



**CALIFORNIA STATE LOTTERY FUND**

Financial Statements

June 30, 2010

(With Independent Auditors' Report Thereon)



KPMG LLP  
Suite 800  
400 Capitol Mall  
Sacramento, CA 95814

## Independent Auditors' Report

The California State Lottery Commission  
Sacramento, California:

We have audited the accompanying statement of net assets of the California State Lottery Fund as of June 30, 2010, and the related statements of revenues, expenses, and changes in net assets and cash flows for the year 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. 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 audit provides a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only the California State Lottery Fund and do not purport to, and do not, present fairly the financial position of the State of California, as of June 30, 2010, the changes in its financial position or its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the California State Lottery Fund as of June 30, 2010, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 2 through 8 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

**KPMG LLP**

October 20, 2010

## MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and analysis of the California State Lottery's financial performance provides an overview of financial activities for the fiscal year ended June 30, 2010. Please read it in conjunction with the California State Lottery Financial Statements that follow this section.

### FINANCIAL HIGHLIGHTS

The assets of the Lottery exceeded its liabilities at the close of the most recent fiscal year by \$125.9 million, which is attributable primarily to realized and unrealized gains on Lottery investments used to fund future payments due on annuitized Lottery prizes.

- Sales for the 2009/2010 fiscal year were more than \$3 billion, marking the first increase in sales in four years. For the tenth consecutive year the California Lottery will transfer more than \$1 billion to California's public schools. Players and retailers benefited, too, as the Lottery paid out more than \$1.6 billion in prizes to players and \$214.5 million in commissions, cashing bonuses and other applicable fees to retailers.
- The California Lottery enlisted the Camelot Group - the company that runs the UK's National Lottery - to assist in the most ambitious and rigorous business planning and implementation process in the Lottery's history. This effort, called RENEW, along with a new Enterprise Project Management Office (EPMO), developed projects that will help increase funds for education as the California Lottery celebrates its 25th anniversary in October 2010. The business plan is analyzing existing jackpot games and identifying alternative games; streamlining Scratchers® ticket production and distribution to maximize sales; and identifying retailer segments to improve sales. The RENEW effort led to the successful revival of the "Imagine What A Buck Can Do" advertising campaign in Los Angeles and San Francisco during recent high MEGA Millions® jackpots.
- On April 8, 2010, the California State Lottery Act was amended by Assembly Bill (AB) 142 in order to further the Lottery's ability to maximize funding to public schools and colleges. Under AB 142 beginning with the 2010/2011 fiscal year, the Lottery will be required to return not less than 87 percent of revenues to the public in the form of prizes and contributions to education, and to spend no more than 13 percent of revenues on operating expenses of the Lottery. Prior to the amendment the Lottery Act mandated that, as nearly as practical, 50 percent of the total annual revenue from Lottery sales be returned to the public in the form of prizes. The California Lottery anticipates that offering higher prize payouts will increase sales and revenues to public schools and colleges.
- Construction is underway on a new headquarters building for the California Lottery. A contract has been awarded to Otto Construction for approximately \$54 million dollars to build the six-story building on the current Lottery headquarters site. The new headquarters will be an environmentally responsible, or green, building. Construction is expected to be completed in the summer or fall of 2011.

## OVERVIEW OF THE FINANCIAL STATEMENTS

These required statements offer short-term and long-term financial information about the California State Lottery. The Statement of Net Assets provides information about the nature and amounts of investments in resources (assets) and obligations (liabilities) at the close of the fiscal year. All of the current year's revenues and expenses are accounted for in the Statement of Revenues, Expenses, and Changes in Net Assets. This statement measures the success of the Lottery's operations over the past year. The final required financial statement is the Statement of Cash Flows. The primary purpose of this statement is to provide information about the Lottery's cash receipts and cash payments during the reporting period. The statement reports cash receipts, cash payments, and net changes in cash resulting from operations, investing, and financing activities, and provides answers to such questions as where did cash come from and what was cash used for. The financial statements are prepared on the accrual basis in accordance with accounting principles generally accepted in the United States of America. The California State Lottery is structured as a single enterprise fund with revenues recognized when earned, not when received.

## NOTES TO THE FINANCIAL STATEMENTS

Financial statement notes provide additional information that is essential to a full understanding of the information provided in the statements. Please refer to the following notes:

- Note 1 - provides a general description of significant accounting policies of the California State Lottery including the implementation of new accounting pronouncements, investment accounting policies, and other significant accounting policies
- Note 2 - provides information about investments and deposits including the Lottery's investment policy, risk mitigation and investment and deposit valuation
- Note 3 - provides information on accounts receivable
- Note 4 - provides information on money due to the Lottery from other state funds
- Note 5 - provides information on capital assets of the Lottery
- Note 6 - provides information on the Lottery's liability to prize winners
- Note 7 - provides information on money owed by the Lottery to other state funds, primarily to the Education Fund
- Note 8 - provides information on the operating leases of the Lottery
- Note 9 - provides information on the Lottery's investment earnings
- Note 10 - provides information on the retirement plan for Lottery employees and on Other Postemployment Benefits (OPEB)
- Note 11 - provides information on statutory compliance with the Lottery Act
- Note 12 - provides information on commitments and contingencies of the Lottery
- Note 13 - provides information on risk management

## FINANCIAL ANALYSIS

### NET ASSETS

A summary of the California State Lottery's net assets is presented below:

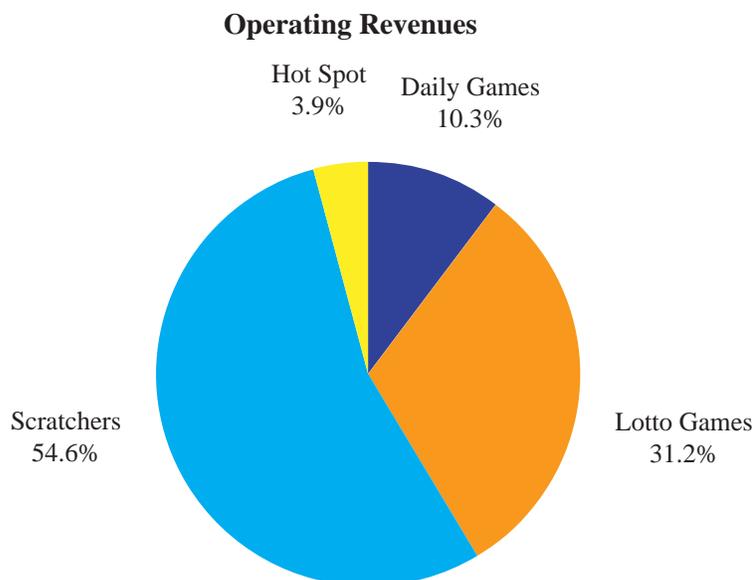
|                            | <u>June 30, 2009</u>    | <u>June 30, 2010</u>    | <u>Dollar Change</u>    | <u>Percent Change</u> |
|----------------------------|-------------------------|-------------------------|-------------------------|-----------------------|
| Current and other assets   | \$ 1,993,002,768        | \$ 1,883,682,961        | \$ (109,319,807)        | (5.5%)                |
| Capital assets             | 45,366,173              | 42,511,326              | (2,854,847)             | (6.3%)                |
| Total assets               | <u>\$ 2,038,368,941</u> | <u>\$ 1,926,194,287</u> | <u>\$ (112,174,654)</u> | <u>(5.5%)</u>         |
| Current liabilities        | \$ 791,914,833          | \$ 789,943,542          | \$ (1,971,291)          | (0.2%)                |
| Long-term liability        | 1,099,416,055           | 1,010,400,578           | (89,015,477)            | (8.1%)                |
| Total liabilities          | <u>\$ 1,891,330,888</u> | <u>\$ 1,800,344,120</u> | <u>\$ (90,986,768)</u>  | <u>(4.8%)</u>         |
| Invested in capital assets | \$ 45,366,173           | \$ 42,511,326           | \$ (2,854,847)          | (6.3%)                |
| Restricted by legislation  | 147,038,053             | 125,850,167             | (21,187,886)            | (14.4%)               |
| Unrestricted (deficit)     | (45,366,173)            | (42,511,326)            | 2,854,847               | (6.3%)                |
| Total net assets           | <u>\$ 147,038,053</u>   | <u>\$ 125,850,167</u>   | <u>\$ (21,187,886)</u>  | <u>(14.4%)</u>        |

A summary of the California State Lottery's change in net assets is presented below:

|                                      | <u>June 30, 2009</u>    | <u>June 30, 2010</u>    | <u>Dollar Change</u>   | <u>Percent Change</u> |
|--------------------------------------|-------------------------|-------------------------|------------------------|-----------------------|
| Operating revenues – Lottery sales   | \$ 2,954,839,094        | \$ 3,040,959,866        | \$ 86,120,772          | 2.9%                  |
| Prizes                               | 1,556,120,634           | 1,611,371,074           | 55,250,440             | 3.6%                  |
| Sales after prizes                   | <u>\$ 1,398,718,460</u> | <u>\$ 1,429,588,792</u> | <u>\$ 30,870,332</u>   | <u>2.2%</u>           |
| Game costs                           | 259,010,134             | 268,683,202             | 9,673,068              | 3.7%                  |
| Income before operating expenses     | <u>\$ 1,139,708,326</u> | <u>\$ 1,160,905,590</u> | <u>\$ 21,197,264</u>   | <u>1.9%</u>           |
| Operating expenses                   | 137,180,433             | 136,740,073             | (440,360)              | (0.3%)                |
| Operating income                     | <u>\$ 1,002,527,893</u> | <u>\$ 1,024,165,517</u> | <u>\$ 21,637,624</u>   | <u>2.2%</u>           |
| Non-operating (expenses) revenues    | (1,020,572,919)         | (1,045,353,403)         | (24,780,484)           | 2.4%                  |
| Change in net assets                 | <u>\$ (18,045,026)</u>  | <u>\$ (21,187,886)</u>  | <u>\$ (3,142,860)</u>  | <u>17.4%</u>          |
| Total net assets – beginning of year | 165,083,079             | 147,038,053             | (18,045,026)           | (10.9%)               |
| Total net assets – end of year       | <u>\$ 147,038,053</u>   | <u>\$ 125,850,167</u>   | <u>\$ (21,187,886)</u> | <u>(14.4%)</u>        |

