



**DELAWARE STATE LOTTERY**

Financial Statements

June 30, 2010 and 2009

(With Independent Auditors' Report Thereon)

# DELAWARE STATE LOTTERY

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## Independent Auditors' Report

Wayne Lemons, Director of the Delaware State Lottery, and  
Tom Cook, Secretary of Finance, State of Delaware:

We have audited the accompanying balance sheets of the Delaware State Lottery (the Lottery) as of June 30, 2010 and 2009, and the related statements of revenue, expenses, and change in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller 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 Lottery's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1 to the financial statements, the financial statements present only the Lottery and do not purport to, and do not, present fairly the financial position of the State of Delaware as of June 30, 2010 and 2009, and the changes in its financial position for the years then ended, 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 Delaware State Lottery as of June 30, 2010 and 2009, and its changes in financial position and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated November 22, 2010 on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, 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 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 audits.



Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplemental information. However, we did not audit the information and express no opinion on it.

KPMG LLP

November 22, 2010

**DELAWARE STATE LOTTERY**  
Management's Discussion and Analysis  
June 30, 2010 and 2009

The management of the Delaware State Lottery (the Lottery) offers this narrative overview and analysis of the Lottery's financial activities for the years ended June 30, 2010 and 2009, which should be read in conjunction with the Lottery's basic financial statements.

**Overview of the Basic Financial Statements**

This discussion and analysis is intended to serve as an introduction to the Lottery's basic financial statements. Since the Lottery is an enterprise fund of the State of Delaware, these financial statements are presented in a manner similar to a private-sector business. As required by accounting principles generally accepted in the United States of America (GAAP), current year's revenues are recorded when earned and expenses are recorded as they are incurred, regardless of when the cash is received or disbursed.

The balance sheet presents information on all of the Lottery's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets serve as a relative indicator of the change in financial position of the Lottery.

The statement of revenue, expenses, and change in net assets shows the result of the Lottery's total operations during fiscal 2010 and reflects both operating and nonoperating activities. Changes in net assets (increases or decreases) reflect the current fiscal year's operating impact upon the overall financial position of the Lottery.

The statement of cash flows provides a detailed analysis of all sources and uses of cash. The direct method of cash flows is presented, ending with a reconciliation of operating income to net cash provided by operating activities. The statement of cash flows is divided into three activities sections-operating, noncapital financing, and investing.

Notes to the basic financial statements contain additional information, and often offer explanations to the basic financial statements. The notes are intended to assist the reader in understanding the Lottery's basic financial statements.

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**Condensed Balance Sheets**

**Table 1**  
**Balance Sheets**  
(In millions)

Assets	June 30		
	2010	2009	2008
Cash and cash equivalents	\$ 16.0	4.7	5.8
Accounts receivable, net of allowance of \$0.7, \$0.7, and \$0.7, respectively	6.3	10.6	14.9
Investments	2.0	3.3	4.7
Capital assets, net	—	—	—
Deposit with Multi-State Lottery	2.3	2.3	2.1
Total assets	<u>\$ 26.6</u>	<u>20.9</u>	<u>27.5</u>
<b>Liabilities and Net Assets</b>			
Liabilities:			
Prizes liability, including \$2.0, \$3.3, and \$4.7, respectively, of prize installment obligation	\$ 5.6	7.0	8.9
Accounts payable and accrued liabilities	10.1	6.0	9.7
Multi-State Lottery reserve	2.3	2.3	2.1
Due to the State of Delaware	6.5	4.6	6.3
OPEB liability	1.1	0.6	0.3
Total liabilities	<u>25.6</u>	<u>20.5</u>	<u>27.3</u>
Net assets:			
Invested in capital assets	—	—	—
Unrestricted	1.0	0.4	0.2
Total net assets	<u>1.0</u>	<u>0.4</u>	<u>0.2</u>
Total liabilities and net assets	<u>\$ 26.6</u>	<u>20.9</u>	<u>27.5</u>

The Lottery's accounting periods are predicated on a 4-4-5 week cycle except at year-end when the closing date includes additional days up to and including June 30. These extra days amounted to eight in 2008, nine in 2009, and only three in 2010. Correspondingly, the additional days in 2009 are reflected in the additional accounts receivable. In 2009, however, the Lottery swept the bank accounts of the three race tracks/casinos for four days of activity (June 22 through June 26) before year-end to ensure to have adequate funds to meet the Lottery's general fund obligations to the state. This would account for the reduction in accounts receivable for 2009. Accordingly, the reduction of extra days in 2010 would be the main reason for the decrease in accounts receivable.

The increase in cash during fiscal 2010 was due to transactions which occurred in the last accounting period, and the ending date of that accounting period in relation to June 30, 2010. For the accounting period June 21-27,

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2010, the amount of net proceeds from video lottery machines was credited to the Lottery's bank account on June 30, 2010, while the portion of net proceeds designated for distribution as purses and commissions did not occur until July 1, 2010.

Investments and the related prize installment obligations have been reduced over the years as a result of the maturing of existing annuities and the Lottery's discontinuation of annuities for prize payments.

