



DELAWARE STATE LOTTERY

Basic Financial Statements

June 30, 2013 and 2012

(With Independent Auditors' Reports Thereon)

DELAWARE STATE LOTTERY

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Independent Auditors' Report

Vernon Kirk, Director of the Delaware State Lottery, and
Tom Cook, Secretary of Finance, State of Delaware:

Report on the Financial Statements

We have audited the accompanying financial statements of the Delaware State Lottery (the Lottery) an enterprise fund of the State of Delaware, which comprise the statements of net position as of June 30, 2013 and 2012, and the related statements of revenue, expenses, and changes in net position, and cash flows for the years ended, and the related notes to the financial statements, which collectively comprise the Lottery's financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Delaware State Lottery as of June 30, 2013 and 2012, and changes in its financial position, and its cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.



Emphasis of Matter

As discussed in note 1 to the financial statements, the financial statements present only the Lottery enterprise fund and do not purport to, and do not, present fairly the financial position of the State of Delaware as of June 30, 2013 and 2012, the changes in its financial position or, where applicable, its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles. Our opinion is not modified with respect to the matter.

Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles require that management’s discussion and analysis on pages 3–8 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management’s responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by Government Auditing Standards

In accordance with *Government Auditing Standards*, we have also issued our report dated November 21, 2013 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 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Lottery’s internal control over financial reporting and compliance.

KPMG LLP

November 21, 2013

DELAWARE STATE LOTTERY

Management's Discussion and Analysis

June 30, 2013 and 2012

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, 2013 and 2012, 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 Statement of Net Position presents information on all of the Lottery's assets and liabilities, with the difference between the two reported as net position. Over time, increases or decreases in net position serve as a relative indicator of the change in financial position of the Lottery.

The statement of revenue, expenses, and changes in net position shows the result of the Lottery's total operations and reflects both operating and nonoperating activities. Changes in net position (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 3 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.

DELAWARE STATE LOTTERY
Management's Discussion and Analysis
June 30, 2013 and 2012

Condensed Net Position

Assets	June 30		
	2013	2012	2011
Cash and investments	\$ 3.5	6.9	6.2
Accounts receivable, net of allowance of \$0.7, \$0.7, and \$0.7, respectively	11.1	10.5	5.4
Investments	0.2	0.5	1.1
Due from State of Delaware	2.2	1.7	1.1
Deposit with Multi-State Lottery	2.4	2.4	2.4
Total assets	<u>\$ 19.4</u>	<u>22.0</u>	<u>16.2</u>
Liabilities and Net Position			
Liabilities:			
Prizes liability, including \$0.2, \$0.5, and \$1.1, respectively, of prize installment obligation	\$ 4.8	4.6	4.7
Accounts payable and accrued liabilities	7.1	6.2	4.7
Due to the State of Delaware	1.5	5.6	1.7
Multi-State Lottery reserve	2.4	2.4	2.4
OPEB liability	2.6	2.2	1.7
Total liabilities	<u>18.4</u>	<u>21.0</u>	<u>15.2</u>
Net position:			
Unrestricted	<u>1.0</u>	<u>1.0</u>	<u>1.0</u>
Total net position	<u>1.0</u>	<u>1.0</u>	<u>1.0</u>
Total liabilities and net position	<u>\$ 19.4</u>	<u>22.0</u>	<u>16.2</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 four in 2011, six in 2012, and seven in 2013. Correspondingly, the additional days in 2013 are reflected in the additional accounts receivable and accounts payable and accrued liabilities.

Over the last three years, 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.

The OPEB liability continued to increase each year because the Lottery is not funding the Annual Required Contribution, but is only paying retiree healthcare on a pay-as-you-go basis.

DELAWARE STATE LOTTERY

Management's Discussion and Analysis

June 30, 2013 and 2012

Revenue

Table 2

Revenue

(In millions)

	Year ended June 30		
	2013	2012	2011
Play 3	\$ 24.9	25.0	25.3
Play 4	19.2	18.7	17.9
Multi Win Lotto	4.2	4.5	5.0
Powerball	29.3	20.8	16.3
Powerplay	4.9	4.2	4.1
Hot Lotto	3.1	2.6	3.3
Mega Millions	7.6	12.0	9.9
Fastplay	—	0.1	0.4
Delaware Cash 5	0.9	1.1	0.7
Keno	2.5	—	—
Instant games	47.5	45.7	40.9
Traditional games revenue	144.1	134.7	123.8
Video lottery, net	396.8	475.7	499.5
Video lottery machine license fees	—	—	0.2
Video lottery expired jackpots and credit slips	0.4	0.3	0.4
Casino license fees	3.0	10.8	17.5
Sports lottery	25.4	17.8	12.9
Table games, net	65.6	75.0	74.2
Total revenue	\$ 635.3	714.3	728.5

Table 2 above compares revenue for each lottery game category. Total lottery revenue for fiscal 2013 was \$79 million, or 11.1% lower than for 2012 and revenue for fiscal 2012 was \$14.2 million, or 2.0%, lower than for fiscal 2011.

