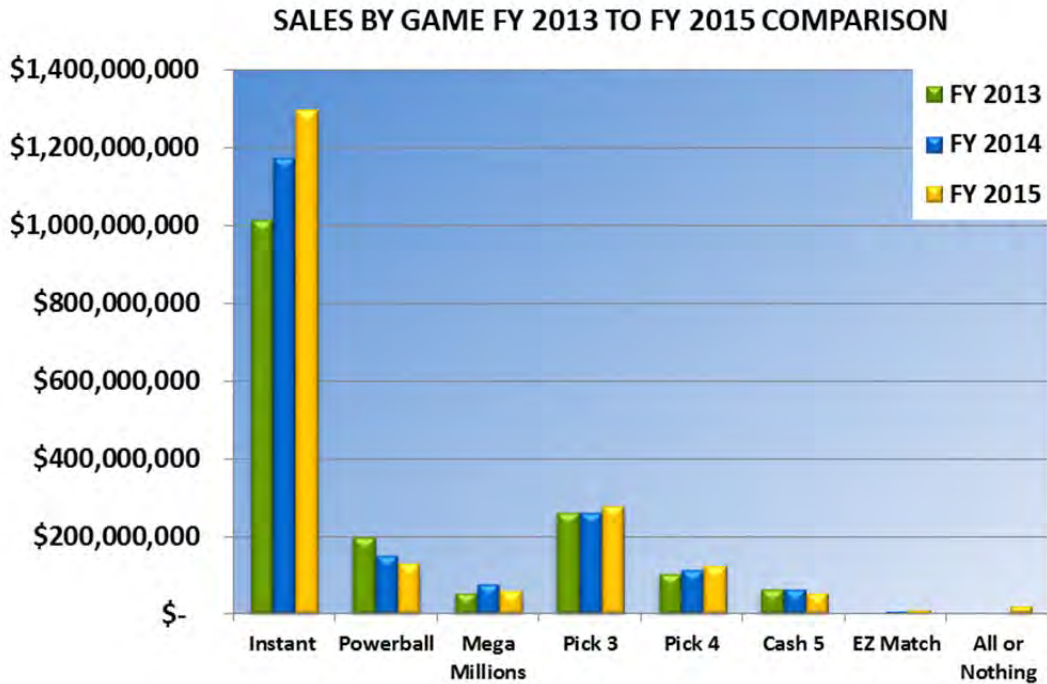
The Carolina Cash 5 top prize exceeded half of a million dollars five times during the fiscal year and reached a peak of \$740 thousand. Fiscal year 2015 was the first full year of the EZ match add-on to the Pick 5 ticket. For an additional dollar, this feature prints an instant "EZ" match number with a corresponding prize amount. If the EZ match number matches any of pick 5 numbers, the player wins the corresponding prize instantly. The EZ match feature generated over \$10 million in sales for the year.

The Carolina Pick 4 game also had increased sales from the previous year. Carolina Pick 4 sales were over \$122.8 million compared to \$113.1 million the previous year, and \$103.9 million in fiscal year 2013.

All or Nothing was launched in September of 2014 as a new draw game for the NCEL. All or Nothing pays out a top prize for matching all twelve numbers drawn or none at all. All or Nothing generated sales of over \$19.5 million during 10 months of sales in fiscal year 2015.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS
 June 30, 2015 and 2014

The following chart depicts the distribution of sales by product for the fiscal years ended June 30, 2015, 2014 and 2013.



All or Nothing sales started on September 7th ended the year with sales of \$19.5 million.

Non-operating Revenues mainly consist of investment earnings on Short Term Investment Fund (STIF) accounts and security lending transactions, and Multi-State Lottery Association (MUSL) dividends received.

Expenses

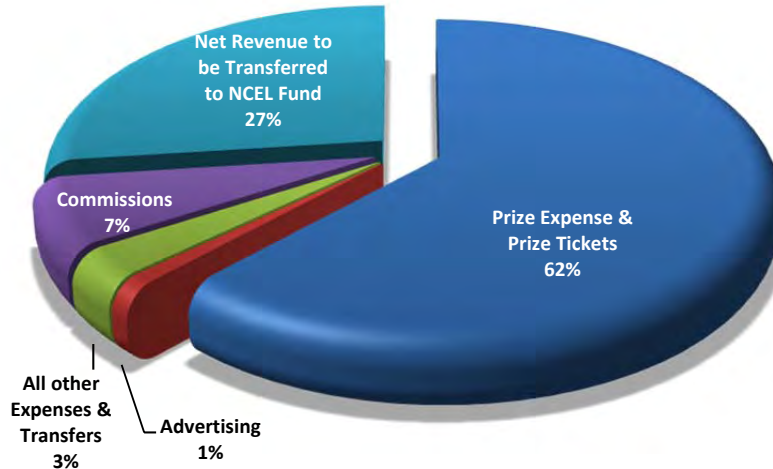
Section 18C-162, NC General Statute stipulates that no more than 8% of the total annual revenues shall be allocated for payment of expenses of the Lottery. Advertising expenses shall not exceed 1% of the total annual revenues.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

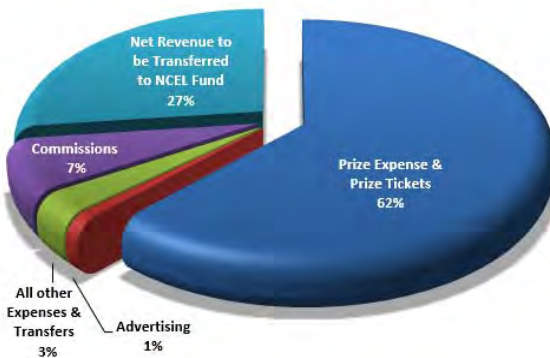
June 30, 2015 and 2014

The following charts show the major components of NCEL operating expenses and transfers as a percentage of total revenues for the fiscal years ended June 30, 2015, 2014 and 2013.

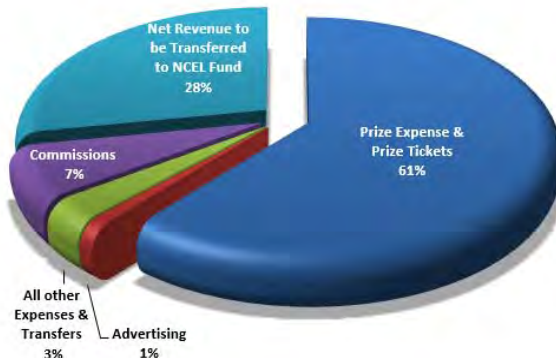
DISTRIBUTION OF REVENUES FY 2015



DISTRIBUTION OF REVENUES FY 2014



DISTRIBUTION OF REVENUES FY 2013



Prizes, commissions and gaming vendor charges all directly relate to sales. As expected, as sales have increased so have these expenses. In fiscal year 2015 total gaming expenses which consist of prizes, retailer commissions and gaming vendor charges (gaming system services), totaled \$1,398 million as compared to \$1,294 million and \$1,170 million for fiscal years 2014 and 2013, respectively. Other operating expenses, which consist of advertising and marketing, salary and benefits, professional fees, rent, maintenance, depreciation and general administrative expenses increased to \$52.8 million in fiscal year 2015, as compared with \$47.3 million and \$46.1 million for fiscal years 2014 and 2013, respectively. Other operating expenses represented 2.7%, 2.6% and 2.7% of total operating revenues in fiscal years 2015, 2014 and 2013, respectively.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

