



FY 2006 Annual Report



Thank You
North Carolina!
-The Students





Table of Contents

Message from Commission Chairman.....	2
NCEL Commission Members.....	3
Message from Executive Director.....	4
NCEL Senior Staff.....	5
Timeline	6
Where the Money Goes.....	8
First Games.....	10
Winners.....	12
Stellar Sellers.....	14
NCEL Regional Offices.....	16
Financials	18

Dr. Charles A. Sanders
Commission Chairman



Thomas N. Shaheen
Executive Director

The fact that Governor Easley appointed me, a non-supporter, to chair the North Carolina Education Lottery Commission was clear testimony to the Governor's interest in the lottery getting started on the right footing, with integrity and security, and being run like a business. I believe we have accomplished that goal.

The Education Lottery Commission oversees the day-to-day operations of the lottery. We do not make the decisions about how the net proceeds are spent. That is the job of the North Carolina General Assembly. However, the Commission is committed to doing its part to insure that the proceeds benefit education by providing new dollars, not supplanting existing dollars.

One of the first acts of the Commission was adoption of a strong ethics policy. Simultaneously the Commission set an aggressive, demanding schedule for the start-up of the lottery. We thought we were being optimistic with a start date of April 5 for selling our first instant scratch-off tickets and Powerball on June 14. Instead, our newly hired executive director, Tom Shaheen, negotiated even earlier start dates once we selected the gaming vendor, GTECH. Consequently, we sold our first tickets the morning of March 30, making North Carolina the fastest start in history for any state lottery.

The inaugural ticket sales coincided with ribbon cuttings for our five regional offices and one prize claim center. Dignitaries, including Howard Lee, chair of the State Board of Education and June Atkinson, Superintendent of Public Instruction, joined us for these important events. Chairman Lee purchased the first ticket, which now hangs in the North Carolina Museum of History.

The Commission oversaw the selection of the gaming vendor and advertising agency, the selection of a lottery logo, and the adoption of rules for every aspect of operations. We met frequently as we helped staff work through all the issues inherent with any start-up operation.

We made our first transfer of dollars to the Education Lottery Fund on June 27 for \$50 million. The Governor and Legislature chose to use this first transfer to fund fully the Education Lottery Reserve Fund, as established by statute. By funding the reserve fully upfront, net proceeds in fiscal year 2007 can be used 100% for the education beneficiary programs.

The Commission looks forward to a successful fiscal year 2007 as we launch several new games and mature into a lottery with a full complement of instant scratch-off and online games.

Charles A. Sanders

Phone: 919.715.6886 • Fax: 919.715.8833
10 Yonkers Road • Raleigh, North Carolina 27604



North Carolina Education Lottery Commission Appointed by Governor Easley

- Bryan Beatty** - Secretary, Crime Control and Public Safety, Raleigh - term expires 8/31/06 (reappointed to a 5-year term, new terms ends 8/31/11)
- John McArthur** - Senior Vice President, Progress Energy, Raleigh - term expires 8/31/06 (reappointed to a 5-year term, new term ends 8/31/11)
- Linda Carlisle** - retired businesswoman, Greensboro - term expires 8/31/07
- Bob Farris** - attorney, Wilson - term expires 8/31/08

Appointed by Speaker Black

- Jim Woodward** - chancellor emeritus, University of North Carolina at Charlotte, Charlotte - term expires 8/31/08
- Max Cogburn** - attorney, Asheville - term expires 8/31/07

Appointed by President Pro Tem Basnight

- Bob Appleton** - associate professor emeritus of accounting, University of North Carolina at Wilmington, Wilmington - term expires 8/31/08
- Bridget-Ann Hampden** - president and CEO of JHR & Associates, LLC, Charlotte - term expires 8/31/07

Pictured from left to right:
Cogburn, Appleton, Hampden, Carlisle, Farris, Beatty, Woodward, McArthur

Dr. Charles A. Sanders
Commission Chairman



Thomas N. Shaheen
Executive Director

I would like to thank the citizens of North Carolina for giving me the wonderful opportunity of starting an education lottery in this state. North Carolina was the last "big" state to have a lottery. From the beginning, I was aware there would be challenges and opportunities, but the job was something I very much wanted to do.