There was a \$78.9 million, or 16.6%, decline in video lottery revenues from 2012 to 2013 and a \$23.8 million, or 4.8%, decline from 2011 to 2012. This was mainly due to increased competition from casinos operating in Maryland and Pennsylvania. Also, a new casino opened in Maryland on June 6, 2012, which is in direct competition with Delaware Park.

The table games revenue was \$9.4 million lower in fiscal 2013 as compared to fiscal 2012. This decline can also be attributed to increased competition from casinos in neighboring states.

Powerball sales are typically driven by the size of the jackpot. Sales for this game increased from 2012 to 2013 and 2011 to 2012 as higher jackpot levels were attained. Mega millions sales are also driven by the size of the jackpot. As a result of having a world record jackpot of \$640 million during 2012, sales for this game increased from 2011.

DELAWARE STATE LOTTERY

Management's Discussion and Analysis

June 30, 2013 and 2012

Instant games sales continue to increase. The “cooperative services” agreement that the Lottery signed with its vendor for instant games is producing 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.

At the end of fiscal 2012, to enhance Delaware’s ability to maintain and grow its gaming revenue, the Delaware Legislature passed the Administration’s *Delaware Gaming Competitiveness Act of 2012*. This act allows for the expansion of the Sports Lottery into retail locations, the implementation of Keno into retail locations, and places Delaware at the very forefront of internet gaming in the United States by authorizing both traditional and casino styles online wagering.

Cost of Games

Table 3

Cost of Games

(In millions and as a percentage of sales)

	Year ended June 30					
	2013		2012		2011	
Commission expense	\$ 213.7	33.6%	\$ 250.6	35.1%	\$ 259.7	35.6%
Gaming vendor fees and costs	33.1	5.2	37.6	5.3	38.0	5.2
Prize expense	99.3	15.6	85.6	12.0	75.8	10.4
Total cost of games	\$ 346.1		\$ 373.8		\$ 373.5	

Commission expense includes payments to lottery retailers for selling lottery and sports betting tickets and to the casinos for the operation of video lottery, sports lottery, and table game facilities. There was a \$36.9 million, or 14.7%, decline in commission expense from 2012 to 2013. This was due to lower revenue for video lottery and table games. Commission expense as a percentage of sales remained relatively unchanged from 2011 to 2012.

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, costs of the instant games supplier, and costs of leasing video lottery terminals from gaming vendors. Gaming vendor fees and costs as a percentage of sales remained relatively unchanged for all three years.

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Management's Discussion and Analysis

June 30, 2013 and 2012

Prize Expense, Net of Reversions

Table 4
Prize Expense, Net of Reversions

(In millions)

	Year ended June 30		
	2013	2012	2011
Play 3	\$ 12.0	12.0	12.9
Play 4	10.3	9.3	8.7
Multi Win Lotto	2.5	2.8	2.8
Powerball	16.0	11.0	8.7
Powerplay	0.8	0.8	1.0
Hot Lotto	1.6	0.9	1.6
Mega Millions	3.7	6.1	5.1
Fastplay	—	0.1	0.2
Delaware Cash 5	0.5	0.5	0.4
Keno	1.5	—	—
Sports lottery	20.0	12.8	7.8
Instant games	30.4	29.3	26.6
Total prize expense	\$ <u>99.3</u>	<u>85.6</u>	<u>75.8</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 2013 compared to 2012 and 2012 compared to 2011 is commensurate with the increases and decreases in traditional lottery sales during the same periods. The increase in prize expense from 2012 to 2013 is due to higher sales on Powerball, instant games and sports lottery. Higher sales for these games also contributed to the increase in prize costs during 2012.

