# Tennessee Education Lottery Corporation

**For the Year Ended**
**June 30, 2004**

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STATE OF TENNESSEE
**COMPTROLLER OF THE TREASURY**
State Capitol
Nashville, Tennessee 37243-0260
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**John G. Morgan**
**Comptroller**

April 28, 2005

The Honorable Phil Bredesen, Governor
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243
and
Board of Directors
Tennessee Education Lottery Corporation
Plaza Tower Metro Center
200 Athens Way, Suite 200
Nashville, Tennessee 37228

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Education Lottery Corporation for the year ended June 30, 2004. You will note from the independent auditor's report that an unqualified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance disclosed certain deficiencies, which are detailed in the Results of the Audit section of this report. The corporation's management has responded to the audit finding; the response is included following the finding. The Division of State Audit will follow up the audit to examine the application of the procedures instituted because of the audit finding.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/cj
04/105

State of Tennessee

# Audit Highlights

Comptroller of the Treasury | Division of State Audit

Financial and Compliance Audit
**Tennessee Education Lottery Corporation**
For the Year Ended June 30, 2004

## AUDIT OBJECTIVES

The objectives of the audit were to consider the corporation's internal control over financial reporting; to determine compliance with certain provisions of laws, regulations, and contracts; to determine the fairness of the presentation of the financial statements; and to recommend appropriate actions to correct any deficiencies.

## INTERNAL CONTROL AND COMPLIANCE FINDING

**The Tennessee Education Lottery Corporation Needs to Improve the Administration of Its Human Resources**
Our audit procedures indicated instances of noncompliance with state law and corporation policies regarding the hiring of corporate employees. In addition, our procedures indicated several weaknesses in internal control related to payroll payments and records.

## OPINION ON THE FINANCIAL STATEMENTS

The opinion on the financial statements is unqualified.

# Audit Report
# Tennessee Education Lottery Corporation
# For the Year Ended June 30, 2004

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# Tennessee Education Lottery Corporation
# For the Year Ended June 30, 2004

## INTRODUCTION

### POST-AUDIT AUTHORITY

This is a report on the financial and compliance audit of the Tennessee Education Lottery Corporation. The audit was conducted pursuant to Section 4-3-304, *Tennessee Code Annotated*, which authorizes the Department of Audit to "perform currently a post-audit of all accounts and other financial records of the state government, and of any department, institution, office, or agency thereof in accordance with generally accepted auditing standards and in accordance with such procedures as may be established by the comptroller."

Section 8-4-109, *Tennessee Code Annotated*, authorizes the Comptroller of the Treasury to audit any books and records of any governmental entity that handles public funds when the Comptroller considers an audit to be necessary or appropriate.

### BACKGROUND

The Tennessee Education Lottery Corporation (TELC) was created on June 11, 2003, by the Tennessee General Assembly through the Tennessee Education Lottery Implementation Law. Pursuant with the law, TELC was incorporated as a body, politic and corporate, and a quasi-public instrumentality. TELC is responsible for the operation of a state lottery and is deemed to be acting in all respects for the benefit of the people of the State of Tennessee. TELC is governed by a seven-member board of directors. The board of directors is appointed by the Governor and confirmed by a joint resolution of each house of the General Assembly. The first seven members of the board of directors were appointed by the Governor on July 1, 2003.

The Tennessee Education Lottery Corporation's lottery games include instant ticket games and online games. At June 30, 2004, TELC had launched a total of 29 instant ticket games and 2 online games, Cash 3 and Powerball. TELC is required to pay its operating expenses from lottery proceeds and, as nearly as possible, make 50% of the money from actual sales of lottery tickets available as prize money. TELC is required by statute to make quarterly transfers of an amount representing net lottery proceeds of the immediately preceding quarter to the state treasury for credit to the "lottery for education account." State law also requires TELC to transfer 50% of monies constituting unclaimed prizes to the state treasury to be deposited in the "after school account" at the end of each fiscal year end.

## ORGANIZATION

The Tennessee Education Lottery Corporation is organized into five major organizational divisions: Executive, Legal, Administration, Sales and Marketing, and Finance and Information Systems.

The Executive Division is responsible for developing and implementing strategies to meet the corporation's objectives. This division oversees the day-to-day operations of the corporation.

The Legal Division includes the departments of Human Resources, Legal Services, and Security. The Human Resources Department manages all personnel functions for the corporate headquarters as well as the district offices. The Legal Services Department provides legal advice and assistance to management and the board of directors. The Legal Services Department also serves as the corporate records keeper and manages contract compliance.

The Administrative Division is responsible for facilities management, legislative affairs, internal audit, prize validation, retailer contract administration, and retailer services.

The Sales and Marketing Division is responsible for overseeing sales operations which include retailer sales and marketing; promotions and research; and distribution. This division is also responsible for the corporation's sales force and the management of the district offices.

The Division of Finance and Information Systems is responsible for financial and retail accounting and reporting, cash management, budgeting, collections, procurement, technology infrastructure, and telecommunications systems.

An organization chart for the Tennessee Education Lottery Corporation is on the following page.