I have been asked by many citizens how we were able to get the lottery started so quickly. It required several main ingredients: solid, well defined legislation, a well balanced board of commissioners and a staff of employees made up of a combination of people with lottery experience and North Carolina experience. North Carolina assembled all three.

Beyond those main ingredients, start-up required other factors. We needed to determine quickly what services and functions to bid out to vendors and what could be done in house. This meant that we quickly issued Requests for Proposals for several major services: instant and online gaming systems, instant ticket printing, advertising, security equipment, to name a few.

We recruited retailers as quickly as possible because without retailers to sell tickets, there is no lottery. We mailed out over 8,000 applications. By February 3, the deadline for applications if a retailer wanted to sell on day one, we had received over 5,000 applications. Those retailers then had to be trained and their equipment installed in order for them to sell tickets on that first day, March 30, 2006. That was accomplished in a record-breaking 58 days by our gaming services vendor, GTECH Corporation.

We had to hire a staff. When I started on December 5, I was a staff of one with three temporary employees available to assist. By the end of the fiscal year (June 30, 2006), we had 184 employees. Even those employees with no previous lottery experience felt like old hands by the time the fiscal year was over.

Other start-up tasks included designing instant games including graphics, prize structure, and play style; producing instant tickets and setting up a distribution system; setting up accounting procedures; ordering computers, furniture, and vehicles; finding permanent office space; setting up a statewide banking network for retrieving lottery proceeds from lottery retailers; and the list goes on.

This was done while praying daily for no snow or ice because there was not a minute to spare. About the time we had accomplished these tasks, we had to start over in order to bring Powerball, a multi-state online game, to North Carolina.

I am proud of the work accomplished by the staff. We successfully implemented an education lottery, ensuring that integrity and security were at the top of the list. I look forward to watching the proceeds from the sale of lottery tickets enhance education in North Carolina.

Thomas N. Shaheen

Phone: 919.715.6886 • Fax: 919.715.8833
Yonkers Road • Raleigh, North Carolina 27604



NCEL Senior Staff

(from left to right)

Nikki Howard, Internal Auditor

Tony Chung, Director, MIS

Tom Shaheen, Executive Director, NCEL

Margaret Spindola-Bode, Director, Human Resources

Deborah Doty, Deputy Executive Director,
MIS/Gaming Systems

Bill Enlow, Director, Administration

Jim Knight, Director, Finance

Sam Hammett, Deputy Executive Director, Sales

Jerry Carter, Director, Security

Carla Archie, Deputy Executive Director, Legal/Security

Lou Ann Russell, Deputy Executive Director,
Marketing/Advertising

Kim McLaurin, Director, Sales

Dina Charland, Director, Gaming Systems

Robin Diehl, Deputy Executive Director,
Finance/Administration

Alice Garland, Deputy Executive Director,
Legislative/Communications

Pam Walker, Director, Communications

Penny Railey, Director, Marketing



How It All Started...

2005-06 Timeline

- 8-31-05: Legislation creating lottery signed into law
- 9-05: NCEL Commission members appointed
- 10-6-05: Initial meeting of NCELC
- 11-17-05: Tom Shaheen appointed Executive Director, NCEL
- 12-5-05: Tom Shaheen begins work
- 12-12-05: NCELC voted to join multi-state Powerball
- 1-12-06: Retail applications posted on web
- 1-30-06: Instant ticket & online games contracts awarded to GTECH
- 2-3-06: 5028 retail applications received
- 2-13-06: First retail equipment installed
- 3-6-06: First retailer trained
- 3-9-06: First instant scratch-off tickets unveiled
- 3-10-06: Tickets delivered to warehouse