DELAWARE STATE LOTTERY
Management's Discussion and Analysis
June 30, 2013 and 2012

Operating Expenses

Table 5
Operating Expenses
(In millions)

	Year ended June 30		
	2013	2012	2011
Operating expenses	\$ 11.4	11.4	11.1

Operating expenses remained relatively unchanged from 2012 to 2013 and 2011 to 2012.

Nonoperating Expenses

Table 6
Nonoperating Expenses
(In millions)

	Year ended June 30		
	2013	2012	2011
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	273.8	325.1	339.9
Total nonoperating expenses	\$ 277.8	329.1	343.9

Decreases in cash contributions to the State of Delaware were consistent with the Lottery's revenue decreases.

Subsequent Event

In July 2013, the legislature convened a Lottery and Gaming Study Commission which is responsible for examining the tax competitive marketplace confronting Delaware gaming and all affected parties. The commission is required to report its findings by January 31, 2014.

DELAWARE STATE LOTTERY

Statement of Net Position

June 30, 2013 and 2012

Assets	2013	2012
Current assets:		
Cash and investments	\$ 3,498,811	6,951,200
Accounts receivable, net of allowance of \$733,877 and \$733,877, respectively	11,069,870	10,508,174
Investments – restricted for payment of prize liabilities	108,375	273,125
Due from State of Delaware	2,221,882	1,662,868
Total current assets	<u>16,898,938</u>	<u>19,395,367</u>
Noncurrent assets:		
Capital assets, net	—	—
Investments – restricted for payment of prize liabilities	101,202	207,191
Deposit with Multi-State Lottery	2,446,626	2,437,297
Total noncurrent assets	<u>2,547,828</u>	<u>2,644,488</u>
Total assets	<u>\$ 19,446,766</u>	<u>22,039,855</u>
Liabilities and Net Position		
Current liabilities:		
Prizes liability, including \$108,375 and \$273,125, respectively, of prize installment obligations	\$ 4,714,470	4,364,996
Accounts payable and accrued liabilities	7,042,040	6,229,439
Due to the State of Delaware	1,544,941	5,579,050
Total current liabilities	13,301,451	16,173,485
Noncurrent liabilities:		
Multi-State Lottery reserve	2,446,626	2,437,297
Prize installment obligations, noncurrent	101,202	207,191
OPEB liability	2,597,487	2,221,882
Total liabilities	<u>18,446,766</u>	<u>21,039,855</u>
Net assets:		
Unrestricted	1,000,000	1,000,000
Total net position	<u>1,000,000</u>	<u>1,000,000</u>
Total liabilities and net position	<u>\$ 19,446,766</u>	<u>22,039,855</u>

See accompanying notes to financial statements.

DELAWARE STATE LOTTERY

Statements of Revenue, Expenses, and Changes in Net Position

Years ended June 30, 2013 and 2012

	2013	2012
Revenue:		
Video lottery, net	\$ 396,775,063	475,729,991
Video lottery expired jackpots and credit slips	365,495	327,050
Casino license fees	3,000,000	10,750,000
Sports lottery	25,422,927	17,846,827
Table games	65,591,850	74,963,837
Online games	96,657,250	88,973,520
Instant games	47,451,154	45,712,056
Total revenue	635,263,739	714,303,281
Cost of games:		
Video lottery commissions	159,688,216	190,984,854
Prize costs, net of reversions	99,264,072	85,649,089
Gaming vendor fees and costs	33,147,920	37,637,540
Online and instant games commissions	8,961,607	8,386,594
Sports lottery commissions	1,688,851	1,669,025
Table games commissions	43,356,213	49,551,096
Total cost of games	346,106,879	373,878,198
Gross margin	289,156,860	340,425,083
Operating expenses:		
Advertising and promotions	3,202,516	2,860,010
Payroll and related benefits	6,292,138	6,173,495
Other general and administrative	1,866,317	2,328,878
Depreciation expense	—	753
Total operating expenses	11,360,971	11,363,136
Operating income	277,795,889	329,061,947
Nonoperating expenses:		
Transfers to the Delaware Standardbred Breeder's Program	3,000,000	3,000,000
Transfers to the Delaware Certified Thoroughbred Program	1,000,000	1,000,000
Transfers to the State of Delaware	273,795,889	325,061,947
Change in net position	—	—
Net position at beginning of year	1,000,000	1,000,000
Net position at end of year	\$ 1,000,000	1,000,000

See accompanying notes to financial statements.