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## AUDIT SCOPE

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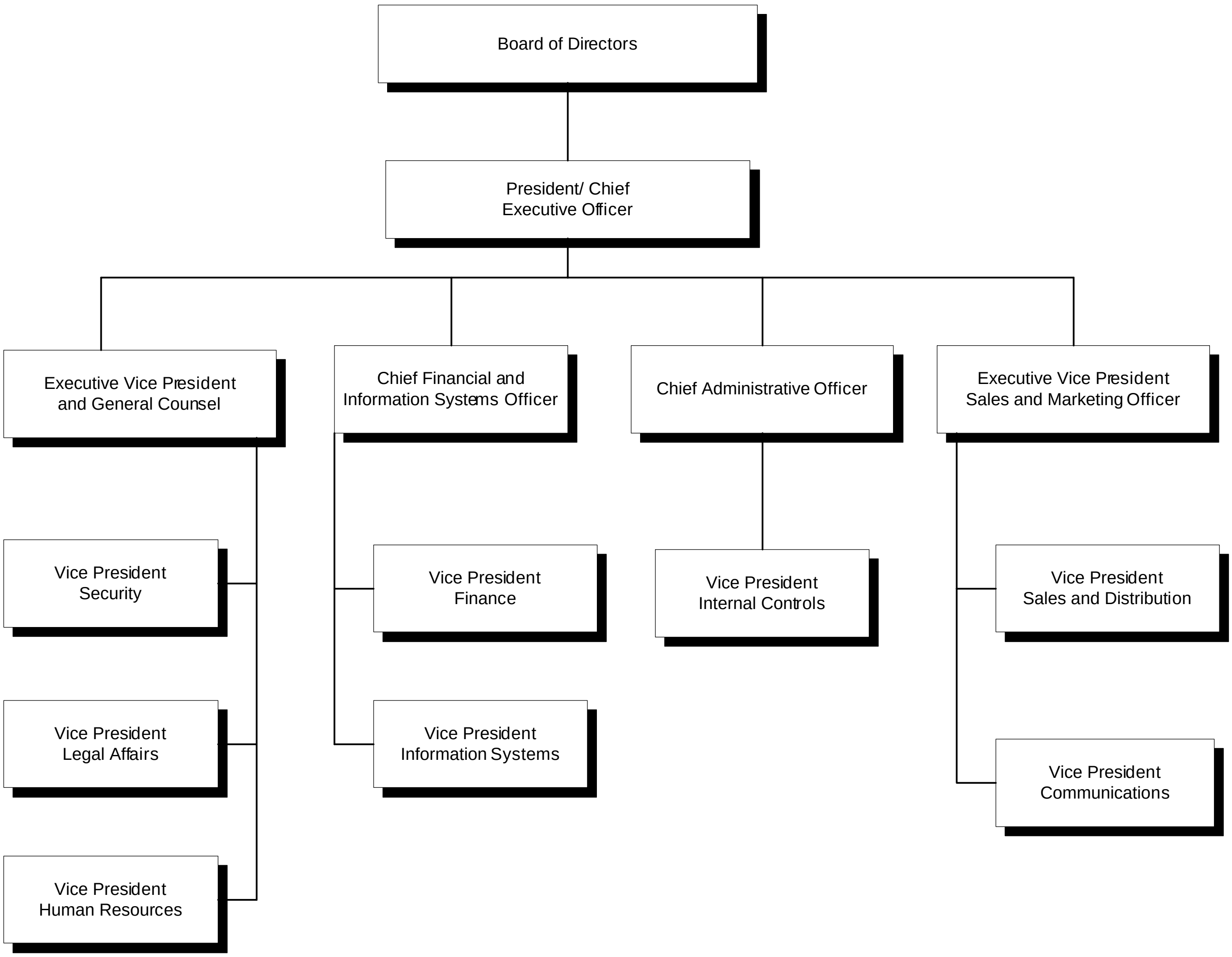
The audit was limited to the period July 1, 2003, through June 30, 2004, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Financial statements are presented for the year ended June 30, 2004. The Tennessee Education Lottery Corporation has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report*.

# Tennessee Education Lottery Corporation
# Organization Chart



## OBJECTIVES OF THE AUDIT

The objectives of the audit were

1. to consider the corporation's internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements;

2. to determine compliance with certain provisions of laws, regulations, and contracts;

3. to determine the fairness of the presentation of the financial statements; and

4. to recommend appropriate actions to correct any deficiencies.

## OBSERVATIONS AND COMMENTS

### INITIAL OBSERVATIONS

The Tennessee Education Lottery Corporation (TELC) began with the Governor's appointment of a seven-member board of directors on July 1, 2003. Subsequently, the Governor assigned one of his employees to assist the board with the start-up of the TELC. At that time, the lottery was without any other staff and had no equipment, furniture, or office.

In the ensuing months, the TELC established its management team, negotiated leases for its headquarters and four district offices across the state, assembled a network of over 4,250 retailers, and hired more than 170 employees.

From the first days of the operation of the TELC, the corporation, its staff and officers were faced with several deadlines to meet in order to have the lottery operational as soon as practicable.

This audit represents the first external examination of the lottery operations since its inception in July 2003. Obviously the lottery corporation and staff have been faced with numerous problems that are to be expected in any start-up of operations on the scale of the TELC. The audit discloses conditions that existed at the time of the audit fieldwork that need to be corrected. The lottery board and management have concurred with the finding and recommendation of the audit and have advised the auditors that they are taking appropriate steps to correct the issues noted in the finding.

As is the case with all audits, the auditors will include a review of these initial findings during the next audit of the TELC and will report on the progress of the board and management of the lottery corporation in addressing the findings. During the audit, the auditors will seek evidence from the board and management supporting the statements made at the conclusion of the current audit that they will implement the recommendations the auditors have made.

Of course, the next audit and succeeding audits will also look at matters beyond those noted in the current audit engagement. It is the expectation of the auditors that, as the operations of the lottery continue, the start-up issues noted in this audit will diminish with time.

During the current audit engagement, the auditors noted a condition that, while it represents non-compliance with state law, is a responsibility of the Governor's office and not the lottery. State law authorizing the Tennessee Education Lottery Corporation calls for a seven-member board of directors to oversee the lottery's creation and ongoing operation. The board, composed of business people from across the state, meets regularly to set policy and maintain appropriate oversight. Section 4-51-103(c)(2), *Tennessee Code Annotated*, requires the Governor to submit the names of potential directors to the Tennessee Bureau of Investigation for a criminal history records check. The names of potential directors are required to be submitted prior to the Governor's appointment of a person as a director. On July 8, 2004, the Governor appointed a director to fill a vacancy. However, the Tennessee Bureau of Investigation has no record of a request for a criminal history records check for the appointee. It is not the responsibility of the corporation's management to comply with this provision of the law. However, since the board is responsible to set policy and maintain appropriate oversight of the corporation, management should make reasonable efforts to ensure that director selection and appointment is in compliance with state law.

Users of this audit report are encouraged to read the Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards* on page 10 and the Independent Auditor's Report on page 17 to better understand the scope of an audit and the inherent limitations in any audit engagement.

## FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99 promulgated by the American Institute of Certified Public Accountants requires auditors to specifically assess the risk of material misstatement of an audited entity's financial statements due to fraud. The standard also restates the obvious premise that management, and not the auditors, is primarily responsible for preventing and detecting fraud in its own entity. Management's responsibility is fulfilled in part when it takes appropriate steps to assess the risk of fraud within the entity and to implement adequate internal controls to address the results of those risk assessments.

During our audit, we discussed these responsibilities with management and how management might approach meeting them. We also increased the breadth and depth of our inquiries of management and others in the entity as we deemed appropriate. We obtained formal assurances from top management that management had reviewed the entity's policies and procedures to ensure that they are properly designed to prevent and detect fraud and that management had made changes to the policies and procedures where appropriate. Top management further assured us that all staff had been advised to promptly alert management of all allegations of fraud, suspected fraud, or detected fraud and to be totally candid in all communications with the auditors. All levels of management assured us there were no known instances or allegations of fraud that were not disclosed to us.