**Revenue**

**Table 2**  
**Revenue**  
(In millions)

	<b>Year ended June 30</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Play 3	\$ 25.9	27.0	26.8
Play 4	17.8	18.0	17.3
Multi Win Lotto	5.6	5.8	7.1
Raffle	—	0.9	1.0
Powerball	26.2	28.6	32.2
Powerplay	3.7	3.0	3.3
Hot Lotto	3.8	3.4	1.6
Mega Millions	3.3	—	—
Fastplay	0.7	—	—
Instant games	36.0	36.5	35.6
Traditional games revenue	123.0	123.2	124.9
Video lottery, net	547.7	579.0	611.5
Video lottery machine license fees	0.5	1.4	0.9
Video lottery performance surcharge	—	—	4.2
Casino license fees	4.0	—	—
Vendor and employee casino license fees	0.3	—	—
Video lottery expired jackpots and credit slips	0.4	0.7	0.7
Sports lottery	10.8	—	—
Table games	3.0	—	—
Total revenue	\$ 689.7	704.3	742.2

Table 2 above compares revenue for each lottery game category. Total lottery revenue from ongoing operations for fiscal year 2010 was \$17.7 million or 2.5% lower than for 2009 and revenue for fiscal year 2009 was \$34.2 million or 4.6% lower than for fiscal year 2008. A law was passed during fiscal year 2007 that enabled the Lottery to charge a video lottery machine license fee to each licensed venue that exceeds a total of 2,500 machines at their facility. This revenue is labeled "Video lottery machine license fees" above. The State of Delaware imposed a penalty on the tracks in 2008 for not reaching forecasted performance goals. This penalty is reflected above under "Video lottery performance surcharge." The Lottery also collected unpaid jackpots and credit slips after their one-year expiration period.

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Powerball sales are typically driven by the size of the jackpot. As a result of reaching lower jackpot levels in 2010 and 2009, sales decreased for both years compared to 2008.

Instant games continue to be steady. The "cooperative services" agreement that the Lottery signed with its vendor for instant games continued to produce positive results. The vendor, in conjunction with the Lottery, continued to offer more attractive products. The Lottery also decided to shorten the life cycle of games offered and increased the introduction of higher price point tickets, as surveys indicated that higher price points with higher prize levels were more attractive to the playing public.

There was a \$32.5 million or 5.3% decline in video lottery revenues from 2008 to 2009. This was primarily due to the opening of a racino in Pennsylvania not far from Delaware Park, the State of Delaware's largest racino. Video lottery revenue continued to decrease in 2010 as a result of increased competition from the racinos in Pennsylvania.

**Cost of Games**

**Table 3**  
**Cost of Games**

(In millions and as a percentage of sales)

	<b>Year ended June 30</b>					
	<b>2010</b>		<b>2009</b>		<b>2008</b>	
Commission expense	\$ 230.9	33.5%	\$ 273.2	38.8%	\$ 298.8	40.3%
Gaming vendor fees and costs	40.4	5.9	41.4	5.9	43.1	5.8
Franchise game fees	—	—	—	—	4.2	0.6
Prize expense	72.5	10.5	66.8	9.5	65.9	8.9
<b>Total cost of games</b>	<b>\$ 343.8</b>		<b>\$ 381.4</b>		<b>\$ 412.0</b>	

Commission expense includes payments to lottery retailers for selling lottery tickets and to the casinos for the operation of video lottery and table game facilities. Commission expense as a percent of sales remained relatively unchanged for 2009 and 2008. However, during 2010 the state's share of the video lottery revenue was increased to 43.5%, thus reducing the amount paid to the casinos for commission.

Gaming vendor fees and costs include costs of the central system used to monitor and collect pertinent data for the online and the video lottery system and costs of leasing video lottery terminals from gaming vendors. Gaming vendor fees and costs remained relatively unchanged as a percent of sales for all three years.

Vendors providing video lottery terminals paid a license fee for certain game themes to third parties. The Lottery splits the cost of these license fees with the racinos on a 50-50 basis through 2008; in 2009, the racinos paid 100% of the fees. Franchise game fees in the table above represent the costs of these license fees.

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**Prize Expense, Net of Reversions**

**Table 4**  
**Prize Expense, Net of Reversions**  
(In millions)

	<b>Year ended June 30</b>		
	<b>2010</b>	<b>2009</b>	<b>2008</b>
Play 3	\$ 12.2	12.8	14.0
Play 4	8.2	10.2	7.0
Multi Win Lotto	3.3	3.5	3.9
Raffle	—	0.5	0.5
Powerball	13.1	13.4	15.5
Powerplay	1.3	1.4	1.6
Hot Lotto	1.8	1.7	1.0
Mega Millions	1.7	—	—
Fastplay	0.4	—	—
Sports lottery	7.3	—	—
Instant games	23.2	23.3	22.4
Total prize expense	<u>\$ 72.5</u>	<u>66.8</u>	<u>65.9</u>

Table 4 above compares prize expense for each lottery game category for the past three years. In general, prize expense by game will increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, the prize expenses for the Play 3 and Play 4 games are impacted by the luck of the draw and actual prize payment is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. Prize expense for the instant game product category is controllable for the most part, by printing a predetermined number and value of winning tickets for each instant game.

Prize expense for 2010 compared to 2009 and 2009 compared to 2008 is commensurate with the increases and decreases in traditional lottery sales during the same periods. The overall increase in prize expense from 2009 to 2010 is due to the introduction of sports lottery and the addition of Mega Millions to the Lottery's product line.