## REVENUES

The following chart shows the major sources and the percentages of operating revenues for the fiscal year ended June 30, 2010:



A summary of total revenues for the fiscal years ended June 30, 2009 and 2010, and the amount and percentage of change in relation to prior year amounts is as follows:

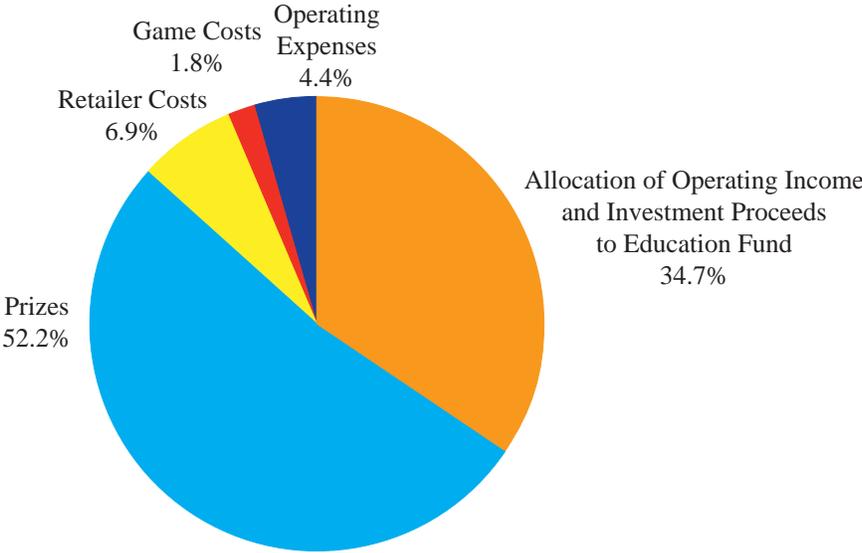
|   | June 30, 2009           | June 30, 2010           | Dollar Change        | Percent Change |
|---|-------------------------|-------------------------|----------------------|----------------|
| <b>Operating revenues:</b>                |                         |                         |                      |                |
| Lotto games                               | \$ 883,844,967          | \$ 947,769,847          | \$ 63,924,880        | 7.2%           |
| Scratchers <sup>®</sup> games             | 1,615,369,207           | 1,661,288,086           | 45,918,879           | 2.8%           |
| Hot Spot <sup>®</sup> game                | 126,361,926             | 117,904,491             | (8,457,435)          | (6.7%)         |
| Daily games                               | 329,262,994             | 313,997,442             | (15,265,552)         | (4.6%)         |
|   | -                       | -                       |                      |                |
| <b>Total operating revenues</b>           | <u>\$ 2,954,839,094</u> | <u>\$ 3,040,959,866</u> | <u>\$ 86,120,772</u> | <u>2.9%</u>    |
| <b>Non-operating revenues:</b>            |                         |                         |                      |                |
| Unrealized gains (losses) on investments  | \$ (966,174)            | \$ 42,593,853           | \$ 43,560,027        | (4,508.5%)     |
| Interest accreted/earned on investments   | \$ 88,377,841           | \$ 58,625,052           | \$ (29,752,789)      | (33.7%)        |
| Interest on funds held by State Treasurer | 8,660,794               | 2,732,562               | (5,928,232)          | (68.4%)        |
| Other income                              | 408,089                 | 347,694                 | (60,395)             | (14.8%)        |
| <b>Total non-operating revenues</b>       | <u>\$ 96,480,550</u>    | <u>\$ 104,299,161</u>   | <u>\$ 7,818,611</u>  | <u>8.1%</u>    |
| <b>Total revenues</b>                     | <u>\$ 3,051,319,644</u> | <u>\$ 3,145,259,027</u> | <u>\$ 93,939,383</u> | <u>3.1%</u>    |

The increase in Lotto revenue is primarily attributable to higher jackpot levels for MEGA Millions. Six jackpots over \$200 million including one for \$336 million occurred during the 2009/2010 fiscal year. California Lottery players won two of these jackpots including sharing the \$336 million jackpot. In 2008/2009 there were only three MEGA Millions jackpots that exceeded \$200 million. Scratchers games also saw significant sales increases due to higher prize payouts and the RENEW effort to optimize ticket placement. Scratchers game sales are reviewed weekly and more popular tickets replace those not selling well. Non-operating revenue was higher due primarily to an increase in the fair value of investments offset by a decrease in interest accreted/earned on investments due to the restructuring of the Lottery’s investment portfolio. Interest on funds in the Surplus Money Investment Fund (SMIF) continued to decline due to lower market interest rates resulting from the economic downturn.

**EXPENSES**

The following chart shows prizes, game costs, operating expenses and allocations as a percentage of operating revenues for the fiscal year ended June 30, 2010:

**Prizes, Game Costs, Operating Expenses and Allocations  
as a Percentage of Operating Revenues and Investment Proceeds**



See Note 11 of the accompanying financial statements for more information on expenses as a percentage of revenues and investment proceeds.

A summary of expenses for the fiscal years ended June 30, 2009 and 2010, and the amount and percentage change in relation to prior year amounts is as follows:

|   | June 30, 2009                  | June 30, 2010                  | Dollar Change               | Percent Change     |
|---|--------------------------------|--------------------------------|-----------------------------|--------------------|
| <b>Prizes:</b>                                    |                                |                                |                             |                    |
| Draw game prizes                                  | \$ 646,778,087                 | \$ 674,624,512                 | \$ 27,846,425               | 4.3%               |
| Scratchers game prizes                            | 892,436,016                    | 923,604,176                    | 31,168,160                  | 3.5%               |
| TV Show   | 16,906,531                     | 13,142,386                     | (3,764,145)                 | (22.3%)            |
| Total prizes                                      | <u>\$ 1,556,120,634</u>        | <u>\$ 1,611,371,074</u>        | <u>\$ 55,250,440</u>        | <u>3.6%</u>        |
| <b>Game costs:</b>                                |                                |                                |                             |                    |
| Retailer costs                                    | \$ 208,105,703                 | \$ 214,484,059                 | \$ 6,378,356                | 3.1%               |
| Draw/Scratchers game costs                        | 50,904,431                     | 54,199,143                     | 3,294,712                   | 6.5%               |
| Total game costs                                  | <u>\$ 259,010,134</u>          | <u>\$ 268,683,202</u>          | <u>\$ 9,673,068</u>         | <u>3.7%</u>        |
| <b>Operating expenses:</b>                        |                                |                                |                             |                    |
| Salaries, wages, and benefits                     | \$ 49,167,678                  | \$ 46,011,332                  | \$ (3,156,346)              | (6.4%)             |
| Advertising                                       | 42,184,700                     | 33,666,684                     | (8,518,016)                 | (20.2%)            |
| Promotion, public relations, and<br>point of sale | 14,064,197                     | 8,025,477                      | (6,038,720)                 | (42.9%)            |
| Other professional services                       | 7,449,016                      | 10,341,565                     | 2,892,549                   | 38.8%              |
| Depreciation and amortization                     | 12,965,067                     | 20,417,236                     | 7,452,169                   | 57.5%              |
| Other general and administrative<br>expenses      | 11,349,775                     | 18,277,779                     | 6,928,004                   | 61.0%              |
| Total operating expenses                          | <u>\$ 137,180,433</u>          | <u>\$ 136,740,073</u>          | <u>\$ (440,360)</u>         | <u>(0.3%)</u>      |
| <b>Non-operating expenses:</b>                    |                                |                                |                             |                    |
| Allocations to Education Fund                     | 1,027,728,959                  | 1,072,496,752                  | 44,767,793                  | 4.4%               |
| Interest imputed on annuitized<br>prize liability | 89,324,510                     | 77,155,812                     | (12,168,698)                | (13.6%)            |
| Total non-operating expenses                      | <u>\$ 1,117,053,469</u>        | <u>\$ 1,149,652,564</u>        | <u>\$ 32,599,095</u>        | <u>2.9%</u>        |
| <b>Total expenses</b>                             | <u><u>\$ 3,069,364,670</u></u> | <u><u>\$ 3,166,446,913</u></u> | <u><u>\$ 97,082,243</u></u> | <u><u>3.2%</u></u> |

The increase in draw game prizes was directly related to more MEGA Millions jackpots over \$200 million. At year end, the Lottery discontinued the television show Make Me a Millionaire because the show did not meet the RENEW project's required return on investment criteria for marketing and sales expenses. In 2008/2009 increases to the advertising and the promotion, public relations and point of sale expenses related to the launch of Make Me a Millionaire. Radio, television spots, in-store POS, ePOS, ticket messages, monitor messages, mall screens and outdoor billboards were used in the campaign. As these expenses were much higher last year, this year's expenses were much lower in comparison. The increase in other general and administrative expenses is due to a legal contingency. Other professional services reflects an increase in consultant contracts related to the RENEW initiative. The increase in depreciation expense and amortization is related to the write off of the Make Me a Millionaire sets and equipment, and the impairment of the current Lottery headquarters building.