## AUDIT COMMITTEE RECOMMENDATIONS

As a result of the fraud-related business failures of companies such as Enron and WorldCom in recent years, Congress and the accounting profession have taken aggressive measures to try to detect and prevent future failures related to fraud. These measures have included the signing of the *Sarbanes-Oxley Act of 2002* by the President of the United States and the issuance of Statement on Auditing Standards No. 99 by the American Institute of Certified Public Accountants. This new fraud auditing standard has not only changed the way auditors perform audits but has also provided guidance to management and boards of directors on creating antifraud programs and controls. This guidance has included the need for an independent audit committee.

As a result of these developments, we are recommending that agencies with boards establish audit committees. Or, where agencies, such as the Tennessee Education Lottery Corporation, already have audit committees, we are recommending that those agencies reexamine the activities of the existing audit committees. The specific activities of any audit committee will depend on, among other things, the mission, nature, structure, and size of each agency. In establishing the audit committee and creating its charter, each board should examine its agency's particular circumstances. Anti-fraud literature notes that there are two categories of fraud: fraudulent financial reporting and misappropriation of assets. The audit committee should consider the risks of fraud in its agency in general as well as the history of its particular agency with regard to prior audit findings, previously disclosed weaknesses in internal control, and compliance issues. The audit committee should consider both the risk of fraudulent financial reporting and the risk of fraud due to misappropriation or abuse of agency assets. Also, the board and the audit committee should keep in mind that quasi-public agencies should have a lower threshold of materiality than private sector entities with regard to fraud risks.

Boards should exercise professional judgment in establishing the duties, responsibilities, and authority of their audit committee. The factors noted below are not intended to be an exhaustive listing of those matters to be considered. The committee should not limit its scope to reacting to a preconceived set of issues and actions but rather should be proactive in its oversight of the agency as it concentrates on the internal control and audit-related activities of the entity. In fact, this individualized approach is one of the main benefits derived from an audit committee.

At a minimum, audit committees should:

1. Develop a written charter that addresses the audit committee's purpose and mission, which should be, at a minimum, to assist the board in its oversight of the agency.

2. Formally reiterate, on a regular basis, to the board, agency management, and staff their responsibilities for preventing, detecting, and reporting fraud, waste, and abuse.

3. Serve as a facilitator of any audits or investigations of the agency, including advising auditors and investigators of any information they may receive or otherwise note regarding risks of fraud or weaknesses in the agency's internal controls; reviewing with the auditors any findings or other matters noted by the auditors during audit engagements; working with the agency management and staff to ensure implementation of audit recommendations; and assisting in the resolution of any problems the auditors may have with cooperation from agency management or staff.

4. Develop a formal process for assessing the risk of fraud at the agency, including documentation of the results of the assessments and assuring that internal controls are in place to adequately mitigate those risks.

5. Develop and communicate to staff of the agency their responsibilities to report allegations of fraud, waste, or abuse at the agency to the committee and the Comptroller of the Treasury's office as well as a process for immediately reporting such information.

6. Immediately inform the Comptroller's office when fraud is detected.

7. Develop and communicate to the board, agency management, and staff a written code of conduct reminding those individuals of the public nature of the agency and the need for all to maintain the highest level of integrity with regard to the financial operations and any related financial reporting responsibilities of the agency; to avoid preparing or issuing fraudulent or misleading financial reports or other information; to protect agency assets from fraud, waste, and abuse; to comply with all relevant laws, rules, policies, and procedures; and to avoid engaging in activities which would otherwise bring dishonor to the agency.

The charter of the audit committee should include, at a minimum, the following provisions:

1. The audit committee should be a standing committee of the board.

2. The audit committee should be composed of at least three members. The chair of the audit committee should preferably have some accounting or financial management background. Each member of the audit committee should have an adequate background and education to allow a reasonable understanding of the information presented in the financial reports of the agency and the comments of auditors with regard to internal control and compliance findings and other issues.

3. The members of the audit committee must be independent from any appearances of other interests that are in conflict with their duties as members of the audit committee.

4. An express recognition that the board, the audit committee, and the management and staff of the agency are responsible for taking all reasonable steps to prevent, detect, and report fraud, waste, and abuse.

5. The audit committee should meet regularly throughout the year. The audit committee can meet by telephone, if that is permissible for other committees. However, the audit committee is strongly urged to meet at least once a year in person. Members of the audit committee may be members of other standing committees of the board, but the audit committee meetings should be separate from the meetings of other committees of the board.

6. The audit committee should record minutes of its meetings.

The Division of State Audit will be available to discuss with the board any questions it might have about its particular audit committee. There are also other audit committees which have been established at other state agencies that the board may wish to contact for advice and further information.

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## RESULTS OF THE AUDIT

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### AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee Education Lottery Corporation's financial statements for the year ended June 30, 2004, we considered internal control over financial reporting to determine auditing procedures for the purpose of expressing an opinion on the financial statements, as required by auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. A reportable condition, along with the recommendation and management's response, is detailed in the finding and recommendation. Consideration of internal control over financial reporting disclosed no material weaknesses.

Compliance and Other Matters

The results of our audit tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*. Immaterial instances of noncompliance or other matters, along with recommendations and management's responses, are included in the finding and recommendation.

Fairness of Financial Statement Presentation

The Division of State Audit has rendered an unqualified opinion on the corporation's financial statements.

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

December 3, 2004

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the financial statements of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of and for the year ended June 30, 2004, and have issued our report thereon dated December 3, 2004. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Tennessee Education Lottery Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the corporation's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

The following reportable condition was noted:

- The Tennessee Education Lottery Corporation needs to improve the administration of its human resources

This condition is described in the Finding and Recommendation section of this report.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

We also noted other matters involving the internal control over financial reporting, which we have reported to the corporation's management in a separate letter.

Compliance and Other Matters

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

We did, however, note certain immaterial instances of noncompliance or other matters that we have included in the Finding and Recommendation section of this report. We also noted certain other less significant matters, which we have reported to the corporation's management in a separate letter.

This report is intended solely for the information and use of the General Assembly of the State of Tennessee, the board of directors, and management and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AAH/cj

## FINDING AND RECOMMENDATION

**<u>The Tennessee Education Lottery Corporation needs to improve the administration of its human resources</u>**

### Finding

The Tennessee Education Lottery Corporation (TELC) was created on June 11, 2003, by the Tennessee Education Lottery Implementation Law. The corporation's headquarters is located in Nashville. In addition to the Nashville district office, the corporation has district offices in Chattanooga, Johnson City, Knoxville, and Memphis. The corporation began hiring employees in September 2003. At June 30, 2004, the corporation employed over 170 employees. As part of its employee benefits, the corporation offers retirement, deferred compensation, flexible spending plans, and incentive bonuses to its employees. During the course of the audit, we performed procedures regarding hiring employees, terminating employees, employee payroll, employee benefit plan deductions, and compliance with state law and corporation policies. Our procedures indicated several weaknesses in internal control related to the corporation's human resources as well as noncompliance with state law and corporation policies.

