



DELAWARE STATE LOTTERY

Financial Statements

June 30, 2012 and 2011

(With Independent Auditors' Reports Thereon)

DELAWARE STATE LOTTERY

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KPMG LLP
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Independent Auditors' Report

Vernon Kirk, 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) an enterprise fund of the State of Delaware as of June 30, 2012 and 2011, 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 enterprise fund and do not purport to, and do not, present fairly the financial position of the State of Delaware as of June 30, 2012 and 2011, and the changes in its financial position and cash flow 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, 2012 and 2011, 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 October 31, 2012, 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.



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.

KPMG LLP

October 31, 2012

DELAWARE STATE LOTTERY

Management's Discussion and Analysis – Unaudited

June 30, 2012 and 2011

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, 2012 and 2011, 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 changes in net assets shows the result of the Lottery's total operations 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 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.

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Management's Discussion and Analysis – Unaudited

June 30, 2012 and 2011

Condensed Balance Sheets

Table 1
Balance Sheets

(In millions)

Assets	June 30		
	2012	2011	2010
Cash and cash equivalents	\$ 6.9	6.2	16.0
Accounts receivable, net of allowance of \$0.7, \$0.7, and \$0.7, respectively	10.5	5.4	6.3
Investments	0.5	1.1	2.0
Due from State of Delaware	1.7	1.1	—
Capital assets, net	—	—	—
Deposit with Multi-State Lottery	2.4	2.4	2.3
Total assets	<u>\$ 22.0</u>	<u>16.2</u>	<u>26.6</u>
Liabilities and Net Assets			
Liabilities:			
Prizes liability, including \$0.5, \$1.1, and \$2.0, respectively, of prize installment obligation	\$ 4.6	4.7	5.6
Accounts payable and accrued liabilities	6.2	4.7	10.1
Due to the State of Delaware	5.6	1.7	6.5
Multi-State Lottery reserve	2.4	2.4	2.3
OPEB liability	2.2	1.7	1.1
Total liabilities	<u>21.0</u>	<u>15.2</u>	<u>25.6</u>
Net assets:			
Invested in capital assets	—	—	—
Unrestricted	1.0	1.0	1.0
Total net assets	<u>1.0</u>	<u>1.0</u>	<u>1.0</u>
Total liabilities and net assets	<u>\$ 22.0</u>	<u>16.2</u>	<u>26.6</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 three in 2010, four in 2011, and six in 2012. Correspondingly, the additional days in 2012 are reflected in the additional accounts receivable and accounts payable and accrued liabilities.

The cash balance in fiscal 2010 was unusually high when compared to the cash balance in fiscal 2011. This was due to transactions that occurred in the last accounting period of fiscal 2010, and the ending date of that accounting period in relation to June 30, 2010. For the accounting period June 21 – 27, 2010, the amount of net proceeds from video lottery machines was credited to the Lottery's bank account on June 30, 2010, while the

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portion of net proceeds designated for distribution as purses and commissions, recorded in accounts payable, did not occur until July 1, 2010.

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.

Revenue

Table 2
Revenue
(In millions)

	Year ended June 30		
	2012	2011	2010
Play 3	\$ 25.0	25.3	25.9
Play 4	18.7	17.9	17.8
Multi Win Lotto	4.5	5.0	5.6
Powerball	20.8	16.3	26.2
Powerplay	4.2	4.1	3.7
Hot Lotto	2.6	3.3	3.8
Mega Millions	12.0	9.9	3.3
Fastplay	0.1	0.4	0.7
Delaware Cash 5	1.1	0.7	—
Instant games	45.7	40.9	36.0
Traditional games revenue	134.7	123.8	123.0
Video lottery, net	475.7	499.5	547.7
Video lottery machine license fees	—	0.2	0.5
Video lottery expired jackpots and credit slips	0.3	0.4	0.4
Casino license fees	10.8	17.5	4.0
Sports lottery	17.8	12.9	10.8
Table games, net	75.0	74.2	3.0
Total revenue	\$ 714.3	728.5	689.4

Table 2 above compares revenue for each lottery game category. Total lottery revenue for fiscal 2012 was \$14.2 million, or 2.0% lower than for 2011 and revenue for fiscal 2011 was \$39.1 million, or 5.7%, higher than for fiscal 2010.