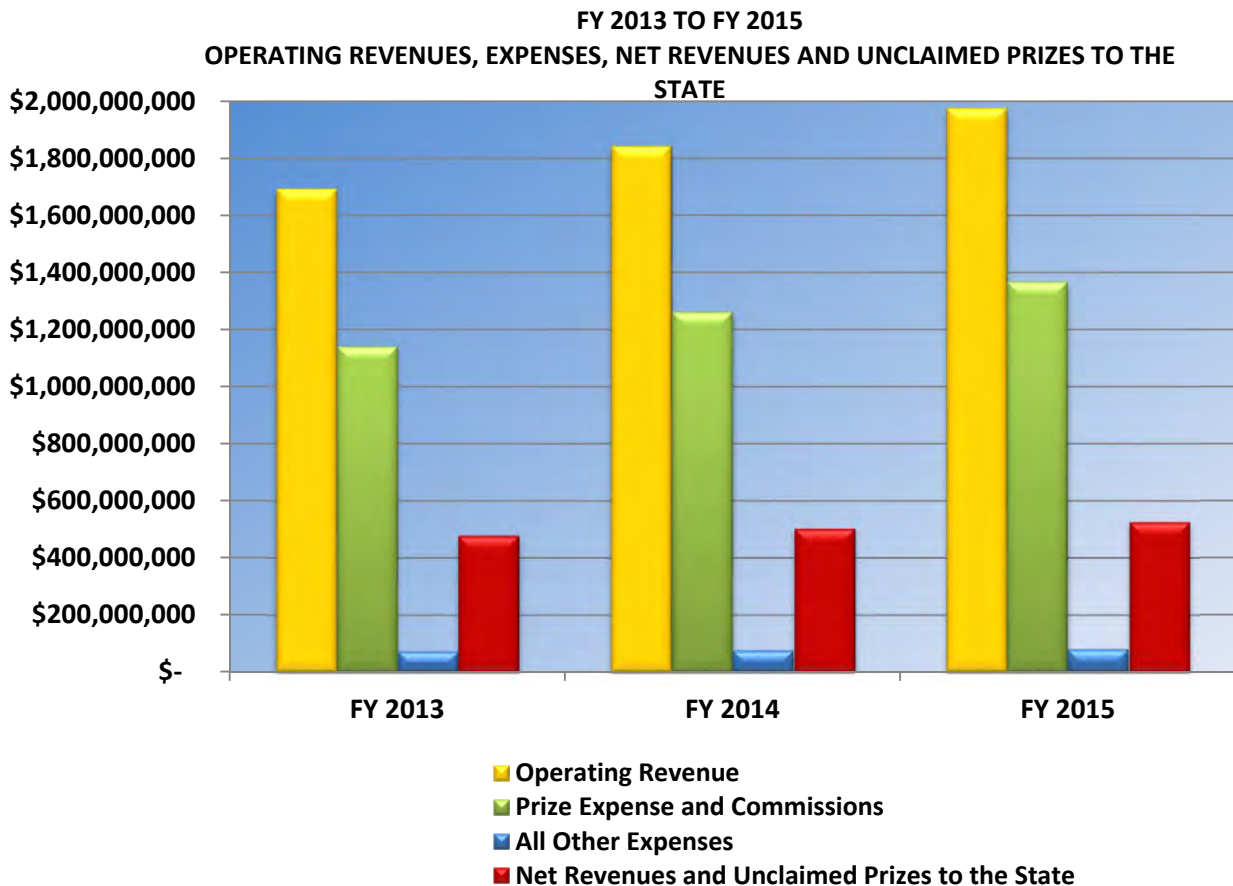
Condensed Statement of Revenues, Expenses and Changes in Net Position (in thousands)

| | <u>2015</u> | <u>2014</u> | <u>2013</u> |
|---|------------------|------------------|------------------|
| Operating Revenues: | | | |
| Gross Sales: | \$ 1,972,220 | \$ 1,839,259 | \$ 1,689,803 |
| Less: Sales/Service Bad Debt | (5) | (48) | (90) |
| Fees and Licenses | <u>5,271</u> | <u>5,425</u> | <u>5,296</u> |
| Total Operating Revenues | <u>1,977,486</u> | <u>1,844,636</u> | <u>1,695,009</u> |
| Operating Expenses: | | | |
| Gaming Expenses: | | | |
| Lottery Prizes | 1,231,238 | 1,135,052 | 1,024,437 |
| Retailer Commissions | 137,767 | 128,551 | 118,148 |
| Gaming Systems Services | 28,678 | 30,343 | 27,262 |
| Total Gaming Expenses | <u>1,397,683</u> | <u>1,293,946</u> | <u>1,169,847</u> |
| Other Operating Expenses | <u>52,770</u> | <u>47,260</u> | <u>46,078</u> |
| Total Operating Expenses | <u>1,450,453</u> | <u>1,341,206</u> | <u>1,215,925</u> |
| Operating Income | <u>527,033</u> | <u>503,430</u> | <u>479,084</u> |
| Nonoperating Revenues (Expenses): | | | |
| Investment Earnings, Nonoperating Revenue (Expense) and Compulsive Gambling Contribution | (606) | (295) | (576) |
| Net Revenues and Unclaimed prizes to the State | <u>(526,427)</u> | <u>(503,135)</u> | <u>(478,508)</u> |
| Total Nonoperating Revenue (Expenses) | <u>(527,033)</u> | <u>(503,430)</u> | <u>(479,084)</u> |
| Change in Net Position | <u>-</u> | <u>-</u> | <u>-</u> |
| Net Position Beginning July 1 | <u>-</u> | <u>-</u> | <u>-</u> |
| Net Position Ending June 30 | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

From fiscal year 2013 to fiscal year 2015, the NCEL has achieved annual increases in revenues and transfers to the State. The following graph depicts these trends.



Budget and Economic Outlook

On June 2nd, 2015, the NCEL Commission approved the Fiscal Year 2016 budget for the NCEL to provide a projected \$528.9 million to the State's Education Lottery Fund. This projected budget is a 1.71% increase over the fiscal year 2015 budget that reflected a \$520 million transfer to the State's Education Lottery Fund. The NCEL will continue to monitor the current economic conditions in the State, and its impact upon lottery ticket sales. As per the General Assembly Fiscal Research Division: "The revenue outlook for the 2015-17 biennium reflects a continuation of moderate, steady economic growth. Employment growth will continue to show improvement as employment markets continue to stabilize. Concern along the economic front continues as global economic weakness and social instability continue to keep risks slightly elevated. Nonetheless, the forecast envisions the pace of growth to remain stable in 2015 and into 2016, with the State's growth in economic activity keeping pace with the nation as a whole." Therefore, the NCEL has constructed an increasing budget and sales forecast for the upcoming fiscal year.