**<u>Noncompliance</u>**

- Section 4-51-110(e), *Tennessee Code Annotated,* requires the chief executive officer or such officer's designee to submit the names of potential employees to the Tennessee Bureau of Investigation for a criminal history records check prior to employment. This requirement applies to an employee at the level of division director and above, at any level within the division of security, and as otherwise required by the board. Based on our testwork, fingerprint searches for 25 of 26 applicable corporation employees (96%) were not completed prior to employment.

- The Tennessee Education Lottery Corporation's pre-employment drug-testing policy states, "All offers of employment with TEL are contingent upon the results of the pre-employment drug test having been received and confirmed to be satisfactory." However, drug test results for 18 of 22 employees sampled (82%) were not received prior to employment.

**<u>Internal control weaknesses</u>**

- The corporation's payroll system has only one user account. It is used by the payroll coordinator for the day-to-day input of payroll information. Because there is only one user account, the vice president of human resources does not have access to the payroll system. It appears a user account with read-only access for the vice president of human resources would enhance the review and approval process. Also, on one occasion, the payroll coordinator was absent from work and provided the vice president of human resources the password to the system in order to complete payroll. Sound internal control practices do not permit the sharing of passwords.

- A job applicant was added to the corporation's payroll and remained for two payroll periods, even though the applicant never officially reported for work. Management could not provide a personnel file or other documentation to support the addition of this individual to the payroll system. The job applicant did not receive the payroll payments.

- One of 15 terminated employees tested (7%) remained on the corporation's payroll for two payroll periods after the employee's termination date. The employee received the payment for the first pay period but not the second. The employee repaid the corporation after it requested the overpayment for the first pay period.

- Gross pay was either miscalculated or could not be recalculated for 5 of 50 payments (10%) sampled. In four instances, it appears the gross pay was calculated using an incorrect number of days in the pay period. In one instance, neither management nor the auditors could recalculate gross pay using the supporting time records.

- Federal income taxes were not withheld, and wages totaling $14,954.03 were incorrectly reported on the W-2 forms of two employees.

- For 6 of 50 payroll payments sampled (12%), amounts withheld for federal income taxes did not agree with the information provided by the employee on the W-4 form.

- Medical and dental insurance premiums, which should not have been withheld, were withheld from 3 of 13 incentive payments sampled (23%).

- During the fiscal year, management did not physically maintain deduction authorization forms for its employee benefit programs at corporate facilities. During the course of payroll testwork, management began obtaining the deduction authorization forms from its human resource contractor and maintaining the forms in personnel files. However, management could not provide authorization forms for 2 of 50 payroll transactions tested (4%).

- Four personnel files either did not contain the corporation's selection and authorization forms, or the forms were not signed by the chief executive officer. Therefore, the authorization of employment and compensation was not always documented and maintained in the personnel files.

- Personnel files for terminated employees did not always include the corporation's Termination Form or a Termination Employee Checklist. The Termination Form documents the reason for termination and provides for the signatures of the supervisor, division executive, vice president of human resources and the chief executive officer. The Termination Employee Checklist documents the return of corporate property, COBRA information, and retirement plan options at termination. Seven of 15 personnel files of terminated employees (47%) had deficiencies in termination documents. Three of 15 personnel files tested (20%) included neither the Termination Form nor the Termination Employee Checklist. For one of 15 personnel files tested (7%), the Termination Form was not signed. Two of 15 personnel files tested (13%) included a Termination Form but not a Termination Employee Checklist. For one of 15 personnel files tested (7%), the Termination Employee Checklist was not signed by the employee.

- There was no formal policy established to remove terminated employees' access to the corporation's information systems. Our testwork indicated that access to the domain system was not removed for 2 of 15 terminated employees (13%).

**Recommendation**

The chief executive officer should ensure that the corporation complies with all state statutes and board policies. The results of criminal history record checks and drug tests should be obtained from the Tennessee Bureau of Investigation prior to hiring employees.

The chief executive officer and the vice president of human resources should work with the audit committee and monitor controls over the human resources area to assess the risk of fraud and the quality of internal control over time. They should develop and implement controls to address the weaknesses noted in this finding as well as any risk areas identified through the ongoing monitoring process.

- Management of human resources should evaluate the user accounts for the payroll system and consider adding an additional user account for situations when the payroll coordinator is absent from work. In addition, management should consider enhancing the review and approval process by creating a read-only access user account for the vice president of human resources.

- Management should consider expanding its payroll review procedures in order to ensure that terminated employees are removed from payroll in a timely manner, only employees properly authorized by management are added to the payroll, gross pay is properly calculated and authorized, and federal income taxes are properly withheld and are supported by a W-4 form. Using the additional user account noted above, the vice president of human resources or an employee independent of payroll system input should review the information entered into the payroll system. This would enable management to identify any changes made to the payroll database and review related documentation to ensure the changes were authorized by the appropriate levels of management and that changes accurately reflect amounts authorized by management or the employee. In addition, management, through the internal audit function or an employee independent of payroll data input, should periodically sample payroll data input to ensure it is accurate and properly authorized. Finally, management should formally maintain documentation of all payroll review procedures performed.

- The vice president of human resources should continue to obtain and physically maintain documentation supporting deductions for employee benefit programs. As part of the recommended payroll review procedures noted above, the vice president of human resources should ensure that all required documentation regarding hiring, federal income tax withholding, employee benefit program deductions, and termination of employees is contained in the employee's personnel file. All of the required documentation should contain the appropriate signatures.
- The vice president of human resources should develop formal procedures to remove access to the corporation's automated systems for terminated employees. The procedures should be sufficient to remove access in a timely manner.

## Management's Comment

**Noncompliance**

Management concurs that the statute requires that a criminal history records check be preformed for all prospective employees prior to their employment with the TELC. During the start-up period this requirement was impractical due to the urgency of getting the lottery operational. All employees were made aware of the requirement prior to employment and told that their continued employment was conditional upon a satisfactory criminal records check. All current employees have subsequently complied with the requirement. Management further recommends that the statute be amended to state that continued employment is conditional on such a record examination and allow for a 15 day period for such a records check to be completed if required.

Management concurs. TEL policy requires that all prospective employees pass a drug test prior to their employment. During the start-up period this requirement was impractical due to the urgency of getting the lottery operational. All employees hired after the effective date of the policy have subsequently complied with the requirement. Management will recommend to the board that the policy be amended to state that continued employment is conditional on successfully completing such tests and to allow for a 15 day period for such tests to be completed if required.