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**Operating Expenses**

**Table 5**  
**Operating Expenses**

(In millions)

	Year ended June 30		
	2010	2009	2008
Operating expenses	\$ 9.6	6.9	7.2

The main reason for the \$2.7 million increase in operating costs from 2009 to 2010 was due to expenses incurred relating to the implementation of table games at the casinos. The primary reason for the \$0.3 million decrease in operating costs from 2008 to 2009 was due to a decrease in advertising costs.

**Nonoperating Expenses**

**Table 6**  
**Nonoperating Expenses**

(In millions)

	Year ended June 30		
	2010	2009	2008
Contributions to the State of Delaware:			
Standardbred breeder's program	\$ 3.0	3.0	3.0
Certified thoroughbred program	1.0	1.0	1.0
Contributions to the State of Delaware	331.6	311.8	319.8
Total nonoperating expenses	\$ 335.6	315.8	323.8

Increases and decreases in cash contributions to the State of Delaware for 2009 and 2008 were consistent with the Lottery's revenue increases and decreases. However, in late 2009 legislation was passed such that the state share portion of the video lottery revenue (net of prizes) was increased to 43.5%. In previous years, the state's share of video lottery averaged around 35%.

## DELAWARE STATE LOTTERY

### Balance Sheets

June 30, 2010 and 2009

<b>Assets</b>	<b>2010</b>	<b>2009</b>
Current assets:		
Cash and cash equivalents	\$ 16,038,328	4,709,131
Accounts receivable, net of allowance of \$724,864 and \$724,864, respectively	6,214,783	10,624,268
Investments – restricted for payment of prize liabilities	949,800	1,384,575
Total current assets	<u>23,202,911</u>	<u>16,717,974</u>
Noncurrent assets:		
Capital assets, net	2,260	3,767
Investments – restricted for payment of prize liabilities	1,066,645	1,900,984
Deposit with Multi-State Lottery	2,292,114	2,290,358
Total noncurrent assets	<u>3,361,019</u>	<u>4,195,109</u>
Total assets	<u>\$ 26,563,930</u>	<u>20,913,083</u>
<b>Liabilities and Net Assets</b>		
Current liabilities:		
Prizes liability, including \$949,800 and \$1,384,575, respectively, of prize installment obligations	\$ 4,545,869	5,142,849
Accounts payable and accrued liabilities	10,062,231	6,016,173
Due to the State of Delaware	6,510,182	4,600,763
Total current liabilities	<u>21,118,282</u>	<u>15,759,785</u>
Noncurrent liabilities:		
Multi-State Lottery reserve	2,292,114	2,290,358
Prize installment obligations, noncurrent	1,066,645	1,900,984
OPEB liability	1,086,889	555,825
Total liabilities	<u>25,563,930</u>	<u>20,506,952</u>
Net assets:		
Invested in capital assets	2,260	3,767
Unrestricted	997,740	402,364
Total net assets	<u>1,000,000</u>	<u>406,131</u>
Total liabilities and net assets	<u>\$ 26,563,930</u>	<u>20,913,083</u>

See accompanying notes to financial statements.

## DELAWARE STATE LOTTERY

### Statements of Revenue, Expenses, and Change in Net Assets

Years ended June 30, 2010 and 2009

	<b>2010</b>	<b>2009</b>
<b>Revenue:</b>		
Video lottery, net	\$ 547,702,096	578,982,656
Video lottery machine license fees	820,200	1,446,830
Video lottery expired jackpots and credit slips	372,794	707,766
Casino license fees	4,000,000	—
Sports lottery	10,815,721	—
Table games	2,998,441	—
Online games	86,852,584	86,701,779
Instant games	36,090,613	36,469,211
Total revenue	689,652,449	704,308,242
<b>Cost of games:</b>		
Video lottery commissions	220,291,319	265,774,363
Prize costs, net of reversions	72,536,611	66,796,659
Gaming vendor fees and costs	40,401,992	41,334,874
Online and instant games commissions	7,383,242	7,384,756
Sports lottery commissions	1,229,648	—
Table games commissions	1,981,969	—
Sales aids	37,890	60,591
Total cost of games	343,862,671	381,351,243
Gross profit	345,789,778	322,956,999
<b>Operating expenses:</b>		
Advertising and promotions	2,493,750	2,339,603
Payroll and related benefits	2,530,752	2,059,138
Other general and administrative	4,560,792	2,508,811
Depreciation expense	1,507	1,507
Total operating expenses	9,586,801	6,909,059
Operating income	336,202,977	316,047,940
<b>Nonoperating expenses:</b>		
Contributions to the Delaware Standardbred Breeder's Program	3,000,000	3,000,000
Contributions to the Delaware Certified Thoroughbred Program	1,000,000	1,000,000
Contributions to the State of Delaware	331,609,108	311,836,851
Change in net assets	593,869	211,089
Net assets at beginning of year	406,131	195,042
Net assets at end of year	\$ 1,000,000	406,131

See accompanying notes to financial statements.