Dr. Sanders and Tom Shaheen unveiling first instant tickets



Instant scratch-off tickets unloading at warehouse



First ticket sold displayed in NC Museum of History



Richard Garland first \$100K instant ticket winner



Powerball launch

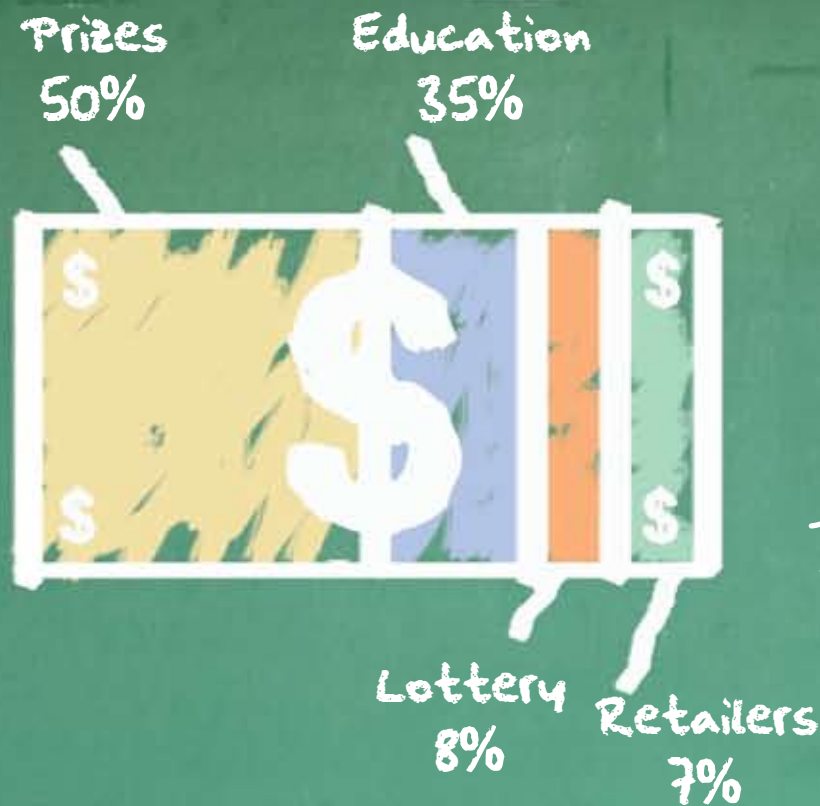


Buddy Poplin first \$1 million Powerball winner

2005-06 Timeline cont...

- 3-18-06: 4000th retailer installed
- 3-27-06: Lottery advertising begins
- 3-28-06: Instant scratch-off tickets shipped to all approved retailers
- 3-30-06: Education lottery begins instant scratch-off ticket sales at approximately 5000 locations; Education lottery web site goes live
- 3-31-06: First \$100,000 instant scratch-off ticket winner comes to Headquarters
- 5-30-06: Powerball sales begin
- 5-31-06: First Powerball draw & first Powerball \$200,000 winner
- 6-7-06: Granite Quarry player wins \$1 million by Power Playing Powerball

Where the Money Goes



Fy 06 Sales
 March 30 - June 30, 2006

Instant \$202,242,898
 (sales began March 30)

+ Powerball \$27,317,594
 (sales began May 30)

Total \$229,530,492

- \$50 million to Education Lottery Reserve Fund (dollars banked as a safety net for future appropriations)
- For June 28th draw, last Powerball draw of fiscal year, 31.7 percent of players Power Played
- For eight of the nine draws in fiscal year 06, North Carolina was the top seller

Beneficiary Programs

The North Carolina State Lottery Act prescribes the distribution of net proceeds from the education lottery. 100 percent of net proceeds, or, as nearly as practical, at least thirty-five percent of gross revenues, go to education programs. Four education programs will benefit from this influx of new state dollars: academic pre-kindergarten programs for at-risk four year olds, class size reduction in grades K-3, public school construction, and college scholarships for need-based students.

The Act also requires that 5 percent of net revenue of the prior year shall be transferred to the Education Lottery Reserve Fund, capped at \$50 million. The Reserve Fund will make up the difference should the net proceeds in any year not equal the amount appropriated by the Legislature to education programs.