**Internal control weaknesses**

Management concurs with the recommendations related to the internal control weaknesses highlighted. Management continues to establish procedures that provide for oversight of the human resources and payroll processes and secure the corporation's assets; and management continues to improve monitor controls over these processes. The Vice President of Human Resources takes an active role in reviewing any changes to the payroll system and continues to obtain and physically maintain all payroll deduction and benefit program documentation at corporate facilities.

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## Independent Auditor's Report

December 3, 2004

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statement of net assets of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of June 30, 2004, and the related statement of revenues, expenses, and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Tennessee Education Lottery Corporation's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Education Lottery Corporation, as of June 30, 2004, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The Honorable John G. Morgan
December 3, 2004
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The management's discussion and analysis 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 required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 3, 2004, on our consideration of the Tennessee Education Lottery Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AAH/cj

## TENNESSEE EDUCATION LOTTERY CORPORATION
## MANAGEMENT'S DISCUSSION AND ANALYSIS
## FOR THE YEAR ENDED JUNE 30, 2004

The management team of the Tennessee Education Lottery Corporation ("TEL") offers readers of the TEL's financial statements this narrative overview and analysis of the financial activities for the fiscal year ended June 30, 2004. We encourage readers to consider the information presented here in conjunction with the financial statements, which begin on page 25 of this annual report. The financial statements, notes, and this discussion are the responsibility of management. In future years, when prior-year information is available, a comparative analysis of financial data will be presented.

### *Financial Highlights*

The TEL launched instant ticket sales on January 20, 2004. The TEL had a statewide network of approximately 3,500 retailers. This increased in the ensuing five months to approximately 4,250 retailers as of June 30, 2004. Sales began with the introduction of four (4) instant ticket games. Since that time, the TEL has introduced an additional twenty-five (25) instant games, averaging two games every two weeks.

On March 1, 2004, we introduced our first online game, CASH 3, with a daily drawing of one three-digit number between 000 and 999.

On April 19, 2004, we began sales for the nationally recognized multi-jurisdictional game, known as Powerball, where the numbers are drawn twice a week on Wednesday and Saturday evenings.

The successful launch of the TEL games enabled the TEL to generate over $123 million in fiscal year 2004 for education, plus over $2 million for after school programs.

Other significant financial highlights include the following:

- Gross ticket sales were $427.69 million. Ticket sales, net of free instant tickets issued as prizes were $391.75 million.

- Gross prize expense was $216.97 million. This expense increases or decreases in direct proportion to ticket sales and represented approximately 55.4% of net ticket sales in 2004.

- Direct gaming expenses (not including prize expense) were $36.73 million. These expenses increase or decrease in proportion to ticket sales and represented approximately 8.59% of gross ticket sales in 2004. These expenses represented retailer commissions of $27.79 million and vendor fee payments of $8.94 million. Vendor fees represent 2.1% of gross ticket sales.

- Operating and other administrative expenses were $11.41 million, representing 2.7% of gross ticket sales.

- Advertising expenses were $4.79 million, representing 1.1% of gross ticket sales.

- Other operating revenues were $1.26 million. These included retailer application and service fees.

***Overview of the Financial Statements***

The TEL is accounted for similar to a business activity and as a discretely presented component unit of the State of Tennessee, reporting transactions using the full accrual basis of accounting. This discussion and analysis is intended to serve as an introduction to the TEL's basic financial statements, along with the notes to the financial statements. The basic financial statements include three components that report the TEL's net assets and changes therein: The Statement of Net Assets on page 25; the Statement of Revenues, Expenses, and Changes in Net Assets on page 26; and the Statement of Cash Flows on pages 27 and 28.

The Statement of Net Assets reflects the TEL's financial position at June 30, 2004.

The Statement of Revenues, Expenses, and Changes in Net Assets reports the activity of selling lottery products and expenses related to such activity for the year ended June 30, 2004.

The Statement of Cash Flows outlines the cash inflows and outflows related to the activity of selling lottery products for the year ended June 30, 2004.

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the financial statements. The notes to the financial statements begin on page 29 of this annual report.

Each quarter, the TEL transfers its net proceeds, as defined by the Tennessee Education Lottery Implementation Law, to the general fund of the state treasury for credit to the Lottery for Education Account. As a result, the TEL's net assets consist of capital assets and funds restricted for other statutorily-defined purposes. The reader of these financial statements should review the assets and liabilities in the Statement of Net Assets and the operating revenues and expenses in the Statement of Revenues, Expenses, and Changes in Net Assets to assess the TEL's financial position as of June 30, 2004.

## *Financial Analysis*

### Current Assets

Cash and other assets at June 30, 2004, were $80.52 million. These consisted primarily of cash and retailer receivables. Deposits with the State of Tennessee Local Government Investment Pool were $66.45 million. Retailer receivables approximated $11.04 million, representing funds due from retailers which are generally collected within three weeks of the reporting period.

### Capital Assets

Total capital assets at June 30, 2004, were $2.3 million. These consisted of fixed assets and leasehold improvements common to a business entity. They are presented net of depreciation and amortization.

### Current Liabilities

Total current liabilities at June 30, 2004, were $79.61 million consisting mainly of the $59.50 million to be transferred to the Lottery Education Account and $2.05 million to be transferred to the After School Program Account in July 2004; $14.53 million representing prizes payable to prize winners; $2.9 million representing amounts due to vendors for goods and services; and $554 thousand representing deferred sales.

### Long Term Liabilities

Total long term liabilities at June 30, 2004, were $915 thousand. This amount represents deferred rent incurred in relation to operating leases for TEL office space.

### Net Assets

Generally, the TEL's net assets are comprised of three components: assets invested in capital assets, unrestricted assets, and restricted assets.

Investments in capital assets were $2.3 million and represent capital assets acquired since inception, net of accumulated depreciation.

Unrestricted assets were a negative $2.3 million, representing capital assets not restricted for use by the business entity.

Restricted assets were $2.3 million and are comprised of $265 thousand restricted for certain uncollected retailer accounts receivable as defined by statute, and $2.05 million in unclaimed prizes restricted for future prizes or special prize promotions as mandated by statute.

**Sales**

Total lottery ticket sales for fiscal year 2004 were $427.69 million.

Gross instant ticket sales for the fiscal year 2004 were $361.86 million. This represents approximately 85% of the total gross sales. The instant ticket marketing strategy included multiple game introductions, along with $1, $2 and $5 price points. The games most popular with the players were Lucky 7's, Sizzling 7's and $100,000 Jackpot.

CASH 3 sales for the fiscal year 2004 were $26.04 million. This represents approximately 6% of gross sales. CASH 3 is a daily game whereby the player chooses a 3-digit number and wins a set prize amount if his or her numbers are selected in a nightly drawing. The aggregate prize amount per draw varies based on the number of winners and the prize amount. Historically, the average prize payout is approximately 50% of the sales for this game.