## CAPITAL ASSETS

A summary of capital assets as of June 30, 2009 and 2010, and the amount and percentage of change in relation to prior year amounts is as follows:

|                                  | <u>June 30, 2009</u> | <u>June 30, 2010</u> | <u>Dollar Change</u>  | <u>Percent Change</u> |
|----------------------------------|----------------------|----------------------|-----------------------|-----------------------|
| Non-depreciable capital assets:  |                      |                      |                       |                       |
| Land                             | \$ 6,469,219         | \$ 6,469,219         | \$ -                  | 0.0%                  |
| Depreciable capital assets:      |                      |                      |                       |                       |
| Gaming equipment                 | \$ 17,618,574        | \$ 17,813,582        | \$ 195,008            | 1.1%                  |
| Vending machines                 | 34,243,343           | 34,243,343           | -                     | 0.0%                  |
| Buildings                        | 33,495,301           | 24,082,716           | (9,412,585)           | (28.1%)               |
| Data processing equipment        | 8,958,050            | 9,019,032            | 60,982                | 0.7%                  |
| Office furniture and equipment   | 8,421,870            | 8,468,599            | 46,729                | 0.6%                  |
| Leasehold improvements           | 1,134,372            | 810,558              | (323,814)             | (28.5%)               |
| Other                            | 6,998,851            | 6,725,850            | (273,001)             | (3.9%)                |
| Subtotal                         | \$ 110,870,361       | \$ 101,163,680       | \$ (9,706,681)        | (8.8%)                |
| Less accumulated depreciation    | <u>(71,973,407)</u>  | <u>(65,121,573)</u>  | <u>6,851,834</u>      | <u>(9.5%)</u>         |
| Total depreciable capital assets | \$ 38,896,954        | \$ 36,042,107        | \$ (2,854,847)        | (7.3%)                |
| Capital assets, net              | <u>\$ 45,366,173</u> | <u>\$ 42,511,326</u> | <u>\$ (2,854,847)</u> | <u>(6.3%)</u>         |

The activity in the buildings account was due primarily to the addition of \$15.7 million related to the construction of a new building offset by approximately \$8.6 million of impairment and \$16.5 million of write offs of accumulated depreciation against building costs. More information on the Lottery's capital assets can be found in Note 5.

## LONG - TERM DEBT

At June 30, 2010, the California State Lottery had over \$1.01 billion in non-current liabilities versus approximately \$1.10 billion last year, a decrease of 8.1 percent. Most of the change is attributable to lotto game prize liability as the majority of SuperLOTTO Plus<sup>®</sup> and MEGA Millions jackpot winners now choose the cash option rather than annuitized payments. In addition, nearly \$5.2 million was accrued for the Net OPEB Obligation (NOO) as required by Statement No. 45 of the Governmental Accounting Standards Board, bringing the total accrued OPEB liability to \$14.8 million as of June 30, 2010. Additional detailed information on long-term prize liability may be found in Note 6 and additional information on the NOO may be found in Note 10.

## CONTACTING THE LOTTERY'S FINANCIAL MANAGER

This financial report is designed to provide a general overview of the California State Lottery's finances and to demonstrate the accountability for the money the Lottery earns. If you have questions about this report or need additional financial information, contact the California State Lottery, Finance Division, 600 N. 10th Street, Sacramento, CA 95811.

**CALIFORNIA STATE LOTTERY FUND**  
**STATEMENT OF NET ASSETS**  
**JUNE 30, 2010**

**ASSETS**

|   |                             |
|---|-----------------------------|
| Current assets:                                 |                             |
| Cash and cash equivalents (Note 2)              | \$ 295,065,519              |
| Investments, current portion (Note 2)           | 193,613,839                 |
| Accounts receivable, net of allowances (Note 3) | 239,783,098                 |
| Due from state funds (Note 4)                   | 872,671                     |
| Ticket inventories                              | 4,815,479                   |
| Other   | <u>1,615,921</u>            |
| <br>Total current assets                        | <br>\$ 735,766,527          |
| Non-current assets:                             |                             |
| Investments, less current portion (Note 2)      | \$ 1,145,731,156            |
| Capital assets, net (Note 5)                    | 42,511,326                  |
| Deferred charges, net                           | <u>2,185,278</u>            |
| <br>Total non-current assets                    | <br>\$ 1,190,427,760        |
| <br>TOTAL ASSETS                                | <br><u>\$ 1,926,194,287</u> |

**LIABILITIES**

|  |                             |
|--|-----------------------------|
| Current liabilities:                           |                             |
| Accounts payable                               | \$ 43,849,964               |
| Current prize liability (Note 6)               | 469,268,126                 |
| Due to state funds (Note 7)                    | 266,668,111                 |
| Accrued liabilities                            | 7,434,164                   |
| Unearned revenue                               | <u>2,723,177</u>            |
| <br>Total current liabilities                  | <br>\$ 789,943,542          |
| Non-current liabilities:                       |                             |
| Prize liability, less current portion (Note 6) | \$ 995,580,578              |
| Other (Note 10)                                | <u>14,820,000</u>           |
| <br>Total non-current liabilities              | <br><u>\$ 1,010,400,578</u> |
| <br>TOTAL LIABILITIES                          | <br><u>\$ 1,800,344,120</u> |

Commitments and contingencies (Notes 8 and 12)

**NET ASSETS**

|   |                           |
|---|---------------------------|
| Invested in capital assets                | \$ 42,511,326             |
| Restricted by legislation (Notes 1 and 2) | 125,850,167               |
| Unrestricted deficit                      | <u>(42,511,326)</u>       |
| <br>TOTAL NET ASSETS                      | <br><u>\$ 125,850,167</u> |

See accompanying notes to the financial statements.

**CALIFORNIA STATE LOTTERY FUND**  
**STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS**  
**YEAR ENDED JUNE 30, 2010**

|  |                              |
|--|------------------------------|
| Operating revenues: Lottery sales              | \$ 3,040,959,866             |
| Prizes   | <u>1,611,371,074</u>         |
| Sales after prizes                             | <u>\$ 1,429,588,792</u>      |
| Less game costs:                               |                              |
| Retailer costs                                 | \$ 214,484,059               |
| Draw game costs                                | 35,984,278                   |
| Scratchers game costs                          | <u>18,214,865</u>            |
| Total game costs                               | <u>\$ 268,683,202</u>        |
| Income before operating expenses               | <u>\$ 1,160,905,590</u>      |
| Operating expenses:                            |                              |
| Salaries, wages, and benefits                  | \$ 46,011,332                |
| Advertising                                    | 33,666,684                   |
| Promotion, public relations, and point of sale | 8,025,477                    |
| Other professional services                    | 10,341,565                   |
| Depreciation and amortization                  | 20,417,236                   |
| Other general and administrative expenses      | <u>18,277,779</u>            |
| Total operating expenses                       | <u>\$ 136,740,073</u>        |
| Operating income                               | <u>\$ 1,024,165,517</u>      |
| Non-operating (expenses) revenues:             |                              |
| Investment earnings (Note 9)                   | \$ 26,795,655                |
| Other income                                   | 347,694                      |
| Allocation to Education Fund (Note 7)          | <u>(1,072,496,752)</u>       |
| Total non-operating (expenses) revenues        | <u>\$ (1,045,353,403)</u>    |
| Change in net assets                           | \$ (21,187,886)              |
| Total net assets - beginning balance           | <u>147,038,053</u>           |
| Total net assets - ending balance              | <u><u>\$ 125,850,167</u></u> |

See accompanying notes to the financial statements.

**CALIFORNIA STATE LOTTERY FUND**  
**STATEMENT OF CASH FLOWS**  
**YEAR ENDED JUNE 30, 2010**

|   |                              |
|---|------------------------------|
| Cash flows from operating activities:                           |                              |
| Receipts from customers   | \$ 3,014,778,765             |
| Payments for prizes   | (2,068,292,573)              |
| Payments to retailers   | (214,459,832)                |
| Payments to suppliers for goods and services                    | (120,308,694)                |
| Payments to employees   | (36,407,944)                 |
| Internal activity-payments to state funds                       | (9,059,437)                  |
| Receipts from other states                                      | 293,298,352                  |
| Other receipts  | <u>350,303</u>               |
| Net cash flows provided by operating activities                 | <u>\$ 859,898,940</u>        |
| Cash flows from non-capital financing activities:               |                              |
| Distributions to Education Fund                                 | <u>\$ (1,093,936,325)</u>    |
| Net cash flows used in non-capital financing activities         | <u>\$ (1,093,936,325)</u>    |
| Cash flows from capital and related financing activities:       |                              |
| Proceeds from disposal of capital assets                        | \$ 226,516                   |
| Payments for capital assets                                     | <u>(17,562,389)</u>          |
| Net cash flows used in capital and related financing activities | <u>\$ (17,335,873)</u>       |
| Cash flows from investing activities:                           |                              |
| Purchase of securities  | \$ (1,214,167,940)           |
| Proceeds from matured securities                                | 237,545,000                  |
| Proceeds from sale of securities                                | 1,224,517,760                |
| Investment Portfolio and SMIF interest received                 | <u>12,801,844</u>            |
| Net cash flows provided by investing activities                 | <u>\$ 260,696,664</u>        |
| Increase in cash and cash equivalents                           | <u>\$ 9,323,406</u>          |
| Cash and cash equivalents at July 1, 2009                       | <u>\$ 285,742,113</u>        |
| Cash and cash equivalents at June 30, 2010                      | <u><u>\$ 295,065,519</u></u> |

See accompanying notes to the financial statements.