NORTH CAROLINA EDUCATION LOTTERY
MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2015 and 2014

A focus of the NCEL Commission is to ensure sound operations. The existence of this focus is apparent in the opinions issued by external audit firms. For the ninth consecutive year, the State Auditor contracted with an outside CPA firm to conduct the fiscal year financial audit, which resulted in an unmodified 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 Position (in thousands)
June 30, 2015 and 2014

| | 2015 | 2014 |
|---|---------|---------|
| ASSETS | | |
| Current Assets: | | |
| Cash and Cash Equivalents: | | |
| Cash | \$ 119 | \$ 155 |
| Pooled Cash | 48,885 | 21,002 |
| Receivables: | | |
| Accounts Receivable | 8,654 | 22,069 |
| Interest Receivable | 41 | 26 |
| Due from Other Funds | 5,275 | - |
| Investment in Annuity Contracts | 5,136 | 4,604 |
| Prepaid Items | 651 | 655 |
| State Treasurer's Security Lending Collateral | 5,050 | 3,032 |
| Total Current Assets | 73,811 | 51,543 |
| Noncurrent Assets: | | |
| Investment in Annuity Contracts | 56,718 | 53,714 |
| Prepaid Items | 655 | 1,306 |
| Capital Assets, Depreciable (Net): | | |
| Furniture and Equipment | 4,805 | 4,489 |
| Accumulated Depreciation | (2,972) | (3,158) |
| Total Capital Assets, Depreciable (Net) | 1,833 | 1,331 |
| Total Assets | 133,017 | 107,894 |
| DEFERRED OUTFLOWS OF RESOURCES | | |
| | 1,471 | - |
| LIABILITIES | | |
| Current Liabilities: | | |
| Accounts Payable | 48,952 | 40,499 |
| Accrued Payroll | 466 | 415 |
| Annuity Prize Award Payable - Current | 5,136 | 4,604 |
| Accrued Paid Time Off - Current | 192 | 294 |
| Due to the State | 10,404 | 4,628 |
| Obligations Under State Treasurer's Security Lending Agreements | 5,050 | 2,770 |
| Total Current Liabilities | 70,200 | 53,210 |
| Noncurrent Liabilities: | | |
| Annuity Prize Award Payable | 56,718 | 53,714 |
| Accrued Paid Time Off | 1,570 | 970 |
| Net Pension Liability | 1,301 | - |
| Total Liabilities | 129,789 | 107,894 |
| DEFERRED INFLOWS OF RESOURCES | | |
| | 4,699 | - |
| NET POSITION | | |
| Net Investment in Capital Assets | 1,833 | 1,331 |
| Unrestricted | (1,833) | (1,331) |
| Total Net Position | \$ - | \$ - |

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY

Statements of Revenues, Expenses and Changes in Net Position (in thousands)
Years Ended June 30, 2015 and 2014

| | 2015 | 2014 |
|--|--------------|--------------|
| Operating Revenues: | | |
| Gross Sales: | \$ 1,972,220 | \$ 1,839,259 |
| Less: Sales/Service Bad Debt | (5) | (48) |
| Fees and Licenses | 5,271 | 5,425 |
| Total Operating Revenues | 1,977,486 | 1,844,636 |
| Operating Expenses: | | |
| Salaries, Wages, and Benefits | 18,738 | 18,127 |
| Lottery Prizes | 1,231,238 | 1,135,052 |
| Retailer Commissions | 137,767 | 128,551 |
| Retailer Incentives | 976 | 825 |
| Gaming Systems Services | 28,678 | 30,343 |
| Advertising | 19,098 | 15,238 |
| Marketing | 4,183 | 3,602 |
| Other Services | 5,272 | 5,158 |
| Furniture, Fixtures, and Equipment | 983 | 1,323 |
| Depreciation | 568 | 439 |
| Other General and Administrative Expenses | 2,952 | 2,548 |
| Total Operating Expenses | 1,450,453 | 1,341,206 |
| Operating Income | 527,033 | 503,430 |
| Nonoperating Revenues (Expenses): | | |
| Investment Earnings | 408 | 669 |
| Compulsive Gambling Contribution | (1,000) | (1,000) |
| Unclaimed Prizes to NC Education Lottery Fund | (13,841) | (14,043) |
| Net Revenues to the State of NC | (512,586) | (489,092) |
| Miscellaneous Nonoperating Revenues (Expenses) | (14) | 36 |
| Total Nonoperating Expenses | (527,033) | (503,430) |
| Change in Net Position | - | - |
| Net Position Beginning, July 1 | - | - |
| Net Position Ending, June 30 | \$ - | \$ - |

See Notes to the Financial Statements.

NORTH CAROLINA EDUCATION LOTTERY

Statements of Cash Flows (in thousands)
Years Ended June 30, 2015 and 2014

| | 2015 | 2014 |
|--|--------------|--------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Receipts from Customers | \$ 1,852,801 | \$ 1,711,791 |
| Payments to Employees and Fringe Benefits | (18,868) | (18,227) |
| Payments for Prizes, Benefits and Claims | (1,216,421) | (1,120,520) |
| Payments to Vendors and Suppliers | (67,518) | (57,182) |
| Other Receipts | 24 | 50 |
| | 550,018 | 515,912 |
| CASH USED FOR NONCAPITAL FINANCING ACTIVITIES | | |
| Transfers to State | (520,651) | (525,824) |
| Transfers to Other State Agencies | (1,000) | (1,000) |
| | (521,651) | (526,824) |
| CASH USED FOR CAPITAL AND RELATED FINANCING ACTIVITIES | | |
| Acquisition and Construction of Capital Assets | (1,086) | (874) |
| | (1,086) | (874) |
| CASH PROVIDED FROM INVESTING ACTIVITIES | | |
| Investment Earnings | 566 | 458 |
| | 566 | 458 |
| Net Increase/(Decrease) in Cash and Cash Equivalents | 27,847 | (11,328) |
| Cash and Cash Equivalents at Beginning of Year | 21,157 | 32,485 |
| Cash and Cash Equivalents at End of Year | \$ 49,004 | \$ 21,157 |
| RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES | | |
| Operating Income | \$ 527,033 | \$ 503,430 |
| Adjustments to Reconcile Operating Income to Cash Provided by Operating Activities: | | |
| Depreciation Expense | 568 | 439 |
| Pension Expense | 606 | - |
| Other Nonoperating Income | 24 | 49 |
| (Increase) Decrease in Assets: | | |
| Accounts Receivable | 13,415 | (4,295) |
| Prepaid Items | 655 | (538) |
| Deferred Outflows for Pensions | (1,285) | - |
| Increase (Decrease) in Liabilities: | | |
| Accounts Payable | 8,453 | 16,927 |
| Accrued Payroll and Related Liabilities | 51 | (16) |
| Other Liabilities | 498 | (84) |
| | \$ 550,018 | \$ 515,912 |
| NONCASH INVESTING, CAPITAL, AND FINANCING ACTIVITIES | | |
| Assets Acquired through the Assumption of a Liability | \$ 2,018 | \$ 2,699 |
| Change in Fair Value of Investments | 262 | 190 |

See Notes to the Financial Statements.

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

June 30, 2015 and 2014

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 POWERBALL lottery tickets. POWERBALL sales began on May 30, 2006. Additional draw 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
- Carolina Pick 4 second daily draw and Carolina Pick 3 second Sunday draw on February 27, 2011
- EZ Match on March 30, 2014
- All or Nothing on September 7, 2014.

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 Accounting Principles Board (APB) opinions. GASB Statement No. 62 incorporates into the GASB's authoritative literature the applicable guidance previously presented in the following pronouncements issued before November 30, 1989: 1) Financial Accounting Standards Board (FASB) Statements and Interpretations, 2) Accounting Principles Board Opinions, and 3) Accounting Research Bulletins of the American Institute of Certified Public Accountants' (AICPA) Committee on Accounting Procedure. The guidance generally has been taken "as-is" from the original FASB and AICPA pronouncements, except a few provisions that have been modified where necessary to relate specifically to the governmental environment.