Powerball sales for the fiscal year 2004 were $39.79 million. This represents approximately 9% of the gross sales. Powerball is a multi-jurisdictional lottery game operated in the following jurisdictions; Arizona, Colorado, Connecticut, Delaware, Idaho, Iowa, Indiana, Kansas, Kentucky, Louisiana, Minnesota, Missouri, Montana, North Dakota, Nebraska, New Hampshire, New Mexico, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Vermont, Wisconsin, West Virginia; District of Columbia and US Virgin Islands. Approximately 50% of gross sales are made available for prize payments. The jackpot prize is paid on a pari-mutuel basis. All other prizes are set prize amounts in accordance with the game prize structure.

**Prize Expense**

Gross prize expense for instant games in fiscal year 2004 was $183.89 million. Instant games prize expense is managed through the number of tickets printed for each game and value of prizes as determined prior to ticket production. Prize expense is recognized based on an established prize structure and related percentage of sales for each game introduced, and is recognized when products are made available for sale to the public.

Gross prize expense for online games generally increases or decreases in direct proportion to ticket sales of the related game. Prize expense for online games is historically 50% of sales.

Gross prize expense for CASH 3 is impacted by the number and the prize value of winning tickets. To recognize prize expense on a consistent basis for this game, the TEL recognizes prize expense based on the historical industry average of 50%. Prize expense for CASH 3 in fiscal year 2004 was $13.19 million.

Gross prize expense for Powerball is recognized at 50% of sales in accordance with the game rules established by the Multi-State Lottery Association. Prize expense for Powerball in fiscal year 2004 was $19.89 million.

**Unclaimed Prizes**

The TEL recognizes a percentage of all prize expenses will remain unclaimed. Due to lack of data specific to unclaimed prizes at the TEL for the 2004 fiscal year, we estimated 2% as the percentage we expect to remain unclaimed relating to all prizes for instant games. For online games, we used an estimate of 2% of the prize liability (excluding jackpot prizes) as unclaimed prizes.

As these percentages are less than the actual industry average from the prior fiscal year (2003), we believe unclaimed prizes is conservatively estimated for fiscal year 2004.

**Direct Gaming and Operating Expenses**

Direct gaming expenses represent retailer commissions and vendor fees, which change in proportion with changes in ticket sales. Retailer commissions for fiscal year 2004 were $27.79 million. The TEL compensates its retailers through a set commission percentage of 6.5% on all instant tickets settled and online tickets sold. In addition, retailers will receive a $25 thousand bonus for selling winning a Powerball jackpot ticket. No bonus was paid in fiscal year 2004.

In 2004, vendor fees were $8.94 million. Vendor fees represent payments and commitments to our two major suppliers, GTECH Corporation and Scientific Games Inc., for the instant and online gaming products, systems, and services. The amount is determined based on a percentage of sales formula in accordance with contractual payment terms.

Advertising expenses were $4.79 million in 2004. The majority of these costs represents payments to Gish, Sherwood and Friends, our major advertising partner, for media buys and production costs.

Operating and other gaming expenses were $11.41 million for the fiscal year 2004. The majority of these costs related to professional fees of $1.44 million, retailer marketing and merchandising costs of $1.75 million and personnel expense of $5.79 million. Included in this figure is $3.6 million of costs incurred prior to start of ticket sales on January 20, 2004.

**Other Operating Revenue**

Other revenue consists primarily of retailer application fees and service fees. Other revenue for fiscal year 2004 totaled $1.26 million.

***Significant Factors Impacting Next Year***

The TEL will continue to work towards expanding its product offerings and product distribution network.

Expected product offerings will include higher price point instant games and a minimum of one additional online game.

As of July 1, 2004, the claim period for online games changed from 365 days to 180 days. We can not determine the impact, if any, to unclaimed prizes for the fiscal year 2005.

***Contacting the TEL's Finance Department***

This financial report is designed to provide the State of Tennessee, the public, and other interested parties with an overview of the financial results of the TEL's activities, and to show the TEL's accountability for conducting business in a fiscally responsible manner. If you have questions about this report or require additional financial information, contact the TEL's Finance Department at the following address:

Tennessee Education Lottery Corporation
Plaza Tower MetroCenter
200 Athens Way, Suite 200
Nashville, Tennessee 37228

Exhibit A

**TENNESSEE EDUCATION LOTTERY CORPORATION**
**STATEMENT OF NET ASSETS**
**AS OF JUNE 30, 2004**

| | |
|---|---|
| ASSETS | |
| CURRENT ASSETS: | |
| Cash (Note 2) | $ 67,729,000 |
| Restricted fidelity fund cash | 265,000 |
| Retailer accounts receivable, net of commissions due to retailers | 11,044,000 |
| Prepaid expenses and other assets | 1,191,000 |
| Prepaid rent | 294,000 |
| Total current assets | 80,523,000 |
| CAPITAL ASSETS, net of depreciation of $166,000 | 2,314,000 |
| TOTAL ASSETS | 82,837,000 |
| LIABILITIES | |
| CURRENT LIABILITES: | |
| Due to Lottery for Education Account (Note 6) | 59,499,000 |
| Due to After School Program Account | 2,049,000 |
| Prizes payable | 14,530,000 |
| Accounts payable | 390,000 |
| Accrued liabilities | 2,518,000 |
| Deferred rent | 68,000 |
| Deferred revenue | 554,000 |
| Total current liabilities | 79,608,000 |
| LONG-TERM LIABILITIES | |
| Noncurrent portion of deferred rent | 915,000 |
| TOTAL LIABILITIES | 80,523,000 |
| NET ASSETS: | |
| Investment in capital assets | 2,314,000 |
| Unrestricted assets | (2,314,000) |
| Restricted Assets: | |
| Restricted for uncollectible retailer receivables | 265,000 |
| Restricted for future prizes | 2,049,000 |
| TOTAL NET ASSETS | $ 2,314,000 |