For Fiscal Year 2006, the Legislature chose to use the first transfer of education lottery proceeds to fund fully the Education Lottery Reserve Fund.

Of the remaining 95 percent of net proceeds (after setting aside 5 percent for the reserve), the distribution is as follows:

- 50 percent of the net proceeds to both class size reduction and the at-risk four year old program known as More at Four to receive a permanent dedicated source of funding.
- 40 percent of net proceeds to counties for school construction dollars based on a formula set in the Act. Sixty-five percent of school construction dollars will be shared among all 100 counties based on average daily membership. The other 35 percent will be shared among those counties whose property tax is greater than the average property tax rate across all counties.
- 10 percent of net proceeds to fund college scholarships. North Carolina students are eligible to receive a scholarship from the education lottery if they meet the following criteria: they qualify as "needy," they meet the eligibility requirements for the Pell Grant, they are a legal resident of North Carolina, they have been admitted to a postsecondary institution, and they maintain satisfactory academic progress in a course of study. The State Education Assistance Authority will oversee the scholarship program.

NCEL's First Games

Instant Scratch-Off Games

Game	Launch Date	Price Point	Top Prize
NCEL	3/30/06	\$1	\$5000
Tic Tac Toe	3/30/06	\$1	\$5000
Black Jack	3/30/06	\$2	\$21,000
\$100,000 Carolina Cash	3/30/06	\$5	\$100,000
Fast 5's	4/18/06	\$1	\$5555
\$25,000 Payday	4/18/06	\$2	\$25,000
Ruby Red 7's	5/2/06	\$5	\$77,777
Ace in the Hole	5/2/06	\$1	\$6000
Bingo	5/16/06	\$3	\$35,000
NCEL II	5/30/06	\$1	\$7000
2 X the Money*	5/30/06	\$2	\$25,000
9's in a Line	6/13/06	\$1	\$9999
Firecracker Cash	6/13/06	\$1	\$7000
Wild 8's	6/27/06	\$1	\$8888
Roulette	6/27/06	\$2	\$30,000
Winner Take All	6/27/06	\$5	\$100,000

* the NCEL chose to withdraw this game due to player confusion on how to play

Prizes for these inaugural instant scratch-off tickets range from free tickets to \$100,000.

After start-up, retailers receive an initial supply of tickets based on past ticket sales for other games. The education lottery retail sales staff calls retailers a minimum of once a week to see if they need a restock for any of the instant games.

The most popular instant scratch-off games have been \$100,000 Carolina Cash, Firecracker Cash, and Ruby Red 7's. The NCEL introduces roughly two new instant scratch-off games every two weeks.

104 players won \$2,251,371 in top tier prizes in the instant scratch-off games in FY06 in just 93 days of sales. In addition to allowing these players to do something they wouldn't have done otherwise, the winnings also put money back into the economy of North Carolina.

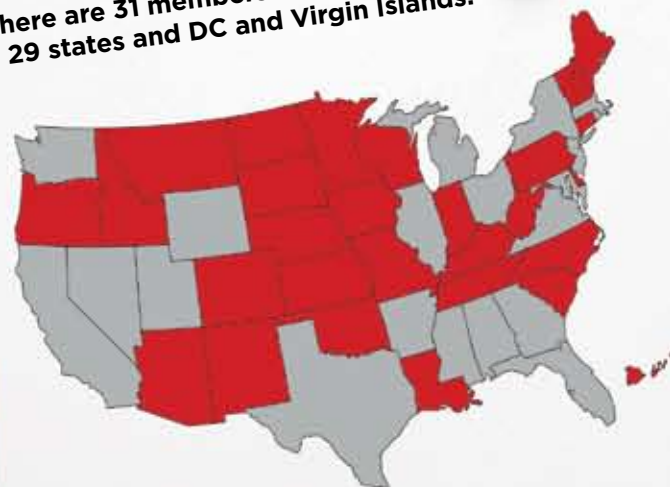
Powerball

Powerball is an online, multi-jurisdictional game where players pick five white ball numbers and one red ball (Powerball number) to try to match numbers drawn in a semi-weekly draw. Powerball draws take place on Wednesday and Saturday nights. The drawings are normally held in West Des Moines, Iowa and broadcast to the 31 Powerball jurisdictions.