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 position, and its operating statement includes all revenues (increases) and expenses (decreases) in net position. 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 for the sales of lottery products. The significant operating expenses include the cost of prizes, commissions, gaming system vendor charges, personnel, advertising and other administrative expenses.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 2 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

B. Basis of Presentation: (continued)

Change in Accounting Principle – During fiscal year 2015, the NCEL adopted the provisions of GASB Statement No. 68, Accounting and Financial Reporting for Pensions and GASB Statement No. 71, Pension Transition for Contributions Made Subsequent to the Measurement Date.

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 Statute 147-69.3(e), the State Treasurer lends securities from its investment pool 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, FNMA'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.

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 "Reports," or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

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, 2015 and 2014.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

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. Deferred Outflows/Inflows of Resources

In addition to assets, the statement of financial position will sometimes report a separate section for deferred outflows of resources. This separate financial statement element, deferred outflows of resources, represents a consumption of net position that applies to a future period and so will not be recognized until then. The NCEL has two items that meet this criterion - a pension related deferral and contributions made to the pension plan in the current fiscal year. The statement of financial position also reports a separate section for deferred inflows of resources. This separate financial statement element, deferred inflows of resources, represents an acquisition of net position that applies to a future period and so will not be recognized until then. The NCEL has one item that meets this criterion - pension related deferrals.

H. Game Revenue Recognition:

For the NCEL's draw games, POWERBALL, Mega Millions, Carolina Cash 5, Carolina Pick 4, Carolina Pick 3, EZ Match, All or Nothing 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).

I. Lottery Prize Expense Recognition:

For POWERBALL, Mega Millions, Carolina Cash 5, Carolina Pick 4, Carolina Pick 3, EZ Match, and for raffles, prize expense is recorded at 50 percent of sales on a daily basis. For All or Nothing prize expense is recorded at 52 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 the value of packs settled. 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.

J. 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.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

K. Retirement Plans:

For purposes of measuring the net pension liability, deferred outflows of resources and deferred inflows of resources related to pensions, and pension expense, information about the fiduciary net position of the Teachers' and State Employees' Retirement System (TSERS) and additions to/deductions from TSERS' fiduciary net position have been determined on the same basis as they are reported by TSERS. For this purpose, plan member contributions are recognized in the period in which the contributions are due. The NCEL's employer contributions are recognized when due and the NCEL has a legal requirement to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of TSERS. Investments are reported at fair value.

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.

| Game Revenue | 2015 | 2014 |
|---------------------------------|--------------|--------------|
| Instant | \$ 1,294,017 | \$ 1,170,248 |
| Draw | 678,203 | 669,017 |
| Bad debt write off | 3 | (48) |
| Damaged tickets, sales services | (8) | (6) |
| Total | \$ 1,972,215 | \$ 1,839,211 |

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 fiscal year 2015 and 2014 were \$5,271 and \$5,425, 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 investment earnings earned on these accounts and the related security lending collateral transactions is \$408 and \$669 for the years ended June 30, 2015 and 2014, respectively.

The NCEL also has miscellaneous non-operating revenue related to dividends received from MUSL which were \$24 and \$49 for the years ended June 30, 2015 and 2014, respectively. The remaining miscellaneous non-operating revenue consisted of sales of surplus property.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 4 – EXPENSES

A. Operating Expenses:

1. Lottery Prize Expense:

| Prize Expense | 2015 | 2014 |
|-------------------------|--------------|--------------|
| Instant | \$ 891,330 | \$ 794,282 |
| Draw | 326,067 | 326,727 |
| 50% of unclaimed prizes | 13,841 | 14,043 |
| Total | \$ 1,231,238 | \$ 1,135,052 |

2. Retailer Commissions:

| Commissions | 2015 | 2014 |
|-------------|------------|------------|
| Instant | \$ 90,429 | \$ 81,799 |
| Draw | 47,338 | 46,752 |
| Total | \$ 137,767 | \$ 128,551 |

3. Retailer Incentives:

In fiscal year 2010, the State Lottery Commission approved a retailer incentive program where retailers would receive compensation for selling a top/second tier prize in the Multi-State games POWERBALL and Mega Millions and a top tier prize in Carolina Cash 5. As of December 2011, the retailer incentive program was expanded to include instant ticket prizes of over \$1 million as well. The total payments issued for the retailer incentive program for fiscal years 2015 and 2014 were \$976 and \$825, respectively.

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. The Other category under Other Services also includes payments issued to the Department of Public Safety's Division of Alcohol and Law Enforcement (ALE) in the amount of \$968 in fiscal year 2015 and \$1,000 in fiscal year 2014.

| | 2015 | 2014 |
|----------------------------------|----------|----------|
| Security services | \$ 18 | \$ 17 |
| Background checks | 1,020 | 1,157 |
| Communications, including wiring | 1,128 | 1,231 |
| Legal services | 32 | 21 |
| Travel | 166 | 192 |
| Other | 2,908 | 2,540 |
| Total | \$ 5,272 | \$ 5,158 |

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 4 – EXPENSES (continued)

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 2F) and therefore expensed. The total expenses for fiscal years 2015 and 2014 were \$983 and \$1,323, respectively.

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> |
|--------------------|-----------------|
| 2016 | \$ 1,164 |
| 2017 | 442 |
| 2018 | 394 |
| 2019 | 329 |
| 2020 | 277 |
| <u>2021-2025</u> | <u>1,268</u> |
| <u>Total</u> | <u>\$ 3,874</u> |

The total space rental costs for the fiscal years 2015 and 2014 were \$1,176 and \$1,145, respectively. The NCEL also has several contracts for various equipment leases including instant ticket vending machines (ITVM's).

B. Non-operating Expenses:

The allocable share of the expenses arising from State Treasurer's Securities Lending Collateral program transactions, totaling \$21 and \$13 for the years ended June 30, 2015 and 2014, respectively, are included as non-operating expense. For the years ended June 30, 2015 and 2014, the remaining non-operating expenses consist of other miscellaneous non-operating items.

C. Transfers Out:

There were three significant transfers from the NCEL. One million dollars 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 State Lottery Act for the years ended June 30, 2015 and 2014 (See Note 7D).

The second transfer was \$13,841 and \$14,043 for the years ended June 30, 2015 and 2014, 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 (See Note 7C).

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 4 – EXPENSES (continued)

C. Transfers Out: (continued)

The third transfer was 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. “Net Revenues” were \$512,586 for fiscal year 2015 compared with \$489,092 for fiscal year 2014 (see Note 12). However, \$520,642 was transferred to the NC Education Lottery Fund for fiscal year 2015 compared with \$525,823 for fiscal year 2014. The balances remaining (\$10,350 and \$4,565 for fiscal years 2015 and 2014) were recorded as a payable to the State for both fiscal years and were transferred subsequent to fiscal year end. NC General Statute 18C-162 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, 2015 and 2014 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, 2015 and 2014, respectively, \$48,885 and \$21,002 of the amounts shown on the Statement of Net Position 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 1.5 and 1.3 years, as of June 30, 2015 and 2014, 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 “Reports” or by calling the State Controller’s Financial Reporting Section at (919) 707-0500.

B. Accounts Receivable:

Accounts Receivable primarily represents amounts due from retailer’s ticket sales 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. Investments 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 \$5,136 and \$56,718 for fiscal year 2015 and \$4,604 and \$53,714 for fiscal year 2014, respectively.

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

June 30, 2015 and 2014

NOTE 5 – ASSETS (continued)

C. Investments in Annuity Contracts: (continued)

The policies of the NCEL only allow for direct purchase of annuity contracts from which the proceeds are used to fund long term installment prizes. As the NCEL is not pursuing other forms of investments, they are not currently anticipated under the policy. As a means of limiting exposure to interest rate risk, the policy only allows for direct purchase of annuity contracts which future value payments are pre-negotiated with the providers of the contracts. These contracts are not subject to foreign currency risk because the provider is required by contract to pay the full annuities. Accordingly, the NCEL does not have a policy regarding foreign currency risk since investments in products subject to this risk are not applicable to the NCEL.