See notes to financial statements

Exhibit B

**TENNESSEE EDUCATION LOTTERY CORPORATION**
**STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS**
**INCEPTION TO JUNE 30, 2004**

| | |
|---|---|
| OPERATING REVENUES: | |
| Ticket sales | $ 427,686,000 |
| Less instant tickets provided as prizes | (35,937,000) |
| Net ticket sales | 391,749,000 |
| Retailer service fees | 992,000 |
| Other | 269,000 |
| Net operating revenues | 393,010,000 |
| OPERATING EXPENSES: | |
| Available prizes | 216,972,000 |
| Prizes recognized as unclaimed | (4,098,000) |
| Net prizes | 212,874,000 |
| Retailer commissions and bonuses | 27,793,000 |
| Contractor fees | 8,939,000 |
| Advertising | 4,799,000 |
| Salaries and benefits | 5,787,000 |
| Retailer merchandising and marketing | 1,748,000 |
| Rent, utilities, and maintenance | 843,000 |
| Depreciation | 166,000 |
| Professional fees | 1,435,000 |
| Other | 1,429,000 |
| Total operating expenses | 265,813,000 |
| Operating income | 127,197,000 |
| NONOPERATING REVENUES (EXPENSES): | |
| Interest revenue | 195,000 |
| Interest expense | (21,000) |
| Retailer fees for future uncollectible retailer receivables | 265,000 |
| Proceeds to After School Program Account | (2,049,000) |
| Proceeds to Lottery for Education Account | (123,273,000) |
| Total nonoperating revenues(expenses) | (124,883,000) |
| NET ASSETS, beginning of year | - |
| NET ASSETS, end of year | $ 2,314,000 |

See notes to financial statements

Exhibit C

**TENNESSEE EDUCATION LOTTERY CORPORATION**
**STATEMENT OF CASH FLOWS**
**FOR THE YEAR ENDED JUNE 30, 2004**

| | |
|---|---|
| OPERATING ACTIVITIES: | |
| Cash received from customers | $ 381,259,000 |
| Other operating cash received | 1,259,000 |
| Cash paid to prize winners | (198,329,000) |
| Cash paid to/on behalf of gaming vendors | (8,575,000) |
| Cash paid to retailers | (27,820,000) |
| Cash paid for advertising | (3,553,000) |
| Cash paid to/on behalf of contractors and employees | (6,219,000) |
| Other operating payments | (4,538,000) |
| Net cash provided by operating activities | 133,484,000 |
| NONCAPITAL FINANCING ACTIVITIES: | |
| Payments to Lottery for Education Account | (63,774,000) |
| Short-term borrowings under line of credit agreement | 3,600,000 |
| Principal payments under line of credit agreement | (3,600,000) |
| Interest paid | (21,000) |
| Fidelity fund cash received from retailers | 288,000 |
| Fidelity fund cash refunded to retailers | (23,000) |
| Net cash used in noncapital financing activities | (63,530,000) |
| CAPITAL AND RELATED FINANCING ACTIVITIES: | |
| Purchase of property and equipment | (2,096,000) |
| Net cash used in capital and related financing activities | (2,096,000) |
| INVESTING ACTIVITIES: | |
| Interest income | 136,000 |
| Net cash provided by investing activities | 136,000 |
| NET CASH PROVIDED BY ALL ACTIVITIES | 67,994,000 |
| CASH at inception | - |
| CASH at end of year | $ 67,994,000 |

**Reconciliation of cash on the statement of net assets**

| | |
|---|---|
| Cash | $ 67,729,000 |
| Restricted fidelity fund cash | 265,000 |
| Cash at end of year | $ 67,994,000 |

See notes to financial statements

Exhibit C

**TENNESSEE EDUCATION LOTTERY CORPORATION**
**STATEMENT OF CASH FLOWS**
**FOR THE YEAR ENDED JUNE 30, 2004 (CONTINUED)**

**Reconciliation of net operating revenue to net cash provided by operating activities**

| | | |
|---|---|---|
| Operating income | $ | 127,197,000 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | |
| Depreciation | | 166,000 |
| Changes in assets and liabilities: | | |
| Retailer accounts receivable | | (11,044,000) |
| Prepaids and other assets | | (1,426,000) |
| Accounts payable and accrued liabilities | | 3,507,000 |
| Prizes payable | | 14,530,000 |
| Deferred revenue | | 554,000 |
| Net cash provided by operating activities | $ | 133,484,000 |

See notes to financial statements

## (1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Organization and Description of Reporting Entity-** Effective June 11, 2003, the Tennessee Education Lottery Implementation Law (the "Act"), *Tennessee Code Annotated* §§ 4-51-101,et.seq., was signed into law, creating the Tennessee Education Lottery Corporation (the "TEL"). Pursuant with the Act, the TEL was incorporated in the State of Tennessee as a body, politic and corporate, and a quasi-public instrumentality.

The TEL is considered a component unit of the State of Tennessee because the state has financial accountability for fiscal matters as follows: (1) the board of directors is appointed by the governor; (2) upon dissolution of the TEL, title to all property owned by the TEL shall vest in the State of Tennessee; and (3) the TEL provides financial benefits to the state in the form of transfer payments to the state treasury. The accompanying financial statements present information only as to the transactions of the programs of the TEL. The TEL is reported as a discretely presented component unit within the State of Tennessee's Comprehensive Annual Financial Report.

The TEL is responsible for the provision of lotteries on behalf of the State of Tennessee in accordance with the Act and is deemed to be acting, in all respects, for the benefit of the people of the State of Tennessee.

The TEL began ticket sales on January 20, 2004. The TEL's lottery games include instant ticket sales and online ticket sales for CASH 3 and Powerball.

**Basis of Presentation –** The accompanying financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board. Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in the financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. The TEL has the option of following subsequent private-sector guidance subject to this same limitation.

**Basis of Accounting and Measurement Focus –** Basis of accounting refers to the timing of recognition of revenues and expenses in the accounts and reporting in the financial statements, and the measurement focus refers to what transactions and events should be recorded. The financial statements are reported using the economic resources measurement focus and the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Under this method, revenues are recognized when they are earned and expenses are recognized when a liability is incurred, regardless of the timing of related cash flows.

**Revenue Recognition** - Lottery games are sold to the public by contracted retailers. Revenue is recognized for instant games when retailers make them available for sale to the public, as indicated by the retailers' activation of tickets. Revenue is recognized for online games when tickets are sold to players and the related draw occurs. Certain instant games include free tickets, which entitle the holder to exchange one instant ticket for another of equal value. The selling price of free tickets reduces instant ticket revenue when the ticket is claimed by a player.

**Net Assets –** Net assets represent cumulative revenues less expenses in excess of net proceeds transferred to the Lottery for Education Account, as defined under the Act (see Note 6). Net assets include funds invested in capital assets, restricted assets and unrestricted net assets.

**Cash** - Cash includes cash in banks, petty cash, and balances on account in the State of Tennessee Local Government Investment Pool (LGIP).

**Retailer Accounts Receivable** - Retailer accounts receivable represents lottery proceeds due from retailers for net ticket sales less commissions and prizes paid by the retailers. Lottery proceeds are collected weekly from retailer bank accounts established in trust for the TEL.