There are nine ways to win in Powerball. In addition, players can play to multiply their non-jackpot winnings by Power Playing. The Power Play multiplier is picked by spinning a wheel during the drawing show before the Powerball numbers are drawn. The Power Play multiplier is a number from 2 to 5.

Thirty-five North Carolina players won \$3,610,000 in top tier prizes in Powerball in FY06. Fourteen of those players Power Played to multiply their winnings. North Carolina had seven players match all five white balls to win \$200,000 or greater if they Power Played and twenty-eight players to match four of the white balls and the Powerball to win \$10,000 or greater if they Power Played. 566,471 North Carolina players won playing Powerball during the fiscal year. Twenty-six percent of those players Power Played to multiply their winnings.

There are 31 members in Powerball
- 29 states and DC and Virgin Islands.



- Arizona Lottery
- Colorado Lottery
- Connecticut Lottery Corporation
- DC Lottery & CGCB
- Delaware State Lottery
- Hoosier Lottery
- Idaho Lottery
- Iowa Lottery
- Kansas Lottery
- Kentucky Lottery Corporation
- Louisiana Lottery Corporation
- Maine Lottery
- Minnesota State Lottery
- Missouri Lottery
- Montana Lottery
- Nebraska Lottery
- New Hampshire Lottery Commission
- New Mexico Lottery Authority
- North Carolina Education Lottery
- North Dakota Lottery
- Oklahoma Lottery
- Oregon Lottery
- Pennsylvania Lottery
- Rhode Island Lottery
- South Carolina Education Lottery
- South Dakota Lottery
- Tennessee Education Lottery
- US Virgin Islands Lottery
- Vermont Lottery
- West Virginia Lottery
- Wisconsin Lottery



We Have A Winner

STATE OF NORTH CAROLINA
 North Carolina Education Lottery
 PO Box 41606 • Raleigh, NC 27629-1606

June 30, 2006

NCEL Players

Total Game Winnings

Thomas N. Shaheen
 AUTHORIZED SIGNATURE

Pay to the Order of

\$118,974,133

Non-Negotiable



Goldsboro 8

**Wayne Co.
 Powerball
 \$600,000**



Josephine Taylor

**Burke Co.
 Ruby Red 7's
 \$77,777**



Jeff Weavil

**Forsyth Co.
 \$100,000
 Carolina Cash
 \$100,000**



Ronald Baker

**Gaston Co.
 Powerball
 \$50,000**



Dora Raysor

**Mecklenburg Co.
 \$25,000 Pay Day
 \$25,000**



Ola Gibbs

**Washington Co.
 Powerball
 \$40,000**



Dennis Mebane

**Rockingham Co.
 Winner Take All
 \$100,000**



Medardo Hernandez

**Johnston Co.
 Tic Tac Toe
 \$5,000**

winners thought they would spend their winnings in a variety of ways: wedding and honeymoon, paying off their home mortgage, buying a new car, taking a big vacation, college for their kids, installing a swimming pool, home improvements, new homes, medical expenses, clothes, bills, paving their church parking lot, and the options are endless.

Stellar Sellers

5744 retailers as of June 20, 2006

\$16.06 million paid to retailers in commission; they receive 7% of ticket sales

Charles Sanders
man



Tom Shaheen
Executive Director

lease: **IMMEDIATE** Contact: Pam Walker
Date: June 26, 2006 Phone: (919) 233-7081

Retailers Get Special Recognition for Going Above and Beyond

Whether it is sounding an alarm for a winner or offering free cheesecake to non-winners, North Carolina Education Lottery (NCEL) retailers are doing what they can to attract players. Many stores are reaping the rewards of player customer service and the NCEL is recognizing their efforts.