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There was a \$23.8 million, or 4.8%, decline in video lottery revenues from 2011 to 2012 and a \$48.2 million, or 8.8% decline from 2010 to 2011. This was mainly due to increased competition from casinos operating in Maryland and Pennsylvania.

The table games revenue was \$71.2 million higher in fiscal 2011 as compared to fiscal 2010. This was due to a full year of table games operations in 2011 as compared to a partial year of operations in fiscal 2010.

Mega Millions sales are typically 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. Powerball sales are also driven by the size of the jackpot. Sales for this game increased in 2012 as higher jackpot levels were attained.

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 U.S. 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					
	2012		2011		2010	
Commission expense	\$ 250.6	35.1%	\$ 259.7	35.6%	\$ 230.9	33.5%
Gaming vendor fees and costs	37.6	5.3	38.0	5.2	40.4	5.9
Prize expense	85.6	12.0	75.8	10.4	72.5	10.5
Total cost of games	\$ 373.8		\$ 373.5		\$ 343.8	

Commission expense includes payments to lottery retailers for selling lottery tickets and to the casinos for the operation of video lottery, sports lottery, and table game facilities. Commission expense as a percentage of sales remained relatively unchanged from 2011 to 2012. During 2011, the commission expense increased by \$28.8 million, or 12.5%, over 2010. The reason for this is that, during 2011, the table games had a full year of operation at the casinos, and the commission for table games is 66.1% of revenue, which is higher than commissions on other games.

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

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terminals from gaming vendors. Gaming vendor fees and costs as a percentage of sales remained relatively unchanged from 2011 to 2012. Gaming vendor fees and costs as a percent of sales decreased 0.7% from 2010 to 2011 due to a similar decrease in video lottery revenue.

Prize Expense, Net of Reversions

Table 4

Prize Expense, Net of Reversions

(In millions)

	Year ended June 30		
	2012	2011	2010
Play 3	\$ 12.0	12.9	12.2
Play 4	9.3	8.7	8.2
Multi Win Lotto	2.8	2.8	3.3
Powerball	11.0	8.7	13.1
Powerplay	0.8	1.0	1.3
Hot Lotto	0.9	1.6	1.8
Mega Millions	6.1	5.1	1.7
Fastplay	0.1	0.2	0.4
Delaware Cash 5	0.5	0.4	—
Sports lottery	12.8	7.8	7.3
Instant games	29.3	26.6	23.2
Total prize expense	\$ 85.6	75.8	72.5

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 2012 compared to 2011, and 2011 compared to 2010 is commensurate with the increases and decreases in traditional lottery sales during the same periods. The increase in prize expense from 2011 to 2012 is due to higher sales on instant games and sports lottery. Also contributing to the increase in prize costs during 2012 was higher sales for Mega Millions and Powerball games. The increase in prize expense from 2010 to 2011 is due to higher sales on instant games.

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Operating Expenses

Table 5

Operating Expenses

(In millions)

	Year ended June 30		
	2012	2011	2010
Operating expenses	\$ 11.4	11.1	9.6

Operating expenses remained relatively unchanged from 2011 to 2012. The main reason for the \$1.5 million increase in operating costs from 2010 to 2011 was due to an increase in payroll and related benefits costs incurred relating to the table games personnel at the casinos.

Nonoperating Expenses

Table 6

Nonoperating Expenses

(In millions)

	Year ended June 30		
	2012	2011	2010
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	325.1	339.9	331.6
Total nonoperating expenses	\$ 329.1	343.9	335.6