**CALIFORNIA STATE LOTTERY FUND  
STATEMENT OF CASH FLOWS  
YEAR ENDED JUNE 30, 2010**

|  |                           |
|--|---------------------------|
| Cash flows from operating activities:  |                           |
| Operating income   | \$ 1,024,165,517          |
| Adjustments to reconcile operating income to<br>net cash provided by operating activities: |                           |
| Depreciation and amortization  | \$ 11,864,652             |
| Impairment of building   | 8,552,584                 |
| Provision for doubtful accounts  | (1,071,539)               |
| Provision for returned tickets   | 2,558,823                 |
| Provision for free ticket redemptions  | 3,491,919                 |
| Non-cash post retirement benefit plan change   | 5,146,000                 |
| Net gain on retirement or disposal of capital assets                                       | (226,516)                 |
| Other income   | 347,694                   |
| Changes in assets and liabilities:   |                           |
| Increase in accounts receivable  | (45,276,266)              |
| Decrease in due from other funds net of SMIF   | 281,346                   |
| Decrease in ticket inventories   | 516,541                   |
| Decrease in other assets   | 5,533,141                 |
| Decrease in deferred charges   | 594,481                   |
| Increase in accounts payable   | 7,576,257                 |
| Decrease in prize liability  | (163,623,148)             |
| Decrease in due to state funds   | (110,298)                 |
| Decrease in accrued liabilities  | (21,869)                  |
| Decrease in deferred revenues  | <u>(400,379)</u>          |
| <br>Net cash flows provided by operating activities  | <br><u>\$ 859,898,940</u> |

Supplemental disclosure of non-cash activities:

|   |                      |
|---|----------------------|
| Interest accreted on annuitized prizes                    | <u>\$ 77,155,812</u> |
| Unclaimed prizes directly allocated to the Education Fund | <u>\$ 17,250,466</u> |
| Unrealized gain on investments                            | <u>\$ 42,593,853</u> |
| Interest accreted on zero coupon bonds                    | <u>\$ 44,464,870</u> |

See accompanying notes to the financial statements.

**CALIFORNIA STATE LOTTERY FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2010**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Organization**

The California State Lottery Fund (the Lottery) was created with the passage of the California State Lottery Act of 1984 (the Act). The Lottery is a part of the primary government of the State of California and is reported as a proprietary fund and business-type activity within the State of California's financial statements. The purpose of the Act is to support the preservation of the rights, liberties, and welfare of the people by providing additional monies to benefit education without the imposition of additional or increased taxes. The operations of the Lottery are separate and distinct from other operations of the State of California.

The Act mandated that, as nearly as practical, 50 percent of the total annual revenues from Lottery sales be returned to the public in the form of prizes and that at least 34 percent be allocated to benefit public education. No more than 16 percent of the total annual revenues from sales of tickets or shares shall be allocated for payment of operating expenses of the Lottery.

On April 8, 2010, the Governor signed Assembly Bill (AB) 142 amending the Lottery Act to allow the Lottery to offer its players a higher prize payout percentage. Lottery management believes that higher prize payouts will result in increased sales revenues and thus increased allocations to education. Under AB 142 beginning with the 2010/2011 fiscal year, the Lottery will be required to return not less than 87 percent of revenues to the public in the form of prizes and contributions to education, and to spend no more than 13 percent of revenues on operating expenses of the Lottery. The bill requires that for each fiscal year beginning with 2010/2011 the Lottery's contribution to education under the new percentages be greater than it was in the 2008/2009 base fiscal year, otherwise the law reverts back to previous percentages. More information on the Lottery's statutory compliance can be found in Note 11.

**Basis of Presentation**

The Lottery is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting and the economic resources measurement focus in accordance with accounting principles generally accepted in the United States of America. Operating revenue and expenses are those that result from providing services and producing and delivering goods and/or services.

**Revenue Recognition – Scratchers® Games**

Sales of lottery tickets are made to the public through contracted retailers. Revenue is recognized upon the sale of tickets to the retailers for active games. An allowance is recognized for the retailers' right to return unsold tickets after each game end. Operating revenue is reduced for free tickets. Retailers receive a commission of six percent which is recognized when tickets are sold to the retailers.

**Revenue Recognition - Draw Games**

Lottery sales are made to the public through gaming terminals at contracted retailers. Revenue is recognized upon the sale to the public. With the exception of MEGA Millions®, the public has the right to cancel a sale on the same day before pool closure. All MEGA Millions sales are final. The applicable retailers' commission of four and one-half to six percent is recognized when sales are made to the public.

Recognition of the revenue from sales for future draws is deferred until those draws become current. The retailers' commission related to the deferred revenue is reflected as a prepaid expense until the related deferred revenue is recognized.

**Prizes – Scratchers Games**

Prize expense for Scratchers games is recognized based on the predetermined prize structure for each game in the period revenue is recognized. Prizes that are not claimed are recognized as unclaimed prizes 180 days after

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Prizes – Scratchers Games (continued)**

the end of each game. Unclaimed prizes not directly payable by the Lottery are recognized as a reduction of prize expense and included in the Lottery's operating income that is allocated to the Education Fund. Unclaimed prizes directly payable by the Lottery are allocated directly to the Education Fund. Prize expense relative to the California Lottery Television Show is recorded based on the estimated prize structure(s). Periodically, prize expense is adjusted to reflect amounts actually won.

Prizes of \$1 million or more are generally paid in equal annual installments over twenty or twenty-five years. The Weekly Grand, the Extravaganza 2000, the Twice as Grand, and the Weekly \$2,000 Payday top prizes are paid in weekly installments for twenty years. The Decade of Dollars top prizes are paid in annual installments for ten years. The top prizes for the Cash for 20 Years game and the \$750,000 Payday game are paid in annual, graduated payments over twenty-year and twenty-five-year periods, respectively. Prize expense for these prizes is based on the present value of the annuity using an interest rate equal to the interest yield on the zero coupon U.S. Treasury bonds which the Lottery acquires to fund the annuity payments. Interest earned is imputed on the annuity using the same interest rate.

The Next Millionaire, California Millionaire and Millions in Cash games all feature top prizes of \$1 million, each paid in a single payment.

**Prizes - Draw Games**

SuperLOTTO Plus<sup>®</sup> and MEGA Millions - Prize expenses for the twice-weekly draw games are recognized on the basis of the predetermined prize structure when the revenue is recognized. Nine distinct prize categories are established which are dependent upon the amount of money wagered and the quantity of numbers to be matched. In the event that no winning share for a specific prize category in SuperLOTTO Plus is selected, all monies allocated for that prize are carried forward to the following drawing and added to the Five of Five plus MEGA number category (grand prize). In the event that no winning share for a specific prize category in MEGA Millions is selected, all monies allocated for that prize are carried forward to the following drawing and remain in the pool for that same prize category.

The total Grand/Jackpot prize liability for each multi-state MEGA Millions drawing shall be shared by each participating state lottery (Party Lottery) as follows: each Party Lottery shall be responsible for an amount equal to a percentage of that Party Lottery's MEGA Millions sales, said percentage being the proportion of the total Grand/Jackpot prize liability to total MEGA Millions sales. The California State Lottery is prohibited by state law from paying fixed prizes and participating in the liability calculation for prize levels two (2) through nine (9). The California State Lottery shall be solely responsible for its own prize liability for prize levels two (2) through nine (9).

All SuperLOTTO Plus prizes won but not claimed within the specified period are allocated directly to the Education Fund. In the event that a MEGA Millions grand/jackpot prize won in California is unclaimed, the prize monies will be returned to the Party Lotteries in the same ratio that each Party Lottery contributed to such prize plus interest and the amount contributed for the grand/jackpot prize by the California State Lottery will be allocated directly to the Education Fund. The unclaimed prize monies for all other MEGA Millions prize categories won in California but not claimed within the specified period are allocated directly to the Education Fund.

Super LOTTO grand/jackpot prizes won prior to April 1, 1998, of \$1 million or more are paid in twenty equal annual installments. Effective April 1, 1998, grand/jackpot prizes of \$1 million or more are paid either in twenty-six graduated annual payments or in a single payment equal to the cash value of the twenty-six-payment annuity, in accordance with the rules and regulations of the Lottery. Beginning September 21, 2005, claimants have up to 60 days after the date they became entitled to the prize to irrevocably elect to receive the cash value or the annuitized payments. Payments for all other prize categories are made in a single payment.

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Prizes – Draw Games (continued)**

MEGA Millions grand/jackpot prizes won in California are paid in 26 equal annual installments, however, claimants have up to 60 days after the date they became entitled to the prize to irrevocably elect to receive the cash value of the prize instead of 26 annual payments. Payments for all other prize categories are made in a single payment.