For those first few months in operation, NCEL retailers that maintained top sales status in their region earned the title of "Stellar Seller." Some other locations earned the title of S.T.A.R. (Spectacular Technique Achieving Retailer) based on NCEL sales representative recommendations for a store's unique sales promotion technique. The NCEL recognized the top two "Stellar Sellers" in each region and one or more S.T.A.R.s.

Top 10 Retailers by sales as of July 1, 2006

- | | |
|-----------------------------|--------------|
| Xpress Mart | High Point |
| Sandy's Convenient #2 | Wilson |
| Dunn's Gas and Grocery, Inc | Four Oaks |
| Bobby Taylor Oil #2 | Fayetteville |
| West Webb Curb Market | Burlington |
| C Mini Mart #3 | Raleigh |
| Pinetops Shell Mart | Pinetops |
| Piggly Wiggly #78 | Kinston |
| BJY FastStop | Conover |
| Randy's Mart #1 | Thomasville |

Top 10 counties by sales as of July 1, 2006

Wake	\$18,084,218
Mecklenburg	\$14,238,668
Guilford	\$13,633,063
Cumberland	\$10,514,634
Forsyth	\$8,711,268
Durham	\$7,048,617
Catawba	\$6,021,285
Pitt	\$5,217,604
Gaston	\$5,201,808
Nash	\$4,964,129



Catamount Travel Center

Asheville Region
Whittier
Ranked 20th Statewide



BJY Fast Stop

Charlotte Region
Conover
Ranked 9th Statewide



Xpress Mart

Greensboro Region
High Point
Ranked 1st Statewide



Sandy's Convenient #2

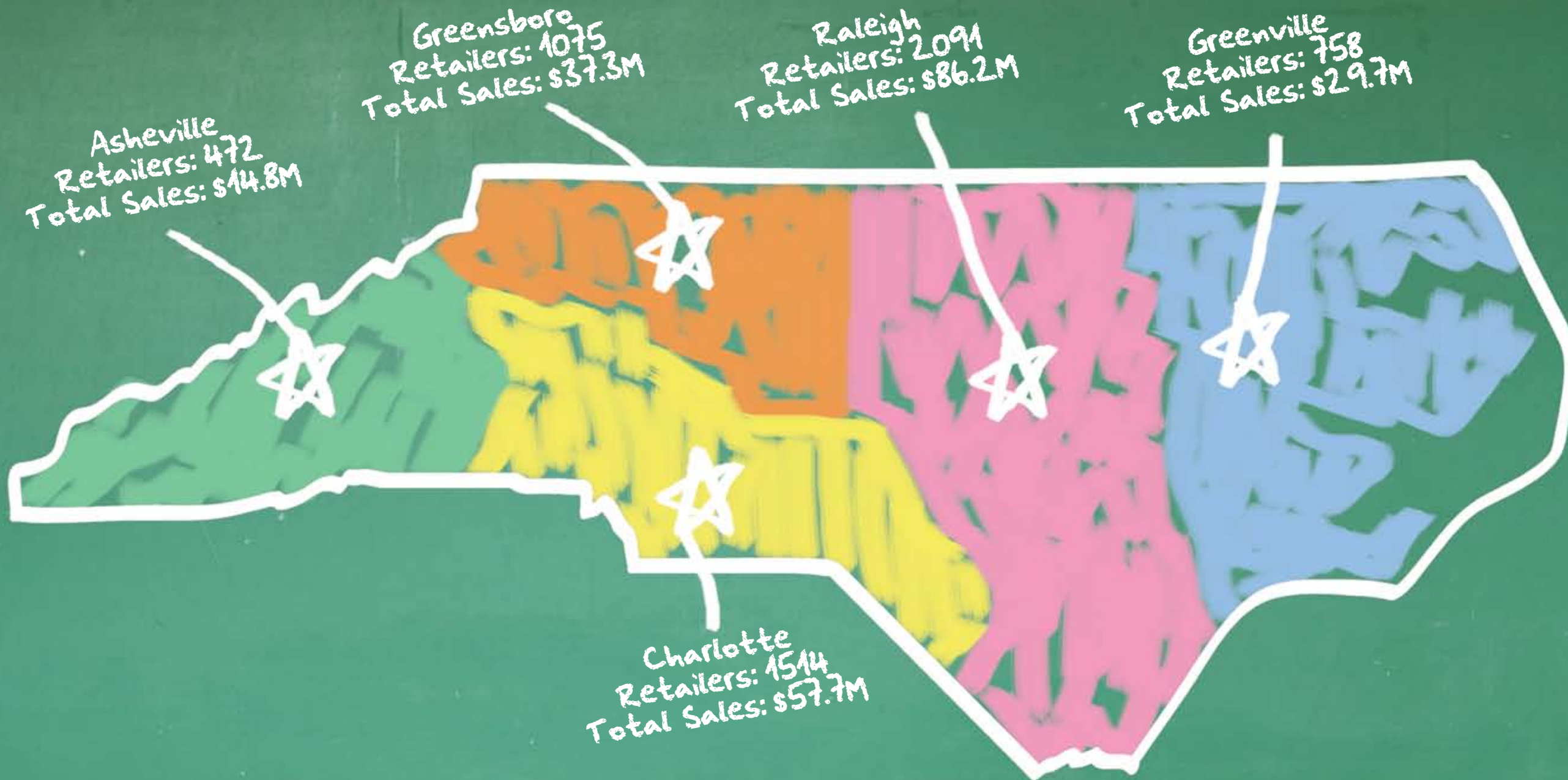
Raleigh Region
Wilson
Ranked 2nd Statewide