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

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Balance Sheets

June 30, 2012 and 2011

Assets	2012	2011
Current assets:		
Cash and cash equivalents	\$ 6,951,200	6,184,429
Accounts receivable, net of allowance of \$733,877 and \$733,877, respectively	10,508,174	5,415,057
Investments – restricted for payment of prize liabilities	273,125	666,625
Due from State of Delaware	1,662,868	1,086,889
Total current assets	19,395,367	13,353,000
Noncurrent assets:		
Capital assets, net	—	753
Investments – restricted for payment of prize liabilities	207,191	448,259
Deposit with Multi-State Lottery	2,437,297	2,396,387
Total noncurrent assets	2,644,488	2,845,399
Total assets	\$ 22,039,855	16,198,399
Liabilities and Net Assets		
Current liabilities:		
Prizes liability, including \$273,125 and \$666,625, respectively, of prize installment obligations	\$ 4,364,996	4,292,441
Accounts payable and accrued liabilities	6,229,439	4,678,765
Due to the State of Delaware	5,579,050	1,719,679
Total current liabilities	16,173,485	10,690,885
Noncurrent liabilities:		
Multi-State Lottery reserve	2,437,297	2,396,387
Prize installment obligations, noncurrent	207,191	448,259
OPEB liability	2,221,882	1,662,868
Total liabilities	21,039,855	15,198,399
Net assets:		
Invested in capital assets	—	753
Unrestricted	1,000,000	999,247
Total net assets	1,000,000	1,000,000
Total liabilities and net assets	\$ 22,039,855	16,198,399

See accompanying notes to financial statements.

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Statements of Revenue, Expenses, and Changes in Net Assets

Years ended June 30, 2012 and 2011

	2012	2011
Revenue:		
Video lottery, net	\$ 475,729,991	499,457,285
Video lottery machine license fees	—	161,700
Video lottery expired jackpots and credit slips	327,050	371,830
Casino license fees	10,750,000	17,500,000
Sports lottery	17,846,827	12,910,308
Table games	74,963,837	74,165,548
Online games	88,973,520	83,082,950
Instant games	45,712,056	40,856,406
Total revenue	714,303,281	728,506,027
Cost of games:		
Video lottery commissions	190,984,854	201,430,519
Prize costs, net of reversions	85,649,089	75,846,095
Gaming vendor fees and costs	37,637,540	38,007,015
Online and instant games commissions	8,386,594	7,466,047
Sports lottery commissions	1,669,025	1,782,610
Table games commissions	49,551,096	49,023,428
Total cost of games	373,878,198	373,555,714
Gross profit	340,425,083	354,950,313
Operating expenses:		
Advertising and promotions	2,860,010	2,376,409
Payroll and related benefits	6,173,495	6,032,883
Other general and administrative	2,328,878	2,643,771
Depreciation expense	753	1,507
Total operating expenses	11,363,136	11,054,570
Operating income	329,061,947	343,895,743
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	325,061,947	339,895,743
Change in net assets	—	—
Net assets at beginning of year	1,000,000	1,000,000
Net assets 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, 2012 and 2011

	2012	2011
Cash flows from operating activities:		
Receipts from customers	\$ 709,210,164	729,305,754
Payments to vendors for goods and services	(43,178,056)	(43,326,353)
Payments to employees for services	(5,772,052)	(5,454,050)
Payments for prizes	(85,817,602)	(76,717,909)
Payments for commissions	(248,531,696)	(264,789,767)
	<u>325,910,758</u>	<u>339,017,675</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	(321,778,555)	(345,773,135)
	<u>(325,778,555)</u>	<u>(349,773,135)</u>
Cash flows from investing activity:		
Proceeds from maturity of investments	634,568	901,561
	<u>634,568</u>	<u>901,561</u>
Net cash provided by investing activity	634,568	901,561
	<u>634,568</u>	<u>901,561</u>
Net increase (decrease) in cash and cash equivalents	766,771	(9,853,899)
Cash and cash equivalents at beginning of year	6,184,429	16,038,328
Cash and cash equivalents at end of year	\$ 6,951,200	6,184,429
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 329,061,947	343,895,743
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense	753	1,507
Changes in operating assets and liabilities:		
Accounts receivable, net	(5,093,117)	799,726
Deposit with Multi-State Lottery	(40,910)	(104,273)
Prizes liability	(168,513)	(871,814)
Accounts payable and accrued liabilities	2,150,598	(4,703,214)
	<u>325,910,758</u>	<u>339,017,675</u>

See accompanying notes to financial statements.

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Notes to Financial Statements

June 30, 2012 and 2011

(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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Notes to Financial Statements

June 30, 2012 and 2011

(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.