Fantasy 5 - Prize expense for the seven-draws-per-week game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established dependent upon the amount of money wagered and the quantity of numbers to be matched. In the event that no winning share for a specific prize category is selected, all monies allocated for that prize category are carried forward to the following drawing and added to the 5 of 5 prize category. All Fantasy 5 prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Daily 3 - Prize expense for the two-draws-per-day game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established which are dependent upon the amount of money wagered, the quantity of numbers to be matched, and the order of numbers chosen. All Daily 3 prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Daily 4 - Prize expense for the seven-draws-per-week game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established which are dependent upon the amount of money wagered, the quantity of numbers to be matched, and the order of numbers chosen. All Daily 4 prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Daily Derby<sup>®</sup> - Prize expense for the seven-draws-per-week game is recognized on the basis of the predetermined prize structure when the revenue is recognized. Distinct prize categories are established which are dependent upon the amount of money wagered, the quantity of numbers to be matched, and the order of numbers chosen. In the event that no winning share for a specific prize category is selected, all monies allocated for that prize category are carried forward to the following drawing and added to the Grand Prize category. All Daily Derby prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Hot Spot<sup>®</sup> - Prize expense for the multiple-draws-per-day game is recognized on the basis of the predetermined prize structure when the revenue is recognized. On November 27, 2006, the Lottery established a Typical Prize Allocation (allocation) for the 8 Spot Match 8 of 8 category and Typical Prize Amounts (amounts) for all spots other than the 8 Spot Match 8 of 8 prize. On that date, the Lottery also made an irrevocable transfer to a Hot Spot Wagered Prize Fund (fund) to pay these allocations and amounts. In addition to the initial transfer, the fund balance is adjusted daily based upon daily sales contributions and prizes won. In the event the balance in the fund is not sufficient to pay the allocations and amounts of a particular draw, prizes will be systematically reduced until the fund is sufficient to pay the reduced amounts. The Director will authorize promotional prize augmentations to ensure that the fund balance at the end of any given fiscal year is liquidated. All Hot Spot prizes won but not claimed within the specified period are allocated directly to the Education Fund.

Prior to the change made on November 27, 2006, distinct prize categories were established which were dependent upon the amount of money wagered and the quantity of numbers to be matched. In the event that no winning share for a specific Hot Spot prize category was selected, all monies allocated for that prize category were carried forward to the following drawing and added to its respective prize category.

Raffle - The Lottery may periodically conduct raffle games. Players may win prizes by matching their raffle numbers to the numbers drawn by the Lottery. Prize expense for the game is recognized on the basis of a predetermined prize structure when the revenue is recognized. All Raffle prizes won but not claimed within the specified period are allocated directly to the Education Fund. The \$1 million top prizes for the two raffle games held to date were each paid in single payments.

**CALIFORNIA STATE LOTTERY FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2010**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Cash Equivalents**

Cash equivalents represent cash deposited in the Surplus Money Investment Fund (SMIF).

**Investments**

The Lottery applies Statement No. 31 of the Governmental Accounting Standards Board (GASB 31), *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. This statement establishes accounting and financial reporting standards for all investments held by governmental external investment pools and establishes fair value standards for other governmental entities. In accordance with GASB 31, the Lottery has stated investments, at fair value. The difference between the carrying value and the fair value of investments is reported as a component of total net assets on the Statement of Net Assets.

The Lottery applies GASB 40, *Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3*. This Statement addresses common deposit and investment risks related to credit risk, concentration of credit risk, interest rate risk, and foreign currency risk. As an element of interest rate risk, this Statement requires certain disclosures of investments that have fair values that are highly sensitive to changes in interest rates. Deposit and investment policies related to the risks identified in this Statement also are required to be disclosed.

**Allowances for Doubtful Accounts, Ticket Returns, and Free Ticket Redemptions**

The allowance for doubtful accounts is based on an analysis of collectibility of accounts receivable which considers the age of the accounts and historical collection results. An allowance for ticket returns for Scratchers games is estimated using sales revenue and historical return data for the games in progress at the end of the reporting period. An allowance for free ticket redemptions for Scratchers games is estimated using sales revenue and free ticket redemption data for games in progress at the end of the reporting period.

**Ticket Inventories**

Inventories are carried at cost and consist of tickets for games in progress not yet sold to retailers and tickets for future games. The cost of tickets is charged to operations when the tickets are sold to retailers. The cost of unissued and returned tickets are written off at the end of each game.

**Capital Assets**

The Lottery has adopted a policy of capitalizing assets with an acquisition cost or established value of \$5,000 or greater. Capital assets are carried at cost. Depreciation on property and equipment is computed using the straight-line method over estimated lives ranging from three to seven years. Depreciation on buildings, improvements, and land improvements is computed using the straight-line method over estimated lives of five to forty years. When assets are retired or otherwise disposed of, the costs and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. Amortization of leasehold improvements is computed using the straight-line method over the remaining lease terms.

The Lottery adopted GASB 51, *Accounting and Financial Reporting for Intangible Assets*, during the 2009/2010 fiscal year. The statement requires that all intangible assets not specifically excluded, including internally generated intangible assets, be classified as capital assets. There was no impact upon the adoption of GASB 51.

**Deferred Charges**

The Lottery incurs costs in connection with certain contracts which extend beyond a one-year period. These costs are deferred and amortized over the life of the contracts. As more fully discussed in Note 12, a prepayment of \$35 million was made on the GTECH contract in the 2003/2004 fiscal year. As of June 30, 2010 the entire amount plus interest was repaid to the Lottery.

**CALIFORNIA STATE LOTTERY FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2010**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Advertising**

Advertising costs are expensed when the related liability is incurred. Advertising expense totaled \$33,666,684 for the year ended June 30, 2010.

**Investment Earnings**

Investment earnings are composed of unrealized gains or losses associated with the change in fair value of investments, interest income and the difference between interest accreted/earned on investments and interest expense imputed on annuitized prize liability. Unrealized gains and losses are generally not realized as the investments are held to satisfy annuitized prizes unless they are sold as part of the Lottery's investment restructuring program. As investments must be stated at fair value, investment earnings or losses are created as a result of the adjustment from cost to fair value. Generally, all cash is held on deposit with the California State Treasurer and is invested by that office in the Surplus Money Investment Fund. Interest on funds held by the State Treasurer is distributed quarterly.

**Compensated Absences Payable**

Vested vacation balances are accrued as a liability and adjusted quarterly.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Government Accounting Standards Board Statement No. 20 (GASB 20)**

As required under GASB 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Lottery will continue to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBS) of the Committee on Accounting Procedure issued on or before November 30, 1989, unless those pronouncements conflict or contradict GASB pronouncements. The Lottery has elected under GASB 20 to not apply all FASB Statements and Interpretations issued after November 30, 1989, due to the governmental nature of the Lottery operations.

**2. DEPOSITS AND INVESTMENTS**

The Lottery presents its deposits and investments in accordance with GASB 40, *Deposit and Investment Risk Disclosures – An Amendment of GASB Statement No. 3*. This statement requires the disclosure of the following risks to the extent that they exist at the date of the statement of net assets:

**Interest Rate Risk**

Interest rate risk is the risk that the value of fixed income securities will decline due to changing interest rates. The prices of fixed income securities with longer time to maturity tend to be more sensitive to changes in interest rates than those with shorter durations.

**Credit Risk**

Credit risk is the risk that a debt issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline.

**CALIFORNIA STATE LOTTERY FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2010**

**2. DEPOSITS AND INVESTMENTS (continued)**

**Custodial Credit Risk**

Custodial credit risk is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of its deposits, investments, or collateral.

**Concentration of Credit Risk**

Concentration of credit risk is the risk of loss attributed to the magnitude of an investor's holdings in a single issuer.

**Investments**

On January 28, 2009, the Lottery Commission approved an amendment to the Lottery's investment policy that allowed for the restructuring of its investment portfolio to maximize the investment return. Prior to this, the Lottery's policy limited investments to U.S. Treasury zero coupon bonds. The amendment authorizes the Lottery to sell its previously held U.S. Treasury zero coupon bonds and replace them with municipal and agency bonds, as well as with other U.S. Treasuries. The Lottery began restructuring its investment portfolio in May 2009. By replacing U.S. Treasury zero coupon bonds with higher yielding investments the Lottery is able to generate cash proceeds that can be used to further the Lottery's directives. On December 19, 2009, the Commission approved the Lottery's comprehensive investment policy, which addresses mitigation of risk.

The deposit and investment policies of the Lottery are determined by the Lottery Commission and state statute. Prize investments consist of zero coupon U.S. Treasury bonds, U.S. Treasury notes, zero coupon agency bonds and municipal bonds. Zero coupon U.S. Treasury bonds and zero coupon agency bonds are carried at fair value and are adjusted for the accretion of interest based on the purchased yield and maturity date. Municipal bonds and U.S. Treasury notes are carried at fair value, and interest is accrued based on the coupon rate.