Pinetops Shell Mart

Greenville Region
Pinetops Shell Mart
Ranked 7th Statewide

NCEL Regional Offices



Regional Functions

The NCEL chose the regional office locations to place all North Carolinians within an approximate 2-hour drive of a regional office/claim center. In addition to claiming prizes at regional offices, players can also purchase tickets. The regional offices can pay out prizes in any amount up to \$99,999.99. Players winning \$600 or more must go to a regional office or mail in their claim. Players winning \$100,000 or more must go to the headquarters in person to claim their prize.

The lottery sales representatives work out of the regional offices. At the end of the fiscal year, there were 55 sales representatives. Each sales representative has between 100 and 120 assigned stores. They call on their stores a minimum of once every two weeks to check their ticket stock, do on-site training and problem solving, and provide tips for promoting and selling lottery tickets to the retailers. The sales representatives also distribute and install point-of-sale promotional items and hold in-store promotions.



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 150 Fayetteville Street
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 Raleigh, NC 27626-0543

Independent Auditors' Report

Commissioners
 The North Carolina Education Lottery:

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

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

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

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

In accordance with *Government Auditing Standards*, we have also issued our report dated November 28, 2006 on our consideration of the NCEL's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

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

KPMG LLP

November 28, 2006

NORTH CAROLINA EDUCATION LOTTERY

Management's Discussion and Analysis

June 30, 2006

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

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

Financial Highlights

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

Overview of the Financial Statements

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

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

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

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

NORTH CAROLINA EDUCATION LOTTERY

Management's Discussion and Analysis

June 30, 2006

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

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

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

Budget and Economic Outlook

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

Conditions Expected to Impact Future Operations

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

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

Requests for Information

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

NORTH CAROLINA EDUCATION LOTTERY

Statement of Net Assets

June 30, 2006

Assets	
Current assets:	
Cash and cash equivalents:	
Cash on hand	\$ 17,551
Pooled cash	18,482,347
Receivables:	
Accounts receivable	10,046,858
Interest receivable	183,688
State treasurer's security lending collateral	<u>16,064,246</u>
Total current assets	<u>44,794,690</u>
Capital assets, depreciable (net):	
Machinery and equipment	700,701
Accumulated depreciation	<u>(76,198)</u>
Total capital assets, depreciable (net)	<u>624,503</u>
Total assets	\$ <u>45,419,193</u>
Liabilities	
Current liabilities:	
Accounts payable	\$ 9,928,319
Accrued payroll	1,583
Other payables	5,276,495
Due to other state funds	13,624,870
Obligations under state treasurer's security lending agreements	<u>16,064,246</u>
Total current liabilities	<u>44,895,513</u>
Noncurrent liabilities:	
Accrued paid time off	<u>523,680</u>
Total liabilities	<u>45,419,193</u>
Net assets/deficit:	
Invested in capital assets	624,503
Unrestricted net deficit	<u>(624,503)</u>
Total net assets	\$ <u>—</u>

See accompanying notes to financial statements.