## DELAWARE STATE LOTTERY

### Statements of Cash Flows

Years ended June 30, 2010 and 2009

	<u>2010</u>	<u>2009</u>
Cash flows from operating activities:		
Receipts from customers	\$ 694,062,734	708,624,010
Payments to vendors for goods and services	(46,454,161)	(46,538,179)
Payments to employees for services	(1,870,270)	(1,736,917)
Payments for prizes	(73,967,930)	(68,701,494)
Payments for commissions	<u>(226,101,182)</u>	<u>(276,591,029)</u>
Net cash provided by operating activities	<u>345,669,191</u>	<u>315,056,391</u>
Cash flows from noncapital financing activities:		
Contributions to the Delaware Standardbred Breeder's Program	(3,000,000)	(3,000,000)
Contributions to the Delaware Certified Thoroughbred Program	(1,000,000)	(1,000,000)
Contributions to the State of Delaware	<u>(331,609,108)</u>	<u>(313,561,304)</u>
Net cash used in noncapital financing activities	<u>(335,609,108)</u>	<u>(317,561,304)</u>
Cash flows from investing activity:		
Proceeds from maturity of investments	<u>1,269,114</u>	<u>1,379,702</u>
Net cash provided by investing activity	<u>1,269,114</u>	<u>1,379,702</u>
Net increase (decrease) in cash and cash equivalents	11,329,197	(1,125,211)
Cash and cash equivalents at beginning of year	<u>4,709,131</u>	<u>5,834,342</u>
Cash and cash equivalents at end of year	<u>\$ 16,038,328</u>	<u>4,709,131</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 336,202,977	316,047,940
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	1,507	1,507
Changes in operating assets and liabilities:		
Accounts receivable, net	4,409,485	4,315,768
Deposit with Multi-State Lottery	1,756	(167,941)
Prizes liability	(1,431,319)	(1,904,835)
Accounts payable and accrued liabilities	<u>6,484,785</u>	<u>(3,236,048)</u>
Net cash provided by operating activities	<u>\$ 345,669,191</u>	<u>315,056,391</u>

See accompanying notes to financial statements.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2010 and 2009

#### (1) Summary of Significant Accounting Policies

##### (a) *Legislative Enactment*

The Delaware State Lottery (the Lottery) was established by Enabling Legislation (the Legislation) passed on May 31, 1974, by the General Assembly of the State of Delaware (the General Assembly) under the authority of the Governor's Office and under the supervision of a Director. In July 1976, the Lottery was transferred to the Office of the Secretary of Finance. The Director has the power and duty to establish rules for conducting games, including the type and number of games, the price of tickets, the number and amounts of winning tickets, the manner of selecting winning tickets, the manner of prize payment, frequency of drawings, locations and methods for the sale of tickets, procedures for licensing of retailers, and all other functions related to the operation of the Lottery.

The Legislation provides that for the nonvideo lottery games, at least 45% of total revenue shall be used to pay prizes, operating expenses shall not exceed 20% of total revenue, and at least 30% of total revenue will be paid to the General Fund of the State of Delaware (the State). Enabling legislation for video lottery was enacted on July 16, 1994 and provides that for the video lottery games at least 87%, but not more than 95% (unless approved by the Director), of total proceeds on an average annual basis shall be used to pay prizes.

##### (b) *Reporting Entity*

The Delaware State Lottery (reporting entity) is an enterprise fund of the State of Delaware.

##### (c) *Basis of Presentation*

In accordance with accounting principles generally accepted in the United States of America, the financial statements are prepared on the accrual basis of accounting, which requires recognition of revenues when earned and expenses when incurred. The Lottery has elected not to apply all Financial Accounting Standards Board statements and interpretations issued after November 30, 1989, in accordance with Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*.

##### (d) *Cash and Cash Equivalents*

Cash and cash equivalents consist of deposits held in bank accounts and highly liquid overnight investment accounts, as well as deposits held by the State to fund future nonprize costs during the next month.

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**(e) *Accounts Receivable***

Accounts receivable consist primarily of unsettled balances due to the Lottery from the racetracks for video lottery, and from retailers, which principally include grocery and convenience stores serving as the primary distribution channel for traditional lottery sales (online and instant games) to the general public.

	<b>2010</b>	<b>2009</b>
Receivables:		
Accounts	\$ 6,939,647	11,349,132
Total receivables	6,939,647	11,349,132
Allowance for doubtful accounts	(724,864)	(724,864)
Total receivables, net	\$ 6,214,783	10,624,268
Amounts not scheduled for collection during the subsequent year	\$ —	—

**(f) *Investments***

Investments consist of annuity contracts purchased from insurance companies to fund future prize payments, and are carried at amortized cost as nonparticipating investment contracts. The practice of purchasing and holding annuity contracts to fund future prize obligations is no longer employed by the Lottery, as investment amounts reported represent annuity contracts whose most recent purchase was during 1998. It is the Lottery's policy to hold all investments of this nature that were purchased to fund prize obligations until maturity. All investments will mature as of February 16, 2018.

**(g) *Capital Assets***

All purchases of capital assets, mostly computer equipment and furniture and fixtures, in excess of \$15,000 are capitalized and carried at cost. Depreciation is computed by using the straight-line method over the estimated useful life of ten years. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal.

**(h) *Revenue Recognition***

Revenue from online games is recognized on the day of the drawing. Revenue from the sale of instant tickets is recognized when the book has been activated and when one of the following occurs:

- 85% of the related prizes of an activated book is paid;
- 90 days from the date of activation; or
- when the next pack of the same game is activated.

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### Notes to Financial Statements

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Revenue from video lottery and table game sales is recognized, net of prizes paid, at the time the public plays the game. Revenue from sports lottery is also recognized at the time the public plays the game.

All revenue that the Lottery reports is considered operating revenue.