The policy of the NCEL restricts direct purchase of annuity contracts to those with companies that hold minimum ratings as follows: AA by Fitch, AA by Moody's or AA by Standard & Poor's. As of June 30, 2015 and June 30, 2014, all annuities carried a rating of Aa/AA.

Maturities for investments in annuity contracts are as follows:

| <u>Maturities</u> | <u>2015</u> | <u>2014</u> |
|--------------------|------------------|------------------|
| Less than 1 year | \$ 5,136 | \$ 4,604 |
| 1 to 5 years | 20,256 | 18,416 |
| 6 to 10 years | 20,256 | 18,416 |
| More than 10 years | 16,206 | 16,882 |
| Total | <u>\$ 61,854</u> | <u>\$ 58,318</u> |

D. Capital Assets:

The activity for capital assets for the year ended June 30, 2015 was:

| <u>Category</u> | <u>Balance July 1, 2014</u> | <u>Increases</u> | <u>Decreases</u> | <u>Balance June 30, 2015</u> |
|--|---------------------------------|------------------|------------------|----------------------------------|
| Capital assets, depreciable | | | | |
| Furniture | \$ 46 | \$ - | \$ - | \$ 46 |
| Equipment | 4,376 | 111 | (778) | 3,709 |
| Motorized equipment | 67 | - | - | 67 |
| Computer software | - | 983 | - | 983 |
| Total capital assets, depreciable | <u>4,489</u> | <u>1,094</u> | <u>(778)</u> | <u>4,805</u> |
| Less accumulated depreciation for: | | | | |
| Furniture | 34 | 3 | - | 37 |
| Equipment | 3,056 | 563 | (753) | 2,866 |
| Motorized equipment | 68 | 1 | - | 69 |
| Computer software | - | - | - | - |
| Total accumulated depreciation | <u>3,158</u> | <u>567</u> | <u>(753)</u> | <u>2,972</u> |
| Total capital assets, depreciable, net | <u>1,331</u> | <u>527</u> | <u>(25)</u> | <u>1,833</u> |
| Capital assets, net | <u>\$ 1,331</u> | <u>\$ 527</u> | <u>\$ (25)</u> | <u>\$ 1,833</u> |

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 5 – ASSETS (continued)

D. Capital Assets: (continued)

The activity for capital assets for the year ended June 30, 2014 was:

| <u>Category</u> | <u>Balance July 1, 2013</u> | <u>Increases</u> | <u>Decreases</u> | <u>Balance June 30, 2014</u> |
|--|---------------------------------|------------------|------------------|----------------------------------|
| Capital assets, depreciable | | | | |
| Furniture | \$ 46 | \$ - | \$ - | \$ 46 |
| Equipment | 3,629 | 889 | (142) | 4,376 |
| Motorized equipment | 67 | - | - | 67 |
| Total capital assets, depreciable | <u>3,742</u> | <u>889</u> | <u>(142)</u> | <u>4,489</u> |
| Less accumulated depreciation for: | | | | |
| Furniture | 31 | 3 | - | 34 |
| Equipment | 2,746 | 436 | (126) | 3,056 |
| Motorized equipment | 68 | - | - | 68 |
| Total accumulated depreciation | <u>2,845</u> | <u>439</u> | <u>(126)</u> | <u>3,158</u> |
| Total capital assets, depreciable, net | <u>897</u> | <u>450</u> | <u>(16)</u> | <u>1,331</u> |
| Capital assets, net | <u>\$ 897</u> | <u>\$ 450</u> | <u>\$ (16)</u> | <u>\$ 1,331</u> |

Equipment expenditures for 2015 and 2014 included replacements of aged instant ticket dispensers, computer server equipment, and accounting software.

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, 2015 and 2014, the balances were:

| <u>Account Type</u> | <u>2015</u> | <u>2014</u> |
|--|------------------|------------------|
| Trade payables to vendors and other | \$ 15,680 | \$ 6,066 |
| Instant prize liability – unused unclaimed | 23,680 | 32,026 |
| Multi state games low-tier liability | 3,694 | 2,287 |
| Prize liability – breakage | 5,898 | 120 |
| Total Accounts Payable | <u>\$ 48,952</u> | <u>\$ 40,499</u> |

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 6 – LIABILITIES (continued)

B. Annuity Prize Awards Payable:

Annuity prize awards payable represents 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 \$5,136 and \$56,718 for fiscal year 2015 and \$4,604 and \$53,714 for fiscal year 2014, respectively. Annuity activity for both short and long term accounts during fiscal year 2015 are as follows:

| | Beginning Balance | Purchases | Annuity Appreciation | Annuity Disbursements | Reclass to Short Term | Ending Balance |
|------------|-------------------|-----------------|----------------------|-----------------------|-----------------------|------------------|
| Short Term | \$ 4,604 | \$ - | \$ - | \$ (5,154) | \$ 5,686 | \$ 5,136 |
| Long Term | 53,714 | 6,332 | 2,358 | - | (5,686) | 56,718 |
| Total | <u>\$ 58,318</u> | <u>\$ 6,332</u> | <u>\$ 2,358</u> | <u>\$ (5,154)</u> | <u>\$ -</u> | <u>\$ 61,854</u> |

Annual activity for both short and long term accounts during fiscal year 2014 are as follows:

| | Beginning Balance | Purchases | Annuity Appreciation | Annuity Disbursements | Reclass to Short Term | Ending Balance |
|------------|-------------------|-----------------|----------------------|-----------------------|-----------------------|------------------|
| Short Term | \$ 4,154 | \$ - | \$ - | \$ (4,128) | \$ 4,578 | \$ 4,604 |
| Long Term | 49,666 | 6,104 | 2,522 | - | (4,578) | 53,714 |
| Total | <u>\$ 53,820</u> | <u>\$ 6,104</u> | <u>\$ 2,522</u> | <u>\$ (4,128)</u> | <u>\$ -</u> | <u>\$ 58,318</u> |

C. Due to the State:

As explained in Note 4C, \$10,350 and \$4,565 for the years ended June 30, 2015 and 2014, respectively, represent the amounts of the "Net Revenues" for the year not yet transferred to the State as of June 30, but will be transferred to the State subsequent to fiscal year-end. The remainder is due to 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 Directors' 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 of service on the date of separation.

Activity for the year ended June 30, 2015:

| Beginning | Earned | Used | Ending | Current Liability | Long Term Portion |
|-----------------|-----------------|-----------------|-----------------|-------------------|-------------------|
| <u>\$ 1,264</u> | <u>\$ 1,554</u> | <u>\$ 1,056</u> | <u>\$ 1,762</u> | <u>\$ 192</u> | <u>\$ 1,570</u> |

Activity for the year ended June 30, 2014:

| Beginning | Earned | Used | Ending | Current Liability | Long Term Portion |
|-----------------|-----------------|-----------------|-----------------|-------------------|-------------------|
| <u>\$ 1,348</u> | <u>\$ 1,542</u> | <u>\$ 1,626</u> | <u>\$ 1,264</u> | <u>\$ 294</u> | <u>\$ 970</u> |

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

June 30, 2015 and 2014

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. As of June 30, 2015, MUSL included 34 state lotteries, the District of Columbia, Loteria Electronica de Puerto Rico and the U.S. Virgin Islands. The chief executive officer of each member lottery serves on the MUSL board of directors.