DELAWARE STATE LOTTERY

Statements of Cash Flows

Years ended June 30, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Cash flows from operating activities:		
Receipts from customers	\$ 634,702,043	709,210,164
Payments to vendors for goods and services	(37,797,652)	(43,178,056)
Payments to employees for services	(5,723,100)	(5,772,052)
Payments for prizes	(99,020,587)	(85,817,602)
Payments for commissions	(213,494,820)	(248,531,696)
Net cash provided by operating activities	<u>278,665,884</u>	<u>325,910,758</u>
Cash flows from noncapital financing activities:		
Transfers to the Delaware Standardbred Breeder's Program	(3,000,000)	(3,000,000)
Transfers to the Delaware Certified Thoroughbred Program	(1,000,000)	(1,000,000)
Transfers to the State of Delaware	(278,389,012)	(321,778,555)
Net cash used in noncapital financing activities	<u>(282,389,012)</u>	<u>(325,778,555)</u>
Cash flows from investing activity:		
Proceeds from maturity of investments	<u>270,739</u>	<u>634,568</u>
Net cash provided by investing activity	<u>270,739</u>	<u>634,568</u>
Net increase (decrease) cash and investments	(3,452,389)	766,771
Cash and investments at beginning of year	<u>6,951,200</u>	<u>6,184,429</u>
Cash and investments at end of year	<u>\$ 3,498,811</u>	<u>6,951,200</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 277,795,889	329,061,947
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	—	753
Changes in operating assets and liabilities:		
Accounts receivable, net	(561,696)	(5,093,117)
Deposit with Multi-State Lottery	(9,329)	(40,910)
Prizes liability	243,485	(168,513)
Accounts payable and accrued liabilities	1,197,535	2,150,598
Net cash provided by operating activities	<u>\$ 278,665,884</u>	<u>325,910,758</u>

See accompanying notes to financial statements.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

(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 GASB issued Statement No. 63 *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position* in June 2011. This statement provides accounting and financial reporting requirements for deferred outflows of resources and deferred inflows of resources as introduced and defined in GASB's Concepts Statement No. 4, *Elements of Financial Statements*. This Statement amends the net asset reporting requirements in Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*. The State has established proper account coding for the deferred items and is incorporating them into its financial statements.

(d) *Cash and Investments*

Cash and investments 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.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

(e) Accounts Receivable

Accounts receivable consist primarily of unsettled balances due to the Lottery from the racetracks for video lottery and table games, 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.

	2013	2012
Receivables:		
Accounts	\$ 11,803,747	11,242,051
Total receivables	11,803,747	11,242,051
Allowance for doubtful accounts	(733,877)	(733,877)
Total receivables, net	\$ 11,069,870	10,508,174
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 \$25,000 are capitalized and carried at cost. Depreciation is computed by using the straight-line method over the estimated useful life of 10 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
- When the next pack of the same game is activated

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.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

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, 2013. Employees earn from 1.25 to 1.75 days of vacation leave per month depending on years of service. The employee or his or her 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, 2013 and 2012, the Lottery had liabilities of \$224,933 and \$204,322 for accrued vacation and \$212,000 and \$187,316 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 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.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

(2) Cash and Investments

Cash and investments reported reflect three types of account balances: the Lottery deposit account, the Lottery prize account, and pooled cash and investments held by the State Treasurer’s Office. 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. Pooled cash and investments are comprised of cash and cash equivalents and short and long-term investments that are managed by the State Treasurer’s Office.

Cash balances consisted of the following:

	June 30	
	2013	2012
On hand and in bank	\$ 1,742,987	2,944,217
Pooled cash and investments	1,755,824	4,006,983
	<u>\$ 3,498,811</u>	<u>6,951,200</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, 2013 and 2012

At June 30, 2013 and 2012, 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, 2013 and 2012, the total bank balance of cash in all bank accounts was \$1,772,120 and \$2,985,415, 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 \$0.2 million as of June 30, 2013) in the event that annuity issuers default on their obligations. Lottery investments as of June 30, 2013 and 2012 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, 2013, 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>
Jefferson-Pilot Life Insurance Company	\$ 78,375	37.40%	a – (excellent)
New York Life Insurance Company	131,202	62.60	aaa – (superior)
Total investments in annuity contracts	\$ <u>209,577</u>	<u>100.00%</u>	