	2012	2011
Receivables:		
Accounts	\$ 11,242,051	6,148,934
Total receivables	11,242,051	6,148,934
Allowance for doubtful accounts	(733,877)	(733,877)
Total receivables, net	\$ 10,508,174	5,415,057
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

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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, 2012. Employees earn from 1.25 to 1.75 days of vacation leave per month depending on years of service. The employee or their 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, 2012 and 2011, the Lottery had liabilities of \$204,322 and \$178,666 for accrued vacation and \$187,316 and \$176,905 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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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 and Cash Equivalents

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:

	June 30	
	2012	2011
On hand and in bank	\$ 2,944,217	4,378,929
Held by the State Treasurer	4,006,983	1,805,500
	\$ 6,951,200	6,184,429

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, 2012 and 2011

At June 30, 2012 and 2011, 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, 2012 and 2011, the total bank balance of cash in all bank accounts was \$2,985,415 and \$4,408,368, 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 \$0.5 million as of June 30, 2012) in the event that annuity issuers default on their obligations. Lottery investments as of June 30, 2012 and 2011 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, 2012, 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	\$ 19,000	3.96%	a – (excellent)
Jefferson-Pilot Life Insurance Company	223,072	46.44	nr – (not rated)
Metropolitan Life Insurance Company	26,125	5.44	aa – (superior)
New York Life Insurance Company	169,369	35.26	aaa – (superior)
Ohio National Life Insurance Company	42,750	8.90	aa – (superior)
Total investments in annuity contracts	\$ <u>480,316</u>	<u>100.00%</u>	

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2012 and 2011

(4) Capital Assets

	<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>1,394,887</u>
Total capital assets being depreciated, net	\$ <u>753</u>	<u>(753)</u>	—	<u>—</u>

	<u>Beginning balance, July 1, 2010</u>	<u>Increase</u>	<u>Decrease</u>	<u>Ending balance, June 30, 2011</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>1,392,627</u>	<u>1,507</u>	—	<u>1,394,134</u>
Total capital assets being depreciated, net	\$ <u>2,260</u>	<u>(1,507)</u>	—	<u>753</u>

During the years ended June 30, 2012 and 2011, the Lottery had no purchases or disposals of capital assets. Depreciation expense for the years ended June 30, 2012 and 2011 was \$753 and \$1,507, 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, 2012 and 2011:

	<u>2012</u>	<u>2011</u>
Prize obligations, beginning of year	\$ 4,740,700	5,612,514
Prize payments	(85,817,602)	(76,717,909)
Prize costs, net of reversions	<u>85,649,089</u>	<u>75,846,095</u>
Prize obligations, end of year	\$ <u>4,572,187</u>	<u>4,740,700</u>

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2012 and 2011

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, 2012, and during the next five years, are as follows:

2013	\$	273,125
2014		108,375
2015		30,000
2016		30,000
2017		<u>50,000</u>
Total payments for unpaid prize installment obligations		491,500
Less imputed interest		<u>(11,184)</u>
Present value of prize installment obligations	\$	<u><u>480,316</u></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, 2012 and 2011, equaled \$2,437,297 and \$2,396,387, 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 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.

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2012 and 2011

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, 2012 and 2011, the Lottery made the following contributions to the State and, as of June 30, 2012 and 2011, had the following liabilities due to the State for excess earnings:

	June 30	
	2012	2011
Amounts transferred during the fiscal year:		
General Fund	\$ 269,000,000	287,000,000
Department of Health and Social Services	2,333,607	2,365,785
Department of Agriculture	49,868,969	55,320,461
	<u>321,202,576</u>	<u>344,686,246</u>
Amounts accrued, beginning of year	(1,719,679)	(6,510,182)
Amounts due to the State of Delaware, end of year:		
General Fund	4,635,996	(137,048)
Department of Health and Social Services	193,605	235,667
Department of Agriculture	749,449	1,621,060
	<u>5,579,050</u>	<u>1,719,679</u>
Amounts accrued, end of year	5,579,050	1,719,679
Total transfers to the State of Delaware	<u>\$ 325,061,947</u>	<u>339,895,743</u>

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2012 and 2011

(9) Revenue and Expenses by Game

The following revenue was recognized:

	Year ended June 30	
	2012	2011
Online games:		
Play 3 Day	\$ 9,449,154	9,509,595
Play 3 Night	15,576,353	15,880,491
Play 4 Day	6,715,182	6,428,114
Play 4 Night	11,918,707	11,612,129
Multi Win Lotto	4,519,716	4,996,528
Powerball	20,738,632	16,269,850
Powerplay	4,222,320	4,127,878
Hot Lotto	2,618,800	3,346,262
Mega Millions	11,964,805	9,876,274
Fast Play	132,417	384,533
Delaware Cash 5	1,117,434	651,296
Instant games	45,712,056	40,856,406
	134,685,576	123,939,356
Video lottery, net	475,729,991	499,457,285
Video lottery machine license fees	—	161,700
Video lottery expired jackpots and credit slips	327,050	371,830
Casino license fees	10,750,000	17,500,000
Sports lottery	17,846,827	12,910,308
Table games	74,963,837	74,165,548
	\$ 714,303,281	728,506,027

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, 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	43,477,114	—	29,328,604	12,843,371	—	85,649,089
	45,496,406	486,807,041	16,383,452	5,003,456	74,963,837	628,654,192
Commissions expense	5,703,534	190,984,854	2,683,060	1,669,025	49,551,096	250,591,569
Contribution margin per game	\$ 39,792,872	295,822,187	13,700,392	3,334,431	25,412,741	378,062,623

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2012 and 2011

	<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, 2011:						
Revenue	\$ 83,082,950	499,457,285	40,856,406	12,910,308	74,165,548	710,472,497
Other income	—	18,033,530	—	—	—	18,033,530
Prize costs, net of reversions	<u>41,519,028</u>	<u>—</u>	<u>26,517,996</u>	<u>7,809,071</u>	<u>—</u>	<u>75,846,095</u>
	41,563,922	517,490,815	14,338,410	5,101,237	74,165,548	652,659,932
Commissions expense	<u>5,055,602</u>	<u>201,430,519</u>	<u>2,410,445</u>	<u>1,782,610</u>	<u>49,023,428</u>	<u>259,702,604</u>
Contribution margin per game	<u>\$ 36,508,320</u>	<u>316,060,296</u>	<u>11,927,965</u>	<u>3,318,627</u>	<u>25,142,120</u>	<u>392,957,328</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 2012 and 2011, the Lottery incurred \$6,173,495 and \$6,032,883, 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, 2012, 2011, and 2010 were \$430,199, \$376,932, and \$219,717, respectively.

The Lottery's accrued pension costs for the years ended June 30, 2012 and 2011 equaled \$25,408 and \$32,446, respectively, and are included within amounts reported as accounts payable and accrued liabilities on the balance sheets.

(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

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2012 and 2011

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 19,530 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 36,154 active eligible plan members. The Lottery has 59 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 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:

	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

DELAWARE STATE LOTTERY

Notes to Financial Statements

June 30, 2012 and 2011

	State total	Lottery allocation
	(In millions)	(In thousands)
Net OPEB obligation as of June 30, 2010	\$ 956.5	1,086.9
Annual required contribution	488.1	891.1
Interest on net OPEB Obligation	48.2	88.0
Adjustment to required contribution	<u>(38.5)</u>	<u>(70.3)</u>
Net OPEB obligation before contributions	1,454.3	1,995.7
Employer contributions	<u>182.3</u>	<u>332.8</u>
Net OPEB obligation as of June 30, 2011	\$ <u>1,272.0</u>	<u>1,662.9</u>

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

<u>Fiscal year ended</u>	<u>Annual OPEB cost</u>	<u>Percentage of annual OPEB cost contributed</u>	<u>Net OPEB obligation</u>
06/30/2012	\$ 2,558,100	13.14%	\$ 2,221,882
06/30/2011	1,995,700	16.67	1,662,868
06/30/2010	1,376,000	21.00	1,086,889

(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 5% to the video lottery terminal providers through June 1, 2013.



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**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 the financial statements of the Delaware State Lottery (the Lottery) as of and for the year ended June 30, 2012, and have issued our report thereon dated October 31, 2012, 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

Management of the Lottery is responsible for establishing and maintaining effective 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 our 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 was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the 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*.



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

October 31, 2012