As a member of MUSL, the NCEL is required to contribute to various prize reserve funds maintained by MUSL. These contributions are included in the 50% prize expense calculated 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, 2015 and 2014, the NCEL had been credited with \$8,956 and \$9,682, respectively, in the MUSL prize reserve funds.

B. Annuity Installment Prizes:

The NCEL funds long term installment prizes through the purchase of insurance company annuities and treasury strips. 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, Prudential Life Insurance Company and Wells Fargo Bank to provide these future prize installment payments. The future value of the annuity prizes awarded as of June 30, 2015 and 2014 were \$76,384 and \$72,872, respectively.

C. Unclaimed Prizes:

As of June 30, 2015 and 2014, 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 recorded on August 1, 2010. Unclaimed prizes for EZ Match were recorded on September 26, 2014. Unclaimed prizes for All or Nothing were recorded on March 6, 2015. The NCEL closed forty-five instant games during fiscal year 2015 resulting in \$18,557 in unclaimed prizes. In 2014, the NCEL closed sixty-six instant games resulting in \$18,080 in unclaimed prizes.

| <u>Game Type</u> | <u>2015</u> | <u>2014</u> |
|-----------------------------|------------------|------------------|
| Instant | \$ 18,557 | \$ 18,080 |
| Powerball | 2,839 | 3,142 |
| Mega Millions | 1,295 | 1,517 |
| Carolina Cash 5 | 1,412 | 2,057 |
| Carolina Pick 4 | 1,332 | 1,404 |
| Carolina Pick 3 | 1,780 | 1,884 |
| All or Nothing | 91 | - |
| EZ Match | 353 | - |
| Monopoly Millionaire's Club | 21 | - |
| Total unclaimed prizes | <u>\$ 27,680</u> | <u>\$ 28,084</u> |

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 7 – OTHER IMPORTANT ITEMS (continued)

D. Compulsive Gambling Contribution:

The North Carolina General Statute states that, 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, 2015.

The types of coverage, limits, and deductibles, as of June 30, 2015, are described below (the following chart is not shown in thousands).

| Coverage Type | Limits (\$) | Deductible (\$) | Comments |
|---|--|--|--|
| Public officers and employee liability | 1,000,000 /10,000,000 | The first 150,000 /1,000,000 per person are 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 | 5,804,735 | 5,000 | |
| Auto – liability | 1,000,000 per person/10,000,000 per accident | | |
| Hired Auto - Physical Damage | 40,000 60,000 if GVW > 10,000 lbs. | 100 250 | 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, 2015 and 2014

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% of covered payroll 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 "Reports" or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

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 a 14-member Board of Trustees, with the State Treasurer serving as Chairman of the Board.

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.

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 "Reports", or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 9 – PENSION AND DEFERRED COMPENSATION PLANS (continued)

B. Benefits Provided

TSERS provides retirement and survivor benefits. Retirement benefits are determined as 1.82% of the member's average final compensation times the member's years of creditable service. A member's average final compensation is calculated as the average of a member's four highest consecutive years of compensation. General employee plan members are eligible to retire with full retirement benefits at age 65 with five years of creditable service (or 10 years of creditable service for members joining TSERS on or after August 1, 2011), at age 60 with 25 years of creditable service, or at any age with 30 years of creditable service. General employee plan members are eligible to retire with partial retirement benefits at age 50 with 20 years of creditable service or at age 60 with five years of creditable service (or 10 years of creditable service for members joining TSERS on or after August 1, 2011). Survivor benefits are available to eligible beneficiaries of members who die while in active service or within 180 days of their last day of service and who have either completed 20 years of creditable service regardless of age or have completed five years of service and have reached age 60 (10 years for members joining on or after August 1, 2011). Eligible beneficiaries may elect to receive a monthly Survivor's Alternate Benefit for life or a return of the member's contributions. The plan does not provide for automatic post-retirement benefit increases. Increases are contingent upon actuarial gains of the plan.

Funding policy. Plan members are required to contribute 6% of their annual covered salary, and the NCEL is required to contribute at an actuarially determined rate. The fiscal year 2015 rate is 9.15% of the annual covered payroll. The contribution requirements of plan members and the NCEL are established and may be amended by the General Assembly. The following table represents the three-year trend of the annual contributions made by the NCEL to the State retirement system. The NCEL made 100% of its required contributions for the years ended June 30, 2015, 2014, and 2013:

| | 2015 | 2014 | 2013 |
|-------------------------------|----------|----------|----------|
| Retirement Contribution | \$ 1,279 | \$ 1,191 | \$ 1,094 |
| Percentage of Covered Payroll | 9.15% | 8.69% | 8.33% |

Net pension liability. At June 30, 2015, the NCEL reported a liability of \$1,301 for its proportionate share of the net pension liability. The net pension liability was measured as of June 30, 2014. The total pension liability used to calculate the net pension was determined by an actuarial valuation as of December 31, 2013. The total pension liability was then rolled forward to the measurement date of June 30, 2014 utilizing update procedures incorporating the actuarial assumptions. The NCEL's proportion of the net pension liability was based on a projection of the NCEL's long-term share of future payroll covered by the pension plan, relative to the projected future payroll covered by the pension plan of all participating TSERS employers, actuarially determined. At June 30, 2014 and at June 30, 2013, the NCEL's proportion was 0.11096% and 0.10540%, respectively.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 9 – PENSION AND DEFERRED COMPENSATION PLANS (continued)

Deferred inflows of resources and deferred outflows of resources related to pensions. For the year ended June 30, 2015, the NCEL recognized pension expense of \$606. At June 30, 2015, the NCEL reported deferred outflows of resources and deferred inflows of resources related to pensions from the following sources:

| | <u>Deferred Outflows of Resources</u> | <u>Deferred Inflows of Resources</u> |
|--|---|--|
| Difference between actual and expected experience | \$ - | \$ 303 |
| Net difference between projected and actual earnings on pension plan investments (see note below) | - | 4,396 |
| Change in proportion and differences between the NCEL's contributions and proportionate share of contributions | 186 | - |
| Contributions subsequent to the measurement date | <u>1,285</u> | <u>-</u> |
| Total | <u>\$ 1,471</u> | <u>\$ 4,699</u> |

Deferred Outflows of Resources of \$1,285 related to pensions resulting from the NCEL's contributions subsequent to the measurement date will be recognized as a decrease of the net pension liability in the year ended June 30, 2016. Other amounts reported as deferred outflows and deferred inflows of resources related to pensions will be recognized in pension expense as follows:

| | |
|----------------------|-------------------|
| Year ending June 30: | |
| 2016 | \$ (1,130) |
| 2017 | (1,130) |
| 2018 | (1,130) |
| 2019 | (1,123) |
| 2020 | - |
| Total | <u>\$ (4,513)</u> |

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 9 – PENSION AND DEFERRED COMPENSATION PLANS (continued)

Actuarial assumptions. The total pension liability was determined by an actuarial valuation performed as of December 31, 2013. The total pension liability was calculated through the use of update procedures to roll forward from the actuarial valuation date to the measurement date of June 30, 2014. The update procedures incorporated the actuarial assumptions used in the valuation. The entry age normal actuarial cost method was utilized. Inflation is assumed to be 3% and salary increases range 4.25% to 9.10% which includes 3.5% inflation and productivity factor. The long-term expected rate of return on pension plan investments used in the determination of the total pension liability is 7.25% and is net of pension plan investment expense, including inflation.