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

(4) Capital Assets

	<u>Beginning balance, July 1, 2012</u>	<u>Increase</u>	<u>Decrease</u>	<u>Ending balance, June 30, 2013</u>
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	<u>1,394,887</u>	<u>—</u>	<u>—</u>	<u>1,394,887</u>
Total capital assets being depreciated, net	<u>\$ —</u>	<u>—</u>	<u>—</u>	<u>—</u>
	<u>Beginning balance, July 1, 2011</u>	<u>Increase</u>	<u>Decrease</u>	<u>Ending balance, June 30, 2012</u>
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	<u>1,394,134</u>	<u>753</u>	<u>—</u>	<u>1,394,887</u>
Total capital assets being depreciated, net	<u>\$ 753</u>	<u>(753)</u>	<u>—</u>	<u>—</u>

During the years ended June 30, 2013 and 2012, the Lottery had no purchases or disposals of capital assets. Depreciation expense for the years ended June 30, 2013 and 2012 was \$0 and \$753, respectively.

(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, 2013 and 2012:

	<u>2013</u>	<u>2012</u>
Prize obligations, beginning of year	\$ 4,572,187	4,740,700
Prize payments	(99,020,587)	(85,817,602)
Prize costs, net of reversions	<u>99,264,072</u>	<u>85,649,089</u>
Prize obligations, end of year	<u>\$ 4,815,672</u>	<u>4,572,187</u>

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

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, 2013, and during the next four years, are as follows:

2014	\$	108,375
2015		30,000
2016		30,000
2017		50,000
		<hr/>
Total payments for unpaid prize installment obligations		218,375
Less imputed interest		<hr/> (8,798)
Present value of prize installment obligations	\$	<hr/> <hr/> 209,577

(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 MUSL has an agreement that grants MUSL the non-exclusive right to offer the multi-jurisdictional lottery game known as the "Mega Millions Game," to be conducted by the MUSL member lotteries.

The amount the Lottery had on deposit with the MUSL, as of June 30, 2013 and 2012, equaled \$2,446,626 and \$2,437,297, respectively. These amounts are also reported as a liability on the 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, 2013 and 2012

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, 2013 and 2012, the Lottery made the following contributions to the State and, as of June 30, 2013 and 2012, had the following liabilities due to the State for excess earnings:

	June 30	
	2013	2012
Amounts transferred during the fiscal year:		
General Fund	\$ 235,300,000	269,000,000
Department of Health and Social Services	1,931,213	2,333,607
Department of Agriculture	40,598,785	49,868,969
	277,829,998	321,202,576
Amounts accrued, beginning of year	(5,579,050)	(1,719,679)
Amounts due to the State of Delaware, end of year:		
General Fund	590,372	4,635,996
Department of Health and Social Services	169,652	193,605
Department of Agriculture	784,917	749,449
	1,544,941	5,579,050
Amounts accrued, end of year	(5,579,050)	(1,719,679)
Total transfers to the State of Delaware	\$ 273,795,889	325,061,947

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

(9) Revenue and Expenses by Game

The following revenue was recognized:

	Year ended June 30	
	2013	2012
Online games:		
Play 3 Day	\$ 9,474,835	9,449,154
Play 3 Night	15,451,429	15,576,353
Play 4 Day	6,975,022	6,715,182
Play 4 Night	12,230,351	11,918,707
Multi Win Lotto	4,249,607	4,519,716
Powerball	29,321,365	20,738,632
Powerplay	4,852,809	4,222,320
Hot Lotto	3,128,775	2,618,800
Mega Millions	7,605,629	11,964,805
Fast Play	—	132,417
Delaware Cash 5	895,666	1,117,434
Keno	2,471,762	—
Instant games	47,451,154	45,712,056
	144,108,404	134,685,576
Video lottery, net	396,775,063	475,729,991
Video lottery expired jackpots and credit slips	365,495	327,050
Casino license fees	3,000,000	10,750,000
Sports lottery	25,422,927	17,846,827
Table games	65,591,850	74,963,837
	\$ 635,263,739	714,303,281

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, 2013:						
Revenue	\$ 96,657,250	396,775,063	47,451,154	25,422,927	65,591,850	631,898,244
Other income	—	3,365,495	—	—	—	3,365,495
Prize costs, net of reversions	48,890,072	—	30,373,383	20,000,617	—	99,264,072
	47,767,178	400,140,558	17,077,771	5,422,310	65,591,850	535,999,667
Commissions expense	6,176,036	159,688,216	2,785,571	1,688,851	43,356,213	213,694,887
Contribution margin per game	\$ 41,591,142	240,452,342	14,292,200	3,733,459	22,235,637	322,304,780
Game vendor fees						33,147,920
Gross profit						289,156,860