**(i) Prize Obligations**

Prize obligations for the online games are determined and recognized after each drawing is held. For the numbers games, winners are paid a certain amount depending upon the number of, or order of, winning numbers. Of every Multi Win Lotto sales dollar, a fixed payment goes to fund the nine lower prize levels with the balance going into the jackpot. If there are no jackpot winners in the Lotto game, the amount is carried forward until there is a winner. For the Powerball, 50% of the revenues are allocated to the prize pool.

Prize obligations related to instant games are recognized by taking the greater of prize cash disbursements or the historical estimates of claimed prizes. Disbursements for prizes, including installment prize awards, are charged against the obligations for unpaid prize awards. Prizes unclaimed after one year revert back to the Lottery and reduce the prize costs for the year. Such unclaimed monies are then remitted to the State.

Prize obligations for the sports lottery are determined and recognized after the completion of National Football League games. All wagers must be parlays consisting of three or more individual games.

**(j) Compensated Absences**

The Lottery has accrued a liability included in accounts payable and accrued liabilities for employee future absences, recognizing the obligation relating to services already rendered. This liability represents benefits accrued to Lottery employees for vacation earned as of year-end and sick leave estimated to be paid out at retirement for services rendered as of June 30, 2010. Employees earn from 1.25 to 1.75 days of vacation leave per month depending on years of service. The employee or his estate is paid for unused vacation upon termination of employment. Employees earn 1.25 days of sick leave per month. The Lottery's obligation for sick leave credit is a maximum of 45 workdays. As of June 30, 2010 and 2009, the Lottery had liabilities of \$144,665 and \$115,379 for accrued vacation and \$149,227 and \$142,182 for accrued sick leave, respectively.

**(k) Operating and Nonoperating Expenses**

Operating expenses generally result from providing services and producing and delivering goods in connection with the Lottery's principal ongoing operations. Operating expenses of the Lottery include personnel costs, contracted services, supplies, and depreciation. All expenses not meeting this definition are reported as nonoperating expenses.

**(l) Pension and Postemployment Benefits**

The Lottery accounts for and reports the value of its future obligation to pay other postemployment benefits (OPEB) which is principally healthcare to employees as the related benefits are earned. The

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Notes to Financial Statements

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resulting liability has been recorded on the balance sheet as OPEB liability and the year over year change in the obligation has been expensed in the statement of revenues, expenses and changes in net assets in the current fiscal year.

**(2) Cash**

Cash and cash equivalents reported reflect three types of account balances: the Lottery deposit account, the Lottery prize account, and deposits held by the State. Cash receipts and all cash transfers to other state agencies are made in and out of the Lottery deposit account. Prize disbursements are made out of the Lottery prize account. Cash held by the State (Treasurer’s Office), while identified for the Lottery, is maintained in an internal investment pool controlled by the State.

Cash balances consisted of the following:

	<b>June 30</b>	
	<b>2010</b>	<b>2009</b>
On hand and in bank	\$ 13,774,254	3,287,442
Held by the State Treasurer	2,264,074	1,421,689
	<u>\$ 16,038,328</u>	<u>4,709,131</u>

***Custodial Credit Risk***

For deposits, custodial credit risk is the risk that, in the event of the failure of a depository financial institution, the deposits or collateral securities may not be recovered from an outside party.

All deposits are required by state law to be collateralized by direct obligations of, or obligations guaranteed by, the U.S. government or other suitable obligations as determined by the State’s Cash Management Policy Board (the Board), unless the Board shall find such collateralization not in the best interest of the State. Additionally, the Board has determined that deposits need not be collateralized provided they are held in a bank that for the previous two years has had a return on total average assets of 0.5% or greater and has had an average capital ratio (total equity to total assets) of at least 5.0%. If the bank does not meet the aforementioned criteria, collateral must consist of one or more of the following:

- U.S. government securities;
- U.S. government agency securities;
- Federal Home Loan Board letters of credit;
- State securities; or
- Securities of a political subdivision of the State with a Moody’s Investors service rating of “A” or better.

In addition, the bank must ensure that those securities pledged as collateral have a market value equal to or greater than 102% of the ledger balance(s) in the account(s) each day and ensure that securities pledged are identified as held in the State’s name and are segregated on the bank’s records.

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2010 and 2009

At June 30, 2010 and 2009, the bank balance of deposits was not subject to custodial credit risk as all amounts were either fully insured and/or collateralized. As of June 30, 2010 and 2009, the total bank balance of cash in all bank accounts was \$13,826,411 and \$3,301,931, respectively.

### (3) Investments

Until April 1998, annuity contracts were purchased from insurance companies to fund prizes of \$150,000 or more, payable on an installment basis. All investments reported on the balance sheet represent such annuities, and are carried on the balance sheet at amortized cost. The Lottery intends to hold the investments until maturity. The Lottery remains liable for future periodic payments of deferred prize obligations (approximately \$2.0 million as of June 30, 2010) in the event that annuity issuers default on their obligations. Lottery investments as of June 30, 2010 and 2009 are considered uncategorized investments as it relates to custodial credit risk under GASB Statement No. 40, *Deposit and Investment Risk Disclosures*.

#### (a) Interest Rate Risk

Interest rate risk is the risk that changes in interest rates of debt instruments will adversely affect the value of an investment. Investments reported on the balance sheet are not subject to interest rate risk.