TSERS currently uses mortality tables that vary by age, gender, employee group (i.e. teacher, general, law enforcement officer) and health status (i.e. disabled and healthy). The current mortality rates are based on published tables and studies that cover significant portions of the US population. The healthy mortality rates also contain a provision to reflect future mortality improvements.

The actuarial assumptions used in the December 31, 2013 valuations were based on the results of an actuarial experience study for the period January 1, 2005 through December 31, 2009.

Future ad hoc Cost of Living Adjustment (“COLA”) amounts are not considered to be substantively automatic and are therefore not included in the measurement.

The projected long-term investment returns and inflation assumptions are developed through review of current and historical capital markets data, sell-side investment research, consultant whitepapers, and historical performance of investment strategies. Fixed income return projections reflect current yields across the Treasury yield curve and market expectations of forward yields projected and interpolated for multiple tenors and over multiple year horizons. Global public equity return projections are established through analysis of the equity risk premium and the fixed income return projections. Other asset categories and strategies’ return projections reflect the foregoing and historical data analysis. These projections are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. The target allocation and best estimates of arithmetic real rates of return for each major asset class as of June 30, 2014 are summarized in the following table:

| <u>Asset Class</u> | <u>Target Allocation</u> | <u>Long-Term Expected Real Rate of Return</u> |
|----------------------|--------------------------|---|
| Fixed Income | 36.0% | 2.5% |
| Global Equity | 40.5% | 6.1% |
| Real Estate | 8.0% | 5.7% |
| Alternatives | 6.5% | 10.5% |
| Credit | 4.5% | 6.8% |
| Inflation Protection | 4.5% | 3.7% |
| Total | <u>100.0%</u> | |

The information above is based on 30-year expectations developed with the consulting actuary for the 2013 asset liability and investment policy study for the North Carolina Retirement Systems, including TSERS. The long-term nominal rates of return underlying the real rates of return are arithmetic annualized figures. The real rates of return are calculated from nominal rates by multiplicatively subtracting a long-term inflation assumption of 3.19%. All rates of return and inflation are annualized.

A new asset allocation policy was finalized during the fiscal year ended June 30, 2014 to be effective July 1, 2014. The new asset allocation policy utilizes different asset classes, implements changes in the structure of certain asset classes, and adopts new benchmarks. Using the asset class categories in the preceding table, the new long-term expected arithmetic real rates of return are: Fixed Income 2.2%, Global Equity 5.8%, Real Estate 5.2%, Alternatives 9.8%, Credit 6.8% and Inflation Protection 3.4%.

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

June 30, 2015 and 2014

NOTE 9 – PENSION AND DEFERRED COMPENSATION PLANS (continued)

Discount rate. The discount rate used to measure the total pension liability was 7.25%. The projection of cash flows used to determine the discount rate assumed that contributions from plan members will be made at the current contribution rate and that contributions from employers will be made at statutorily required rates, actuarially determined. Based on these assumptions, the pension plan’s fiduciary net position was projected to be available to make all projected future benefit payments of the current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

Sensitivity of the net pension liability to changes in the discount rate. The following presents the NCEL’s proportionate share of the net pension liability calculated using the discount rate of 7.25%, as well as, what the NCEL’s proportionate share of the net pension asset or net pension liability would be if it were calculated using a discount rate that is one percentage point lower (6.25%) or one percentage-point higher (8.25%) than the current rate:

| | 1% Decrease (6.25%) | Discount Rate (7.25%) | 1% Increase (8.25%) |
|---|------------------------|--------------------------|------------------------|
| NCEL's proportionate share of the net pension liability (asset) | \$ 9,339 | \$ 1,301 | \$ (5,486) |

Pension plan fiduciary net position. Detailed information about the TSERS fiduciary net position 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 “Reports”, or by calling the State Controller’s Financial Reporting Section at (919) 707-0500.

C. 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 the 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 \$185, \$123 and \$138 for the years ended June 30, 2015, 2014 and 2013, respectively.

D. 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 Plan’s Board of Trustees. 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 \$38, \$47 and \$58, for the years ended June 30, 2015, 2014 and 2013, respectively.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

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 post-employment health insurance to eligible former employees. Eligible former employees include long term disability beneficiaries of the Disability Income Plan of North Carolina and retirees of the Teachers' and State Employees' Retirement 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, Article 3B, 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.

The General Statute states that 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. The General Statute states that 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 established by the General Assembly.

For the current fiscal year 2015, the NCEL contributed 5.5% of the covered payroll under the Teachers' and State Employees' Retirement System. Required contribution rates for the years ended June 30, 2014 and 2013, were 5.4% and 5.3%, respectively. The NCEL made 100% of its annual required contributions to the Plan for the years ended June 30, 2015, 2014, and 2013, which were \$769, \$740, and \$696, 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.osc.nc.gov/> and clicking on "Reports", or by calling the State Controller's Financial Reporting Section at (919) 707-0500.

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 Statute, 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, 2015, the NCEL made a statutory contribution of .41% 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, 2015, 2014 and 2013, were .41%, .44% and .44%, respectively. The NCEL made 100% of its annual required contributions to the DIPNC for the years ended June 30, 2015, 2014, and 2013, which were \$57, \$60, and \$58, respectively. The NCEL assumes no liability for long term disability benefits under the Plan other than its contribution.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

NOTE 10 – OTHER POSTEMPLOYMENT BENEFITS (continued)

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 “Reports”, or by calling the State Controller’s Financial Reporting Section at (919) 707-0500.

NOTE 11 – LITIGATION

As of June 30, 2015, the NCEL is not, nor anticipates being, a party to any litigation.

NOTE 12 – ALLOCATION OF TOTAL NET REVENUES/TRANSFERS TO NC EDUCATION LOTTERY FUND

| | <u>2015</u> | | |
|---|-------------------|-----|-------------------------|
| Lottery Ticket Sales | \$ 1,972,215 | | |
| Fees and Licenses | 5,271 | | |
| Investment Earnings and Other Revenues | 394 | | |
| Total Annual Revenue | <u>1,977,880</u> | | |
| Prize Expense | (1,231,238) | 62% | Of Total Annual Revenue |
| Advertising | (19,098) | 1% | Of Total Annual Revenue |
| All Other Expenses and Transfers | (63,350) | | |
| Total Section 18C-162.a.3 | <u>(82,448)</u> | 4% | Of Total Annual Revenue |
| Commissions (per 18C-142) | (137,767) | 7% | Of Lottery Ticket Sales |
| Unclaimed Prizes to The State of North Carolina | 13,841 | | |
| Net Revenues to The State of North Carolina | 512,586 | | |
| Total Revenues to The State of North Carolina | <u>\$ 526,427</u> | 27% | Of Total Annual Revenue |

NORTH CAROLINA EDUCATION LOTTERY
 NOTES TO FINANCIAL STATEMENTS (in thousands)
 June 30, 2015 and 2014

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

| | <u>2014</u> | | |
|---|-------------------|-----|-------------------------|
| Lottery Ticket Sales | \$ 1,839,211 | | |
| Fees and Licenses | 5,425 | | |
| Investment Earnings and Other Revenues | <u>705</u> | | |
| Total Annual Revenue | <u>1,845,341</u> | | |
| Prize Expense | (1,135,052) | 62% | Of Total Annual Revenue |
| Advertising | (15,238) | 1% | Of Total Annual Revenue |
| All Other Expenses and Transfers | <u>(63,365)</u> | | |
| Total Section 18C-162.a.3 | <u>(78,603)</u> | 4% | Of Total Annual Revenue |
| Commissions (per 18C-142) | (128,551) | 7% | Of Lottery Ticket Sales |
| Unclaimed Prizes to The State of North Carolina | 14,043 | | |
| Net Revenues to The State of North Carolina | <u>489,092</u> | | |
| Total Revenues to The State of North Carolina | <u>\$ 503,135</u> | 27% | Of Total Annual Revenue |

In accordance with Section § 18C-162 of the North Carolina State Lottery 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 face value of tickets or shares, 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 percent (50%) to enhance prizes under subdivision (a) (1) of this section.
 - (2) Fifty percent (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).)