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

	<u>Online</u>	<u>Video lottery, net</u>	<u>Instant</u>	<u>Sports lottery</u>	<u>Table games</u>	<u>Total</u>
Year ended June 30, 2012:						
Revenue	\$ 88,973,520	475,729,991	45,712,056	17,846,827	74,963,837	703,226,231
Other income	—	11,077,050	—	—	—	11,077,050
Prize costs, net of reversions	<u>43,477,114</u>	<u>—</u>	<u>29,328,604</u>	<u>12,843,371</u>	<u>—</u>	<u>85,649,089</u>
	45,496,406	486,807,041	16,383,452	5,003,456	74,963,837	628,654,192
Commissions expense	<u>5,703,534</u>	<u>190,984,854</u>	<u>2,683,060</u>	<u>1,669,025</u>	<u>49,551,096</u>	<u>250,591,569</u>
Contribution margin per game	<u>\$ 39,792,872</u>	<u>295,822,187</u>	<u>13,700,392</u>	<u>3,334,431</u>	<u>25,412,741</u>	<u>378,062,623</u>
Game vendor fees						<u>37,637,540</u>
Gross profit						<u>340,425,083</u>

(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 2013 and 2012, the Lottery incurred \$6,292,138 and \$6,173,495, 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, 2013, 2012, and 2011 were \$474,899, \$430,199, and \$376,932, respectively.

The Lottery's accrued pension costs for the years ended June 30, 2013 and 2012 equaled \$46,640 and \$25,408, 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, 2013 and 2012

(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 is a single-employer defined-benefit plan and provides retirement medical coverage to 19,277 pensioners and their eligible dependents through the same healthcare 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 35,571 active eligible plan members. The Lottery has 63 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.

The State's annual OPEB cost is calculated based on the actuarially determined annual required contribution (ARC) of the employer. 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:

	State total	Lottery allocation
	(In millions)	(In thousands)
Net OPEB obligation as of June 30, 2012	\$ 1,581.4	2,221.9
Annual required contribution	397.8	762.3
Interest on net OPEB Obligation	67.5	129.4
Adjustment to required contribution	(61.3)	(117.5)
Net OPEB obligation before contributions	1,985.4	2,996.1
Employer contributions	208.0	398.6
Net OPEB obligation as of June 30, 2013	\$ 1,777.4	2,597.5

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2013 and 2012

	State total	Lottery allocation
	(In millions)	(In thousands)
Net OPEB obligation as of June 30, 2011	\$ 1,272.0	1,662.9
Annual required contribution	490.5	886.2
Interest on net OPEB Obligation	54.4	98.3
Adjustment to required contribution	(49.4)	(89.3)
Net OPEB obligation before contributions	1,767.5	2,558.1
Employer contributions	186.1	336.2
Net OPEB obligation as of June 30, 2012	\$ 1,581.4	2,221.9

The Lottery's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation are as follows:

Fiscal year ended	Annual OPEB cost	Percentage of annual OPEB cost contributed	Net OPEB obligation
06/30/2011	\$ 1,995,700	16.67%	\$ 1,662,868
06/30/2012	2,558,100	13.14	2,221,882
06/30/2013	2,996,100	13.30	2,597,487

(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 5.371% of online sales to its central system provider through February 2015 and 5.6% of instant sales through January 2015. For video lottery, the Lottery is committed to 1% to the central system provider through February 2015 and a range of 5.5% to 7.0% to the video lottery terminal providers through October 28, 2018. For video lottery terminals classified as electronic table games, the Lottery is committed to 10% to Shufflemaster through October 4, 2015 and 11% to Spielo through December 15, 2013, for roulette.



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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***

Vernon Kirk, Director of the Delaware State Lottery, and
Tom Cook, Secretary of Finance, State of Delaware:

We have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the financial statements of the Delaware State Lottery (the Lottery), an enterprise fund of the State of Delaware, as of and for the year ended June 30, 2013 and have issued our report thereon dated November 21, 2013.

Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Lottery's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of Lottery's internal control. Accordingly, we do not express an opinion on the effectiveness of Lottery's internal control.

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

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

Compliance and Other Matters

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



Purpose of this Report

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

KPMG LLP

Philadelphia, Pennsylvania
November 21, 2013