#### (b) Credit Risk and Concentration of Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. While the Lottery no longer utilizes the purchase of annuity contracts to fulfill prize obligations, the Lottery places no limit on the amount it may invest in any one issuer. As of June 30, 2010, the insurance companies with which the Lottery's investments in annuity contracts to pay future prize obligations are held were rated by A.M. Best Company and concentrated as follows:

<u>Insurance company</u>	<u>Total annuity contract values</u>	<u>Concentration</u>	<u>A.M. Best rating</u>
Sun America Life Insurance Company	\$ 54,323	2.70%	a (excellent)
Jefferson-Pilot Life Insurance Company	1,129,473	56.00	nr (not rated)
Metropolitan Life Insurance Company	381,547	18.90	aa- (superior)
New York Life Insurance Company	234,456	11.60	aaa (superior)
Ohio National Life Insurance Company	<u>216,646</u>	<u>10.80</u>	aa- (superior)
Total investments in annuity contracts	<u>\$ 2,016,445</u>	<u>100.00%</u>	

**DELAWARE STATE LOTTERY**

Notes to Financial Statements

June 30, 2010 and 2009

**(4) Capital Assets**

	<b>Beginning balance July 1, 2009</b>	<b>Increase</b>	<b>Decrease</b>	<b>Ending balance June 30, 2010</b>
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,391,120	1,507	—	1,392,627
Total capital assets being depreciated, net	\$ 3,767	(1,507)	—	2,260
	<b>Beginning balance July 1, 2008</b>	<b>Increase</b>	<b>Decrease</b>	<b>Ending balance June 30, 2009</b>
Capital assets being depreciated:				
Computer equipment and software	\$ 1,394,887	—	—	1,394,887
Total capital assets being depreciated	1,394,887	—	—	1,394,887
Less accumulated depreciation	1,389,613	1,507	—	1,391,120
Total capital assets being depreciated, net	\$ 5,274	(1,507)	—	3,767

During the years ended June 30, 2010 and 2009, the Lottery had no purchases or disposals of capital assets. Depreciation expense for the years ended June 30, 2010 and 2009 was \$1,507.

**(5) Prize Obligations**

The following is a reconciliation of changes in the prize liability account, which includes the present value of prize installment obligations, for the fiscal years ended June 30, 2010 and 2009:

	<b>2010</b>	<b>2009</b>
Prize obligations, beginning of year	\$ 7,043,833	8,948,668
Prize payments	(73,967,930)	(68,701,494)
Prize costs, net of reversions	72,536,611	66,796,659
Prize obligations, end of year	\$ 5,612,514	7,043,833

**DELAWARE STATE LOTTERY**

Notes to Financial Statements

June 30, 2010 and 2009

The Lottery pays the winners of certain jackpots in annual installments over periods that vary generally from 14 to 20 years. The future prize installment obligations payable as of June 30, 2010, and during the next five years and thereafter, are as follows:

2011	\$	949,800
2012		666,625
2013		273,125
2014		108,375
2015		30,000
Thereafter		<u>80,000</u>
Total payments for unpaid prize installment obligations		2,107,925
Less imputed interest		<u>(91,480)</u>
Present value of prize installment obligations		<u>\$ 2,016,445</u>

**(6) Participation in the Multi-State Lottery**

The Lottery is a member of the Multi-State Lottery (the MUSL), which operates online games on behalf of participating state lotteries. Each MUSL member sells game tickets through its agents and makes weekly wire transfers to the MUSL in an amount equivalent to the member's share of the estimated grand prize liability. Each MUSL member pays lesser prizes directly to the winners. The MUSL operates the Powerball games, as well as the Powerplay feature associated with Powerball. The MUSL also operates the Hot Lotto game, in which the Lottery began participating during fiscal year 2008. Participating lotteries are required to maintain deposits with MUSL for contingency reserves to protect MUSL from unforeseen prize liabilities. The money in this reserve fund is refundable to MUSL members if the MUSL disbands or if a member leaves the MUSL Board.

The amount the Lottery had on deposit with the MUSL, as of June 30, 2010 and 2009, equaled \$2,292,114 and \$2,290,358, respectively. These amounts are also reported as a liability on Lottery's balance sheet because they represent the amount to be paid to the State upon separation from the MUSL if the MUSL is not required to use a portion of the Lottery's reserves held by the MUSL.

Complete separate financial statements for the MUSL may be obtained by sending a written request to the Lottery's Administrative Office.

**(7) Delaware Standardbred Breeder's Program and Delaware Certified Thoroughbred Program**

In March 1998, an amendment to the Legislation was passed by the General Assembly that established the Delaware Standardbred Breeder's Program (the Breeder's Program) for the purpose of promoting the Delaware harness racing industry. Under this amendment, the Lottery was initially required to withhold \$2,000,000 of funds annually (\$1,000,000 from the General Fund of the State and \$1,000,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program. Under an amendment signed in April 2004, the Lottery is required to withhold \$3,000,000 of

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2010 and 2009

funds annually (\$1,500,000 from the General Fund of the State and \$1,500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these fees to the Breeder's Program.

In the epilogue language of the Fiscal Year 2006 Bond Bill, an amendment was passed by the General Assembly that established the Delaware Certified Thoroughbred Program for the purpose of enhancing the quantity of thoroughbred foals and/or yearlings stabled within Delaware. Under this amendment, effective July 1, 2006, the Lottery is required to withhold \$1,000,000 of funds annually (\$500,000 from the General Fund of the State and \$500,000 from the Purse Increase Funds of the State Department of Agriculture) and remit these funds to the Delaware Certified Thoroughbred Program.