NORTH CAROLINA EDUCATION LOTTERY

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

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

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

See accompanying notes to financial statements.

NORTH CAROLINA EDUCATION LOTTERY

Statement of Cash Flows

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

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

See accompanying notes to financial statements.

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

(1) Organization

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

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

(2) Summary of Significant Accounting Policies

(a) Reporting Entity

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

(b) Basis of Presentation

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

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

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

(c) Cash and Cash Equivalents

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

(d) Capital Assets

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

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

(e) Game Revenue Recognition

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

(f) Lottery Prize Expense Recognition

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

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

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

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

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

(h) *Use of Estimates*

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

(i) *Allowance for Doubtful Accounts*

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

(3) Revenue

(a) *Operating Revenue*

Game Revenue

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

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

Fees and Licenses

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

(b) *Nonoperating Revenue*

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

(4) Expenses

(a) *Operating Expenses*

Lottery Prize Expense

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

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

Retailer Commissions

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

Other Services

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

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

Furniture, Fixtures, and Equipment

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

Leases – Buildings and Offices

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

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

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

(b) Nonoperating Expenses

Interest

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

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

Transfers Out

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

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

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

(5) Assets

(a) Cash

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

(b) Accounts Receivable

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

(c) Capital Assets

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

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

(6) Liabilities

(a) Accounts payable

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

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

(b) Other Payables

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

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

(c) Due to other funds

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

(d) Accrued Paid Time Off

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

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

(7) Other Important Items

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

MUSL is a voluntary association created for the purpose of administering joint, multi-jurisdictional lottery games, such as Powerball. MUSL currently includes 29 state lotteries, the District of Columbia and the U.S. Virgin Islands. The chief executive officer of each member lottery serves on the MUSL board of directors.

As a member of MUSL, the NCEL is required to contribute to various prize reserve funds maintained by MUSL. These contributions are included in the 50% prize expense computed on Powerball sales. The net amount of the 50% prize expense less the amount required to pay low-tier prizes within the State is paid to MUSL. This payment is to cover the NCEL's share of current jackpot prizes based on the NCEL's percent of sales for each drawing and the NCEL share of the prize reserve fund. The prize reserve fund serves as a contingency reserve to protect all MUSL members including the NCEL from unforeseen prize liabilities. All prize reserve funds remitted, and

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

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

(b) Unclaimed Prizes

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

(c) Compulsive Gambling Contribution

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

(d) Limitations on Operating and Advertising Expenses

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

(e) Start-up Working Capital Advance

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

(8) Risk Management

The NCEL is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The NCEL participates in the State’s Risk Management Program for property, liability, crime and automobile coverage, and pays an annual premium for this coverage. The Lottery has not experienced any losses during the period ended June 30, 2006.

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

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

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

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

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

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

(9) Pension and Deferred Compensation Plans

(a) Retirement Plan

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

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

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

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

(b) Supplemental Retirement Income Plan

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

(c) Deferred Compensation Plan

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

(10) Other Postemployment Benefits

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

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

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006

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

(b) Long-Term Disability

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

(11) Litigation

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

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

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

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

NORTH CAROLINA EDUCATION LOTTERY

Notes to the Financial Statements

June 30, 2006



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

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

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

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

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

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

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

The Board of Directors
The North Carolina Education Lottery:

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

Internal Control over Financial Reporting

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

Compliance and Other Matters

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

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

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

KPMG LLP

November 28, 2006

Get 'r
done!



NCEL Regional Offices

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