As of June 30, 2010, the Lottery's investments, with yields ranging from 0.029 percent to 5.71 percent, consist of the following:

|                              | <u>Face Amount</u>      | <u>Cost</u>             | <u>Fair Value</u>       |
|------------------------------|-------------------------|-------------------------|-------------------------|
| Current portion:             |                         |                         |                         |
| U.S. Treasury Notes          | \$ 30,000,000           | \$ 30,122,968           | \$ 30,136,325           |
| U.S. Treasury Strips         | 126,887,000             | 71,196,348              | 126,832,038             |
| U.S. Agency Holdings         | 34,829,000              | 34,655,299              | 35,034,868              |
| U.S. Municipal Bond Holdings | 1,600,000               | 1,610,916               | 1,610,608               |
| Total current portion        | <u>\$ 193,316,000</u>   | <u>\$ 137,585,531</u>   | <u>\$ 193,613,839</u>   |
| Long-term portion:           |                         |                         |                         |
| U.S. Treasury Notes          | \$ 55,000,000           | \$ 55,649,647           | \$ 55,919,639           |
| U.S. Treasury Strips         | 265,106,000             | 143,363,614             | 213,811,790             |
| U.S. Agency Holdings         | 468,911,000             | 350,725,103             | 380,247,027             |
| U.S. Municipal Bond Holdings | 475,695,000             | 479,426,042             | 495,752,700             |
| Total long-term portion      | <u>\$ 1,264,712,000</u> | <u>\$ 1,029,164,406</u> | <u>\$ 1,145,731,156</u> |
| Total investments            | <u>\$ 1,458,028,000</u> | <u>\$ 1,166,749,937</u> | <u>\$ 1,339,344,995</u> |

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**2. DEPOSITS AND INVESTMENTS (continued)**

**Investments (continued)**

As discussed in Note 1, the Lottery applies the provisions of GASB 31. In accordance with GASB 31, the Lottery carries its investments at fair value. The fair value of investments is based on published market prices and quotations from an outside investment firm. The following represents the changes in fair value of investments for the year ended June 30, 2010, in accordance with the requirements of GASB 31.

|   |                      |
|---|----------------------|
| Changes in fair value of investments:       |                      |
| Unrealized investment gains at July 1, 2009 | \$ 102,740,456       |
| Realized gain on investment restructuring   | (88,287,852)         |
| Unrealized investment gain, current period  | 42,593,853           |
| Total unrealized investment gains           | <u>\$ 57,046,457</u> |

As previously discussed the Lottery began restructuring its investment portfolio during the 2008/2009 fiscal year. In the current fiscal year, the Lottery sold zero coupon U.S. Treasury bonds with a fair value of \$747,041,340, which included unrealized gains of \$88,287,852 as of the sale date. The Lottery reinvested \$701,790,361 of the sales proceeds generated in U.S. agency and municipal bond holdings. As the U.S. agency and municipal bond holdings carried higher interest rates than the investments sold, the Lottery generated \$45,250,979 in unrestricted net cash proceeds. The difference between the unrealized gain as of the day of sale and the net cash proceeds generated of \$43,036,873 continues to be reported as restricted net assets as it was required to be reinvested to meet annuitized prize liabilities.

**Interest Rate Risk – Investments**

The Lottery does not have a specific policy to manage interest rate risk, as investments are purchased to mirror the payment stream of recorded prize liability. The Lottery's investments have weighted average maturities based on the final maturity dates of all investments as follows:

|                               |            |
|-------------------------------|------------|
| U.S. Treasury Notes           | 1.35 years |
| U.S. Treasury Strips          | 3.76 years |
| U.S. Agency Holdings          | 5.36 years |
| U.S. Municipal Bond Holdings  | 9.43 years |
| Surplus Money Investment Fund | 0.56 years |

**Credit Risk and Concentration of Credit Risk - Investments**

The Lottery has adopted a specific policy to manage credit risk in the Lottery's investment portfolio. The zero coupon U.S. Treasury bonds and U.S. Treasury bills are backed by the full faith and credit of the United States government. Therefore, the U.S. Treasury obligation investments are not considered to have credit risk or a concentration of credit risk, as defined by the Governmental Accounting Standards Board. The Lottery's policy to manage credit risk requires municipal bonds to have a minimum double A credit rating by Fitch, Moody's or Standard and Poor's to be eligible for purchase as part of the Lottery's investment portfolio. Agency bonds have a triple A credit rating and the Surplus Money Investment Fund is not rated at June 30, 2010. Credit risk is further mitigated by a \$2.7 million par value agency bond reserve. The bond reserve has a fair value of \$1,398,359.

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**2. DEPOSITS AND INVESTMENTS (continued)**

**Investments (continued)**

As of June 30, 2010, the fair value of the Lottery's investment portfolio expressed as a percentage of Moody's credit rating categories was as follows:

| Moody's Credit Rating | Fair Value              | Percent of<br>Total Portfolio |
|-----------------------|-------------------------|-------------------------------|
| Aaa                   | \$ 869,739,370          | 64.94%                        |
| Aa1                   | 126,149,305             | 9.42%                         |
| Aa2                   | 102,790,958             | 7.67%                         |
| A1                    | 240,665,362             | 17.97%                        |
| Totals                | <u>\$ 1,339,344,995</u> | <u>100.00%</u>                |

The following table provides information about the Lottery's concentration of credit risk. It shows investments by any one issuer representing 5 percent or more of the Lottery's total portfolio, and not explicitly guaranteed by the U.S. government.

| Issuer              | Cost           | Fair Value     | Percent of<br>Total Portfolio | Moody's<br>Credit Rating |
|---------------------|----------------|----------------|-------------------------------|--------------------------|
| State of California | \$ 214,828,217 | \$ 221,207,671 | 16.52%                        | A1                       |

**Custodial Credit Risk – Investments**

The Lottery does not have a formal investment policy for custodial credit risk for investments. As of June 30, 2010, all the prize investments are uninsured, registered investments held in book-entry form by the State Treasurer's Office in a master custody account with Citibank, N.A.

**Deposits**

The following deposits, included in cash and cash equivalents, are in pools managed by other State of California government units and are not evidenced by securities. Interest income earned on outstanding cash balances is allocated among pool participants based on average daily cash balances. As of June 30, 2010, the carrying value of deposits in the Surplus Money Investment Fund approximated fair value.

|                               |                       |
|-------------------------------|-----------------------|
| State Treasury                | \$ 11,024,839         |
| Surplus Money Investment Fund | <u>284,024,000</u>    |
|                               | <u>\$ 295,048,839</u> |

The SMIF consists of available cash of all special funds of the State of California which do not have investment authority of their own. Cash balances in excess of needs in any of these participating funds are invested by the State Treasurer. The Pooled Money Investment Board (PMIB) provides regulatory oversight over the State Treasurer's pooled investment program and is responsible for determining whether any cash balances of the participating funds are in excess of current needs and available for investment, or whether it is necessary to liquidate previous investments to meet current requirements. The PMIB is composed of the State Treasurer, as chairman; the State Controller; and the Director of Finance for the State of California.

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**2. DEPOSITS AND INVESTMENTS (continued)**

**Deposits (continued)**

All of the resources of the SMIF are invested through the Pooled Money Investment Account (PMIA). By law, PMIA monies can be invested only in the following categories: U.S. Government securities; securities of federally-sponsored agencies; domestic corporate bonds; interest-bearing time deposits in California banks, savings and loan associations, and credit unions; prime-rated commercial paper; repurchase and reverse repurchase agreements; security loans; banker's acceptances; negotiable certificates of deposit; and loans to various bond funds.

At June 30, 2010, the allocation of the deposits held by the Lottery in the SMIF was estimated as follows:

|                              | Lottery's Share<br>of SMIF |
|------------------------------|----------------------------|
| U.S. Treasury Securities     | \$ 132,528,432             |
| Federal Agency Debt          | 37,764,742                 |
| IBRD Bonds                   | 1,228,018                  |
| Bank Notes                   | 1,637,357                  |
| Certificates of Deposit      | 30,966,609                 |
| Commercial Paper             | 31,778,883                 |
| Corporate Bonds              | 512,163                    |
| Time Deposits                | 16,971,820                 |
| AB 55 and General Fund Loans | 30,635,976                 |
| Total                        | \$ 284,024,000             |

The value of the deposits in the State Treasurer's pooled investment program, including the SMIF, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2010, this difference was immaterial to the valuation of the deposits held by the Lottery in the SMIF.

The Lottery's share in the interest earnings of the PMIA is based on its ratio of dollar-day contributions to the total dollar-day investments of the PMIA. The overall return on investment for the PMIA was 0.65 percent for the year ended June 30, 2010.

**3. ACCOUNTS RECEIVABLE**

Accounts receivable consists of the following:

|  |                |
|--|----------------|
| Amounts due, primarily from retailers      | \$ 285,844,707 |
| Less: Allowance for free ticket redemption | (36,044,581)   |
| Allowance for doubtful accounts            | (3,276,049)    |
| Allowance for ticket returns               | (6,740,979)    |
| Accounts receivable, net                   | \$ 239,783,098 |

**4. DUE FROM STATE FUNDS**

Due from state funds consists of interest income due on cash deposited with the State Treasurer in the Surplus Money Investment Fund.

**CALIFORNIA STATE LOTTERY FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2010**

**5. CAPITAL ASSETS**

Capital assets consist of the following:

|  | Beginning<br>Balance   | Increase               | Decrease               | Ending<br>Balance      |
|--|------------------------|------------------------|------------------------|------------------------|
| Non-depreciable capital assets:                    |                        |                        |                        |                        |
| Land   | \$ 6,469,219           | \$ -                   | \$ -                   | \$ 6,469,219           |
| Depreciable capital assets:                        |                        |                        |                        |                        |
| Gaming equipment                                   | 17,618,574             | 195,008                | -                      | 17,813,582             |
| Vending machines                                   | 34,243,343             | -                      | -                      | 34,243,343             |
| Buildings  | 33,495,301             | 15,735,598             | (25,148,183)           | 24,082,716             |
| Data processing equipment                          | 8,958,050              | 76,515                 | (15,533)               | 9,019,032              |
| Office furniture and equipment                     | 8,421,870              | 95,469                 | (48,740)               | 8,468,599              |
| Leasehold improvements                             | 1,134,372              | -                      | (323,814)              | 810,558                |
| Other  | 6,998,851              | 1,475,332              | (1,748,333)            | 6,725,850              |
|  | <u>\$ 117,339,580</u>  | <u>\$ 17,577,922</u>   | <u>\$ (27,284,603)</u> | <u>\$ 107,632,899</u>  |
| Less accumulated depreciation<br>and amortization: |                        |                        |                        |                        |
| Gaming equipment                                   | \$ (4,947,910)         | \$ (6,500,315)         | \$ -                   | \$ (11,448,225)        |
| Vending machines                                   | (30,875,286)           | (2,511,018)            | -                      | (33,386,304)           |
| Buildings  | (16,807,326)           | (661,783)              | 16,639,042             | (830,067)              |
| Data processing equipment                          | (8,290,408)            | (380,273)              | -                      | (8,670,681)            |
| Office furniture and equipment                     | (6,142,024)            | (867,062)              | 48,740                 | (6,960,346)            |
| Leasehold improvements                             | (678,526)              | (89,054)               | 280,371                | (487,209)              |
| Other  | (4,231,927)            | (855,147)              | 1,748,333              | (3,338,741)            |
|  | <u>\$ (71,973,407)</u> | <u>\$ (11,864,652)</u> | <u>\$ 18,716,486</u>   | <u>\$ (65,121,573)</u> |
| Capital assets, net                                | <u>\$ 45,366,173</u>   | <u>\$ 5,713,270</u>    | <u>\$ (8,568,117)</u>  | <u>\$ 42,511,326</u>   |