During fiscal 2008, the General Assembly approved House Bill #514 which reduces the State's annual contribution to the Delaware Standardbred Breeder's Program and the Certified Thoroughbred Program by \$750,000 and \$250,000 respectively. The State's video lottery agents will pick up the reduction of the State's contribution. The amounts paid by the agents is recorded as a reduction to video lottery commissions and/or accounts payable and accrued liabilities, and is then transferred by the lottery to the respective programs.

#### (8) Contributions to the State of Delaware

As required, under the Legislation, net assets of the Lottery may not exceed \$1,000,000; therefore, the Lottery periodically transfers surplus funds to the State in accordance with the Legislation. For the years ended June 30, 2010 and 2009, the Lottery made the following contributions to the State and, as of June 30, 2010 and 2009, had the following liabilities due to the State for excess earnings:

	June 30	
	2010	2009
Amounts transferred during the fiscal year:		
General Fund	\$ 275,500,000	248,000,000
Department of Health and Social Services	2,382,505	1,661,340
Department of Agriculture	51,817,184	63,899,964
	329,699,689	313,561,304
Amounts accrued, beginning of year	(4,600,763)	(6,325,216)
Amounts due to the State of Delaware, end of year:		
General Fund	(117,080)	(246,323)
Department of Health and Social Services	210,767	201,952
Department of Agriculture	6,416,495	4,645,134
Amounts accrued, end of year	6,510,182	4,600,763
Total contributions to the State of Delaware	\$ 331,609,108	311,836,851

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2010 and 2009

#### (9) Revenue and Expenses by Game

The following revenue was recognized:

	Year ended June 30	
	2010	2009
Online games:		
Play 3 Day	\$ 9,562,464	9,993,811
Play 3 Night	16,301,398	17,012,765
Play 4 Day	6,273,997	6,349,291
Play 4 Night	11,510,214	11,706,740
Multi Win Lotto	5,560,320	5,842,236
Hot Lotto	3,757,950	3,385,943
Raffle	—	898,238
Powerball	26,216,665	28,552,663
Powerplay	3,680,300	2,960,092
Mega Millions	3,316,934	—
Fast Play	672,342	—
	86,852,584	86,701,779
Video lottery, net	547,702,096	578,982,656
Video lottery machine license fees	520,300	1,446,830
Casino license fees	4,000,000	—
Vendor license fees	299,900	—
Video lottery expired jackpots and credit slips	372,794	707,766
Sports lottery	10,815,721	—
Table games	2,998,441	—
Instant games	36,090,613	36,469,211
	\$ 689,652,449	704,308,242

The revenue, prize costs, and commissions expense, by game type, are listed below:

	Online	Video lottery, net	Instant	Sports lottery	Table games	Total
Year ended June 30, 2010:						
Revenue	\$ 86,852,584	547,702,096	36,090,613	10,815,721	2,998,441	684,459,455
Other income	—	5,192,994	—	—	—	5,192,994
Prize costs, net of reversions	41,980,112	—	23,235,080	7,321,419	—	72,536,611
	44,872,472	552,895,090	12,855,533	3,494,302	2,998,441	617,115,838
Commissions expense	5,280,192	220,291,319	2,103,050	1,229,648	1,981,969	230,886,178
Contribution margin per game	\$ 39,592,280	332,603,771	10,752,483	2,264,654	1,016,472	386,229,660

**DELAWARE STATE LOTTERY**

Notes to Financial Statements

June 30, 2010 and 2009

	<u>Online</u>	<u>Video lottery, net</u>	<u>Instant</u>	<u>Total</u>
Year ended June 30, 2009:				
Revenue	86,701,779	578,982,656	36,469,211	702,153,646
Other income	—	2,154,596	—	2,154,596
Prize costs, net of reversions	43,459,275	—	23,337,384	66,796,659
	<u>43,242,504</u>	<u>581,137,252</u>	<u>13,131,827</u>	<u>637,511,583</u>
Commissions expense	5,269,793	265,774,363	2,114,963	273,159,119
Contribution margin per game	\$ 37,972,711	315,362,889	11,016,864	364,352,464

**(10) Payroll-Related and Other Benefits**

All Lottery personnel are employees of the State and are covered by pension, health insurance, and other employee benefit programs administered by agencies of the State. During 2010 and 2009, the Lottery incurred \$2,530,752 and \$2,059,138, respectively, of payroll and benefit costs, including pension, health insurance, and other employee benefit costs, paid to various state agencies responsible for the administration of benefit programs.

**(11) Retirement and Other Postemployment Benefits**

**(a) Retirement**

The Lottery contributes to the State Employees' Pension Plan (the State Plan) established by the State to provide benefits for state employees. While the State Plan is an agent multiple employer public employee retirement system, the Lottery accounts for the plan as a cost-sharing multiple employer public employees retirement system since a separate valuation is not performed for the Lottery and the Lottery's only obligation to the plan is its required annual contributions. The State Plan is considered part of the State's financial reporting entity, and is not considered as part of the Lottery's reporting entity. The State Plan prepares separate financial statements, which can be obtained by writing to the State Board of Pension Trustees and Office of Pensions, McArdle Building, Suite #1, 860 Silver Lake Boulevard, Dover, Delaware 19904-2402.