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

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

Additionally, in accordance with Section § 18C-142 of the North Carolina State Lottery 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.

The NCEL transferred \$520.6 million to the NC Education Lottery Fund for fiscal year 2015 compared with \$525.8 million for fiscal year 2014. As explained in Note 4C, \$10.4 million and \$4.6 million for fiscal years ended June 30, 2015 and 2014, respectively, were the amounts of the “Net Revenues” and “50% of Unclaimed Prizes” that were transferred to the State subsequent to the end of the respective fiscal year.

NOTE 13 – CHANGES IN FINANCIAL ACCOUNTING AND REPORTING

For the fiscal year ended June 30, 2015, the NCEL implemented the following pronouncements issued by the Governmental Accounting Standards Board (GASB):

- Statement No. 68, *Accounting and Financial Reporting for Pensions—an Amendment of GASB Statement No. 27*,
- Statement No. 69, *Government Combinations and Disposals of Government Operations*, and
- Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date—an Amendment of GASB Statement No. 68*.

Statement No. 68 replaces the requirements of Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers* and Statement No. 50, *Pension Disclosures*, as they relate to governments that provide pensions through pension plans administered as trusts or similar arrangements that meet certain criteria. Statement 68 requires governments that participate in defined benefit pension plans to report in their statement of net position a net pension liability (or asset) and to more comprehensively and comparably measure the annual costs of pension benefits. The net pension liability is the difference between the total pension liability (the present value of projected benefit payments to employees based on their past service) and the assets (mostly investments reported at fair value) set aside in a trust and restricted to paying benefits to current employees, retirees, and their beneficiaries. Statement 68 requires cost-sharing employers to record a liability and expense equal to their proportionate share of the collective net pension liability and expense for the cost-sharing plan. In specific circumstances called special funding situations, this Statement requires governments that are nonemployer contributing entities to recognize in their own financial statements their proportionate share of the other governmental employers’ net pension liability and pension expense. The existing standards for governments that provide defined contribution pensions are largely carried forward in Statement No. 68. These governments recognize pension expenses equal to the amount of contributions or credits to employees’ accounts, absent forfeited amounts. The Statement also enhances accountability and transparency through revised and new note disclosures and required supplementary information (RSI).

Statement No. 71 modifies the transition guidance provided in GASB Statement No. 68, *Accounting and Financial Reporting for Pensions*, as it relates to employer contributions made subsequent to the measurement date of the beginning net pension liability, but before the start of the government’s fiscal year. Specifically, the revised guidance clarifies that such amounts would always be treated as a deferred outflows of resources, regardless of whether it is practical to determine the beginning amounts of all other deferred outflows of resources and deferred inflows of resources related to pensions.

NORTH CAROLINA EDUCATION LOTTERY
NOTES TO FINANCIAL STATEMENTS (in thousands)
June 30, 2015 and 2014

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

Statements No. 69 did not result in any significant changes to the financial statements.

The cumulative effect of the changes in accounting principles relating to the net pension liability was recognized in the Statement of Revenues, Expenses, and Changes in Net Position for the year ended June 30, 2015.

NOTE 14 – SUBSEQUENT EVENTS

The Commission of the NCEL has evaluated all subsequent events for potential recognition and disclosure through October 21, 2015, the date these financial statements will be available.

NORTH CAROLINA EDUCATION LOTTERY
REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULE OF THE PROPORTIONATE SHARE OF NET PENSION LIABILITY
TEACHERS' AND STATE EMPLOYEES' RETIREMENT SYSTEM

Last Two Fiscal Years

| | <u>2015</u> | <u>2014</u> |
|--|-------------|-------------|
| (1) Proportionate share percentage of collective net pension liability | 0.11096% | 0.10540% |
| (2) Proportionate share of TSERS collective net pension liability | \$ 1,301 | \$ 6,399 |
| (3) Covered-employee payroll | \$ 13,989 | \$ 13,706 |
| (4) Net pension liability as a percentage of covered-employee payroll | 9% | 47% |
| (5) Plan fiduciary net position as a percentage of the total pension liability | 98.24% | 90.60% |

Information is not available for preceding years, to the extent 10 years of information is not presented.

NORTH CAROLINA EDUCATION LOTTERY
REQUIRED SUPPLEMENTARY INFORMATION
SCHEDULE OF CONTRIBUTIONS
TEACHERS' AND STATE EMPLOYEES' RETIREMENT SYSTEM

Last Ten Fiscal Years

| | 2015 | 2014 | 2013 | 2012 | 2011 |
|--|-------------|-------------|-------------|-------------|-------------|
| (1) Contractually required contribution | \$ 1,279 | \$ 1,191 | \$ 1,094 | \$ 955 | \$ 592 |
| (2) Contributions in relation to the contractually determined contribution | 1,279 | 1,191 | 1,094 | 955 | 592 |
| (3) Contribution deficiency (excess) | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |
| (4) Covered-employee payroll | \$ 13,989 | \$ 13,706 | \$ 13,139 | \$ 12,839 | \$ 12,018 |
| (5) Contributions as a percentage of covered-employee payroll | 9.15% | 8.69% | 8.33% | 7.44% | 4.93% |

| | 2010 | 2009 | 2008 | 2007 | 2006 |
|--|-------------|-------------|-------------|-------------|-------------|
| (1) Contractually required contribution | \$ 425 | \$ 378 | \$ 313 | \$ 257 | \$ 262 |
| (2) Contributions in relation to the contractually determined contribution | 425 | 378 | 313 | 257 | 262 |
| (3) Contribution deficiency (excess) | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> |
| (4) Covered-employee payroll | \$ 11,968 | \$ 11,696 | \$ 10,862 | \$ 9,720 | \$ 3,842 |
| (5) Contributions as a percentage of covered-employee payroll | 3.55% | 3.23% | 2.88% | 2.64% | 6.82% |

**Report of Independent Auditor 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, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to the financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the financial statements of the North Carolina Education Lottery (“NCEL”), a major enterprise fund of the State of North Carolina, as of and for the years ended June 30, 2015 and 2014, and the related notes to the financial statements, which collectively comprises the NCEL’s basic financial statements as listed in the table of contents, and have issued our report thereon dated October 21, 2015.

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, 2015 and 2014, and the changes in their financial position and their 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 of the financial statements, we considered the NCEL’s internal control over financial reporting (“internal control”) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements but not for the purpose of expressing an opinion on the effectiveness of the NCEL’s internal control. Accordingly, we do not express an opinion on the effectiveness of the NCEL’s internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct 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 NCEL’s financial statements will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet, important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit, we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the NCEL’s financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

Purpose of this Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the NCEL's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the NCEL's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

A handwritten signature in black ink that reads "Cheryl Bekart LLP". The signature is written in a cursive, flowing style.

Raleigh, North Carolina
October 21, 2015

The audit report required 550 audit hours at a cost of \$71,500.