The increase in accumulated depreciation and amortization of capital assets charged to income was \$11,864,652 for the year ended June 30, 2010. An \$8.6 million impairment charge was recorded per GASB 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, due to the impairment of the Lottery's current Headquarters building as a result of the expected decrease in its service utility due to the construction of a new building. The increase in accumulated depreciation and amortization plus the impairment charge account for the depreciation and amortization expense of \$20,417,236 reported on the Statement of Revenues, Expenses and Changes in Net Assets. The activity in the buildings account was due primarily to the addition of \$15.7 million related to the construction of a new building offset by the \$8.6 million impairment charge and \$16.5 million of accumulated depreciation written off against building costs.

**CALIFORNIA STATE LOTTERY FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2010**

**6. PRIZE LIABILITY**

Prize liability consists of the following:

|                                       | <u>Scratchers<br/>Games</u> | <u>Draw<br/>Games</u>   | <u>Total</u>            |
|---------------------------------------|-----------------------------|-------------------------|-------------------------|
| Current:                              |                             |                         |                         |
| Annuitized prizes                     | \$ 16,301,149               | \$ 263,201,824          | \$ 279,502,973          |
| Other prizes                          | <u>168,599,733</u>          | <u>21,165,420</u>       | <u>189,765,153</u>      |
| Total current prize liability         | <u>\$ 184,900,882</u>       | <u>\$ 284,367,244</u>   | <u>\$ 469,268,126</u>   |
| Long-term annuitized prizes           | \$ 134,331,000              | \$ 1,312,562,000        | \$ 1,446,893,000        |
| Less imputed interest                 | <u>(41,035,032)</u>         | <u>(410,277,390)</u>    | <u>(451,312,422)</u>    |
| Net present value of long-term prizes | <u>\$ 93,295,968</u>        | <u>\$ 902,284,610</u>   | <u>\$ 995,580,578</u>   |
| Total prize liability                 | <u>\$ 278,196,850</u>       | <u>\$ 1,186,651,854</u> | <u>\$ 1,464,848,704</u> |

The amount of prizes due within one year is \$469,268,126.

Long-term prize liability as of June 30, 2010, for each of the next five years and for subsequent years is as follows:

|                                   | <u>Principal</u>      | <u>Interest</u>       | <u>Total</u>          |
|-----------------------------------|-----------------------|-----------------------|-----------------------|
| For the year ending June 30, 2012 | \$ 79,258,079         | \$ 100,388,931        | \$ 179,647,010        |
| 2013                              | 69,460,855            | 80,282,137            | 149,742,992           |
| 2014                              | 59,981,062            | 63,279,148            | 123,260,210           |
| 2015                              | 50,205,444            | 45,357,939            | 95,563,383            |
| 2016                              | 40,166,637            | 30,550,596            | 70,717,233            |
| 2017-2021                         | 126,744,233           | 64,254,754            | 190,998,987           |
| 2022-2026                         | 91,169,674            | 40,734,937            | 131,904,611           |
| 2027-2031                         | 39,771,709            | 9,486,315             | 49,258,024            |
| 2032-2036                         | <u>4,391,619</u>      | <u>96,509</u>         | <u>4,488,128</u>      |
| Total long-term prize liability   | <u>\$ 561,149,312</u> | <u>\$ 434,431,266</u> | <u>\$ 995,580,578</u> |

Activity in the prize liability accounts consists of:

|  |                         |
|--|-------------------------|
| Balance, July 1, 2009  | \$ 1,563,836,076        |
| Prize expense  | 1,611,371,074           |
| Prize payments   | (2,068,292,573)         |
| Grand/Jackpot prize contributions from other Party Lotteries | 293,298,352             |
| Interest imputed on annuities                                | 77,155,812              |
| Cash option adjustment                                       | 4,730,429               |
| Unclaimed prizes   | <u>(17,250,466)</u>     |
| Balance, June 30, 2010                                       | <u>\$ 1,464,848,704</u> |

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**7. DUE TO STATE FUNDS**

Due to state funds consists of the following:

|                              |                                  |
|------------------------------|----------------------------------|
| Due to Education Fund        | \$ 266,528,409                   |
| Due to other state funds     | <u>139,702</u>                   |
| <br>Total due to state funds | <br><u><u>\$ 266,668,111</u></u> |

Activity in the Due to Education Fund account consists of:

|  |                   |                                  |
|--|-------------------|----------------------------------|
| Balance, July 1, 2009  |                   | \$ 270,717,516                   |
| Allocation to Education Fund, earned<br>by the California State Lottery Fund | \$ 1,072,496,752  |                                  |
| Unclaimed prizes directly allocated<br>to the Education Fund                 | <u>17,250,466</u> |                                  |
|  |                   | 1,089,747,218                    |
| <br>Distribution to the Education Fund                                       |                   | <br><u>(1,093,936,325)</u>       |
| <br>Balance, June 30, 2010   |                   | <br><u><u>\$ 266,528,409</u></u> |

**8. LEASES**

The Lottery leases office, warehouse, and parking lot facilities under operating leases. These leases expire in various years through June 30, 2017. Most operating leases have a provision for early termination. These leases could be terminated between November 2010 and June 2017.

The future minimum lease payments under operating leases as of June 30, 2010, are as follows:

|                            | Operating<br>Leases            |
|----------------------------|--------------------------------|
| For the year June 30, 2011 | \$ 1,550,767                   |
| 2012                       | 1,209,791                      |
| 2013                       | 1,055,563                      |
| 2014                       | 840,250                        |
| 2015                       | 729,397                        |
| Thereafter                 | <u>993,132</u>                 |
| <br>Total minimum payments | <br><u><u>\$ 6,378,900</u></u> |

Rental expense for all operating leases totaled \$1,733,644 for the year ended June 30, 2010.

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**9. INVESTMENT EARNINGS**

Investment earnings consist of:

|   |                |
|---|----------------|
| Interest on funds held by State Treasurer                   | \$ 2,732,562   |
| Change in Fair Market Value of Investments                  | 42,593,853     |
| Interest accreted/earned on investments                     | 58,625,052     |
|   | \$ 103,951,467 |
| Less interest expense imputed on annuitized prize liability | (77,155,812)   |
| Investment earnings, net                                    | \$ 26,795,655  |

**10. RETIREMENT PLAN AND OTHER POSTEMPLOYMENT BENEFITS**

**Retirement Plan**

The Lottery contributes to the Public Employees' Retirement Fund administered by the California Public Employees' Retirement System (CalPERS), an agent multiple-employer public employee defined benefit pension plan. The State of California (State) is considered the employer and the Lottery is a department of the State. CalPERS provides retirement benefits to plan members and beneficiaries. CalPERS acts as a common investment and administrative agent for participating public entities within the State and uses the accrual basis of accounting. Benefit provisions and all other requirements are established by state statute. Since all state agencies are considered collectively to be a single employer, the actuarial present value of vested and non-vested accumulated plan benefits attributable to the Lottery's employees cannot be determined. Similarly, the net assets available for benefits of Lottery employees cannot be determined. CalPERS issues a separate comprehensive annual financial report that includes financial statements and required supplementary information. CalPERS' annual financial report may be obtained by writing to the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229 or by visiting the CalPERS web site at [www.CalPERS.ca.gov](http://www.CalPERS.ca.gov).

Generally, full-time employees are eligible to participate as members of CalPERS and are eligible to retire at age 50 with at least five years of service or age 55 with at least ten years of service depending on the plan selected by the employee. Annual retirement benefits are determined based on age at retirement, the length of membership service, and the amount of earnings based on the highest or last 12 or 36 consecutive months' average. Health care and dental benefits may be provided to members depending on the date hired and the years of credited service of a member. If members are not fully vested, the health care and dental contributions will be prorated based on the years of service.

Active plan members are required to contribute a percentage of their salary depending on their plan selection and employment classification. Employees' required contributions vary from 0.0% to 8.0%. The Lottery is required to contribute at an actuarially determined rate. The Lottery's contributions are based on a percentage of annual covered payroll depending on the plan selected and member status. For the year ended June 30, 2010, the Lottery's payroll for employees covered by CalPERS was approximately \$27.5 million and the total payroll for the period was approximately \$28.3 million. The contribution requirements of plan members and the Lottery are established and may be amended by CalPERS. Required employer contribution rates (expressed as a percentage of compensation) for the 2010 fiscal year are as follows:

|  |         |
|--|---------|
| State Miscellaneous Member First Tier  | 16.917% |
| State Miscellaneous Member Second Tier | 16.737% |
| State Safety Member                    | 18.099% |
| Peace Officer                          | 25.848% |

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**10. RETIREMENT PLAN AND OTHER POSTEMPLOYMENT BENEFITS (continued)**

**Retirement Plan (continued)**

The Lottery's pension cost for the year ended June 30, 2010, was equal to the Lottery's required contributions which were determined as part of the most recent actuarial valuation performed by CalPERS dated September 30, 2008.