The State Plan consists of several plans, which are managed by the State. The various plans have different vesting periods ranging from 5 to 20 years, various eligibility requirements, and various benefits that are provided. The Lottery's required contributions, which equaled actual contributions made for the years ended June 30, 2010, 2009, and 2008, were \$219,717, \$177,523, and \$193,867, respectively.

The Lottery's accrued pension costs for the years ended June 30, 2010 and 2009 equaled \$12,764 and \$11,713, respectively, and are included within amounts reported as accounts payable and accrued liabilities on the balance sheets.

**DELAWARE STATE LOTTERY**

Notes to Financial Statements

June 30, 2010 and 2009

**(b) Other Postemployment Benefits**

All full-time Lottery employees are covered under the State of Delaware Other Post-Employment Benefits Fund Trust (the OPEB Trust), which was established pursuant to Section 115 of the Internal Revenue Code and administered by the Delaware Public Employees' Retirement System. No stand-alone financial report is issued for the OPEB Trust, but the Trust is included in the statewide Comprehensive Annual Financial Report, which will be available from the Division of Accounting.

The OPEB Trust provides retirement medical coverage to 16,949 pensioners and their eligible dependents through the same health care plans that are available to active employees. Retirees' contributions depend on date of hire and years of service and range from 0 to 100% of the cost. There are currently 35,926 active eligible plan members. The Lottery has 54 active eligible plan members, which is the basis on which plan costs are allocated.

By State statute Title 29 of the Delaware Code c.52, contribution requirements of plan members and the government are established and may be amended by the State Legislature. The contribution rates for the employer and retiree are established annually by the budgeting process of the State of Delaware, but are not actuarially determined. Those rates include an employer contribution based on projected pay-as-you-go financing requirements, with an additional amount to prefund benefits, which was 0.00% and 0.54% of payroll in 2010 and 2009, respectively.

The State's annual OPEB cost is calculated based on the actuarially determined annual required contribution of the employer (ARC). The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize the unfunded actuarial liabilities over a period of 30 years. Amounts "required" but not actually set aside to pay for these benefits are accumulated as part of the Net OPEB obligation. The following table shows the components of the annual OPEB cost for the year, the amount actually contributed to the plan, and the net OPEB obligation, as well as the amounts allocated to the Lottery:

	<b>State total</b>	<b>Lottery allocation</b>
	(In millions)	(In thousands)
Net OPEB obligation as of June 30, 2009	\$ 641.5	555.8
Annual required contribution	486.5	820.2
Adjustment to required contribution	—	—
Annual OPEB cost	1,128.0	1,376.0
Employer contributions	171.5	289.1
Net OPEB obligation as of June 30, 2010	\$ 956.5	1,086.9

## DELAWARE STATE LOTTERY

### Notes to Financial Statements

June 30, 2010 and 2009

	<u>State total</u> (In millions)	<u>Lottery allocation</u> (In thousands)
Net OPEB obligation as of June 30, 2008	\$ 281.4	246.4
Annual required contribution	519.1	446.1
Adjustment to required contribution	—	—
Annual OPEB cost	800.5	692.5
Employer contributions	159.0	136.6
Net OPEB obligation as of June 30, 2009	\$ 641.5	555.9

The State's actuarial accrued liability for benefits was \$5,884 million, and the actuarial value of assets was \$104 million, resulting in an unfunded actuarial accrued liability (UAAL) of \$5,780 million for the primary government. The Lottery's approximate share of the UAAL is \$9.7 million.

#### (12) Risk Management

The Lottery stipulates in its vendor contracts that the vendors carry various insurance coverages such as property (video gaming machines and online terminals, etc.), general liability, errors and omissions, automotive, and crimes. The Lottery's risks of losses related to workers' compensation, employee healthcare, automobile, and a portion of property and casualty claims are insured internally by the State.

#### (13) Commitments

The Lottery has entered into various contracts for services to be rendered relating principally to the operation of the Lottery's games. Under the gaming systems vendor contracts, the Lottery is committed to the vendors.

The Lottery is committed to 4.18% of online sales to its central system provider through February 2015 and 7.8987% of instant sales through November 2011. For video lottery, the Lottery is committed to 1% to the central system provider through February 2015 and a percentage ranging from 4.0% to 6.5% to the video lottery terminal providers through June 1, 2011.



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

Wayne Lemons, Director of the Delaware State Lottery and  
Tom Cook, Secretary of Finance, State of Delaware:

We have audited the financial statements of the Delaware State Lottery (the Lottery) as of and for the year ended June 30, 2010, and have issued our report thereon dated November 22, 2010 which includes an explanatory paragraph noting that the Lottery is a fund of the State of Delaware. 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 Lottery's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Lottery's internal control over financial reporting.

A deficiency in internal control over financial reporting 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 combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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



### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Lottery'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 Lottery in a separate letter dated November 22, 2010.

This report is intended solely for the information and use of the Secretary of Finance, Lottery Management, the Office of the Governor, the Office of the Controller General, the Office of the Attorney General, the Office of Management and Budget, and the Office of the Auditor of Accounts and others within the entity, and is not intended to be and should not be used by anyone other than these specified parties. However, under 29 Del. C, Section 0102(d), this report is public record and its distribution is not limited.

**KPMG LLP**

November 22, 2010