Three year trend information for the Lottery:

| Fiscal Year<br>Ending | Annual Pension<br>Cost (APC) | Percentage Of APC<br>Contributed | Net Pension<br>Obligation |
|-----------------------|------------------------------|----------------------------------|---------------------------|
| 6/30/08               | \$4,873,529                  | 100%                             | \$0                       |
| 6/30/09               | \$4,776,155                  | 100%                             | \$0                       |
| 6/30/10               | \$4,479,257                  | 100%                             | \$0                       |

**Other Postemployment Benefits**

Post-retirement health care benefits are also provided to Lottery employees through the programs sponsored by the State as administered by CalPERS and the Department of Personnel Administration (DPA). As the post-retirement health care plan is sponsored by the State it is considered a single-employer plan. The Lottery is considered a department of the State. The total other postemployment benefits (OPEB) actuarial accrued liability is reported at the State level.

Health care and dental benefits may be provided to members depending on the date hired and the member's years of credited service. Post-retirement health benefits include medical, prescription drug and dental benefits and are currently funded on a pay-as-you-go basis. Employer contributions for health premiums during the 2009/2010 fiscal year maintain the 100/90 percent contribution formula established by Government Code. Under this formula, the State uses 100 percent of the weighted average premiums of the four largest health benefit plans in order to calculate the maximum amount the State will contribute toward the retiree's health benefits. The State also contributes 90 percent of this average for the health benefits of each of the retiree's dependents. The retiree is responsible for paying all health benefit plan costs that exceed the average of the four largest benefit plans. The monthly contribution maximums are \$542 for a single enrollee, \$1,030 for an enrollee and one dependent, and \$1,326 for an enrollee and two or more dependents. Dental care premiums vary by plan and number of dependents. The contribution formulas are subject to approval and amendment by the legislature of the State. If members are not fully vested, the health care and dental contributions will be prorated based on the years of service.

The Lottery paid approximately \$2.7 million for post-retirement health and dental benefits for retired members for the year ended June 30, 2010. The Lottery adopted GASB 45 during the 2007/2008 fiscal year. GASB 45 was implemented prospectively and the Lottery had a zero net OPEB obligation (NOO) upon adoption. The Lottery's annual OPEB cost (AOC) is calculated based on the annual required contribution (ARC). The AOC recorded by the Lottery is calculated by the primary government and represents an allocation of the total ARC of the State, adjusted for interest and other adjustments. The allocation is based on the Lottery's retiree health benefit costs in relation to the total State retiree health benefit costs. The ARC represents the normal cost plus an amortization of the difference between the actuarial accrued liability and any assets available to pay benefits. The AOC for the year ended June 30, 2010, was \$7,814,000. The total NOO liability recorded as of June 30, 2010, is \$14,820,000. The following table shows the components of the Lottery's AOC, the amount actually contributed to the plan and the NOO as of and for the year ended June 30, 2010 and the previous fiscal year (in thousands).

**CALIFORNIA STATE LOTTERY FUND  
NOTES TO FINANCIAL STATEMENTS  
JUNE 30, 2010**

**10. RETIREMENT PLAN AND OTHER POSTEMPLOYMENT BENEFITS (continued)**

**Other Postemployment Benefits (continued)**

|  |    |                      |
|--|----|----------------------|
| Net OPEB obligation (NOO), July 1, 2008  | \$ | 5,038                |
| Fund allocated annual OPEB cost (AOC)    |    | 7,280                |
| Fund allocated contributions             |    | <u>(2,644)</u>       |
| Net OPEB obligation (NOO), June 30, 2009 |    | 9,674                |
| Fund allocated annual OPEB cost (AOC)    |    | 7,814                |
| Fund allocated contributions             |    | <u>(2,668)</u>       |
| Net OPEB obligation (NOO), June 30, 2010 | \$ | <u><u>14,820</u></u> |

The actuarial valuation report for OPEB may be obtained by writing to the Office of State Controller John Chiang, P.O. Box 942850, Sacramento, CA 94250 or by visiting the State Controller's Web site at [www.SCO.ca.gov](http://www.SCO.ca.gov). The Lottery's ARC, AOC and NOO will be calculated and adjusted for on an annual basis.

**11. STATUTORY COMPLIANCE (Unaudited)**

Lottery prize payments and other operating expenses are shown below as a percentage of total sales and proceeds generated from investment portfolio restructuring for the year ended June 30, 2010.

|   |    |                      |         |
|---|----|----------------------|---------|
| Lottery sales   | \$ | 3,040,959,866        |         |
| Investment proceeds from portfolio restructuring          |    | <u>45,250,979</u>    |         |
| Total sales and proceeds from portfolio restructuring     | \$ | <u>3,086,210,845</u> | 100.00% |
| <hr/>   |    |                      |         |
| Prizes  |    | 1,611,371,074        | 52.21%  |
| <hr/>   |    |                      |         |
| Expenses of the Lottery                                   |    |                      |         |
| Retailer costs  | \$ | 214,484,059          | 6.95%   |
| Game costs  |    | 54,199,143           | 1.76%   |
| Operating expenses  |    | 136,740,073          | 4.43%   |
| Less bartered operating expenses                          |    | <u>(65,810)</u>      | 0.00%   |
| Total expenses of the Lottery                             | \$ | <u>405,357,465</u>   | 13.14%  |
| <hr/>   |    |                      |         |
| Revenues to Education                                     |    |                      |         |
| Allocation subtotal                                       | \$ | 1,069,482,306        | 34.65%  |
| Unclaimed prizes directly allocated to the Education Fund |    | 17,250,466           |         |
| Interest income   |    | 2,732,562            |         |
| Other income  |    | 347,694              |         |
| Less bartered income                                      |    | <u>(65,810)</u>      |         |
| Total declared for allocation to the Education Fund       | \$ | <u>1,089,747,218</u> |         |

**CALIFORNIA STATE LOTTERY FUND**  
**NOTES TO FINANCIAL STATEMENTS**  
**JUNE 30, 2010**

**11. STATUTORY COMPLIANCE (Unaudited, continued)**

Per the Act and Lottery policy, the Lottery returns, as nearly as practical, 50 percent of the total annual revenues from Lottery sales and proceeds from investment portfolio restructuring to the public in the form of prizes; allocates at least 34 percent to benefit public education; and allocates no more than 16 percent for the payment of expenses of the Lottery. In addition, unclaimed prizes not directly payable by the Lottery, which amounted to \$31,983,461 for the year ended June 30, 2010, are recognized as a reduction of prize expense and included in the Lottery's net income that is distributed to the Education Fund.

As discussed in Note 2, proceeds realized from the investment portfolio restructuring were \$45,250,979 for the year ended June 30, 2010. Per Lottery policy, these proceeds are utilized to maximize the amount of funding allocated to public education within the framework of the statutory compliance model.

Unclaimed prizes directly payable by the Lottery and all interest earned on funds held in the State Lottery Fund shall be allocated directly to the Education Fund.

**12. COMMITMENTS AND CONTINGENCIES**

A contract has been awarded to GTECH that includes both gaming and telecommunication systems and services. The Lottery pays a fee of 1.36 percent of sales. The original contract ran through October 13, 2009, and had a total estimated cost of \$300 million. A series of contract extensions were awarded. The latest, signed by the Director in June 2010 extends the contract to October 13, 2019, and includes a complete upgrade of the gaming system. The total contract expenditure is not to exceed \$1.075 billion. Approximately \$344.5 million in fees have been incurred under the contract as of June 30, 2010.

In addition to the fees incurred, a prepayment of \$35 million was made to GTECH by the Lottery at contract inception. GTECH repaid the full amount plus interest via weekly payments equal to 0.2 percent of sales. The prepayment included interest at a rate equal to the Surplus Money Investment Fund rate plus one-half of one percent. The entire \$35 million was repaid by June 30, 2010.

On June 26, 2009, the Lottery Commission awarded a contract to Otto Construction for pre-construction services and construction of a new Lottery Headquarters building. The estimated construction costs are \$46.9 million for demolition, site work, and construction of the new building. An additional \$6.8 million is estimated for pre-construction services, green building and operation efficiency elements, and modular furniture. The total contract cost is \$53.7 million with additional contingency and escalation allowances of \$9.1 million and \$1.0 million, respectively. Costs incurred on the contract as of June 30, 2010, were \$12.4 million.

The Lottery has been named as a defendant in various lawsuits and claims. Legal counsel has determined that it is probable that one of these lawsuits may be settled in favor of the plaintiffs. As a result, a legal contingency of \$6.75 million has been recorded in the accompanying Statement of Net Assets at June 30, 2010.

**13. RISK MANAGEMENT**

Since its inception, the Lottery has been primarily self-insured for risks such as flood, business interruption, theft, employee errors and omissions, and other potential liabilities. Losses are recognized when conditions for accrual are met. Liabilities for workers' compensation costs are accrued based on estimates derived from the State Compensation Insurance Fund. This estimate is based on actuarial reviews of the employee workers' compensation program and includes indemnity payments, compensation benefits, and leave benefits. The liability for workers' compensation claims is not material of the financial statements taken as a whole.