**Capital Assets -** Capital assets are stated at cost less accumulated depreciation. Depreciation on capital assets is computed using the straight line method over the estimated useful lives of the assets, which is 3 to 7 years for most assets. Leasehold improvements are amortized over their expected useful lives or the lease term, whichever is shorter. 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 the results from operations in the period of disposal.

**Deferred revenue –** Funds collected from retailers for online game tickets sold in advance of the prize drawings are recorded as deferred revenue and recognized as revenue once the related drawing occurs.

**Fidelity Fund** - In accordance with the Act, upon acceptance as a TEL retailer, retailers contribute a fee to a fidelity fund. Funds may be used to cover losses incurred as a result of nonfeasance, malfeasance, or misfeasance of TEL retailers. Fidelity fund proceeds are held in a demand deposit account at Citizens Bank and are classified as restricted fidelity fund cash on the Statement of Net Assets. At the end of each fiscal year, the net assets exceeding $500 thousand may be treated as net proceeds from the TEL subject to transfer to the Lottery for Education Account. As of the year ended June 30, 2004, there were no fidelity funds available for transfer as net proceeds.

**Retailer Commissions and Bonuses –** Retailers receive a commission of 6.5% on all instant tickets settled and online tickets sold. Where commission has been paid to retailers for deferred revenue ticket sales, this fee is recorded as a prepaid expense until the related revenue is recognized. A $25 thousand bonus will be paid to the retailer who sells a winning Powerball jackpot ticket. No bonus was paid in fiscal year 2004.

**Contractor Fees –** The TEL has contracted with two vendors, GTECH Corporation ("GTECH") and Scientific Games International, Inc. ("Sci-Games"), for the majority of the gaming systems and supplies.

GTECH operates the gaming network that consists of over 4,250 instant and online retailer ticket terminals and associated software. GTECH receives a fee of 1.24% of the selling price of online tickets sold, and of instant ticket activations, net of free tickets available as prizes.

Sci-Games prints and distributes the instant game tickets to retailers. Sci-Games receives a fee of 1.139% of the selling price of instant ticket activations by retailers.

**Prizes –** In accordance with the Act, as nearly as practical, at least 50% of ticket proceeds must be made available as prize money. Gross prize expense for instant ticket sales is recognized based on a predetermined prize structure for each game. Generally, gross prize expense for online games is recognized based on the estimated payout experience over the life of the games or the industry averages.

Powerball prizes are shared based on contributions to the prize pool by all member lotteries of the Powerball Group of the Multi-State Lottery Association ("MUSL"). All Powerball grand prizes won by players who purchase tickets in Tennessee will be funded by investments purchased by MUSL. The investments will be held by MUSL in trust for the TEL.

**Unclaimed Prizes –** Prizes not claimed within 90 days of the game-end date for instant games, and within 365 days of a game draw date for online games are forfeited as unclaimed prizes.

For instant games, an estimated percentage of total prize expense is recognized as unclaimed prizes based upon the lottery's claim experience or industry averages.

For online games, an estimated percentage of prize liability, excluding jackpot prizes, is recognized as unclaimed prizes based upon the lottery's claim experience or industry averages.

In accordance with the Act, fifty percent (50%) of unclaimed prizes recognized at the fiscal year end must be transferred to the After School Programs Special Account. On July 30, 2004, the TEL transferred $2.049 million to the State of Tennessee After School Programs Special Account, representing 50% of unclaimed prizes recognized at June 30, 2004. The remainder of unclaimed prizes is used to fund future prizes or special prize promotions, as defined by the statute.

**Budget** – Pursuant with the Act, annually by June 30, the TEL is required to submit a proposed operating budget for the next fiscal year to the Tennessee Department of Finance and Administration, Office of Legislative Budget Analysis, and Comptroller of the Treasury. Additionally, the TEL is required to submit for informative purposes, a proposed operating budget for the succeeding fiscal year by September 1, to the Tennessee Department of Finance and Administration.

**Contingencies** – Liabilities for loss contingencies arising from claims, assessments, litigation, fines and penalties, and other sources are recorded when it is probable that a liability has been incurred and the amount of the liability can be reasonably estimated. As of June 30, 2004, no such liability exists.

**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 certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the financial statements in the period they are determined.

**Advertising** – In accordance with AICPA Statement of Position 93-7, *Reporting on Advertising Costs*, advertising costs are expensed the first time the related advertising takes place.

**Insurance** – In order to minimize financial losses resulting from the occurrence of theft; employee dishonesty; legal judgments; work-related employee injury and accidents; and catastrophic events, the TEL has obtained insurance from various providers. In the event of loss, coverage is provided as follows:

Employee dishonesty – aggregate of $500 thousand total

Business personal property – limit of $300.5 thousand in any one occurrence

Automobile – limit of $1million combined single limit (bodily injury/property damage)

General liability – aggregate of $2 million

Worker's compensation – up to statutory limits

Employment practices liability – aggregate of $5 million

Umbrella coverage – aggregate of $5 million

**Non Operating Revenues and Expenses –** Represents revenues and expenses resulting from activities not associated with the sale of lottery tickets.

**Compensated Absences -** On June 30, 2004, TEL had a temporary paid time off policy in effect. This policy allowed each employee to use up to eight days of paid leave. If an employee terminated their employment with the TEL, the corporation would not be liable to the employee for any unused balance. Therefore, no accrual was made for compensated absences for this fiscal year.

## (2) CASH

Cash is held in demand deposit accounts at various financial institutions. At June 30, 2004, the bank balances of approximately $2.2 million were fully insured by either federal depository insurance or the state's collateral for public deposits in accordance with the Collateral Pool for Public Deposits Act of 1990 (*Tennessee Code Annotated*, Title 9, Chapter 4-501). Pursuant to the aforementioned act, these deposits were collateralized with U.S. Government securities; surety bonds issued by insurance companies meeting certain requirements, including licensure under the laws of the State of Tennessee; or standby letters of credit from approved Federal Home Loan Banks. The securities are held in the name of the State of Tennessee by an authorized trustee custodian. The fair value of the underlying securities must be equal to at least 90% of the amount of funds held by the financial institution on behalf of the TEL. In the event of bank failure by financial institutions holding TEL funds, remaining members of the collateral pool are contractually obligated to refund any uncollateralized balances to the TEL.

Cash in excess of immediate needs represent surplus cash deposited in the LGIP fund, administered by the State of Tennessee Office of the Treasury. The voluntary fund is a short-term investment vehicle that is available for use by state and local government entities. The LGIP invests its assets in the following instruments:

- United States bonds, notes and treasury bills or other obligations guaranteed as to principal and interest by the United States or any of its agencies;
- Repurchase agreements for obligations of the United States or its agencies;
- Certificates of deposit in banks and savings and loans associations recognized as state depositories pursuant to *Tennessee Code Annotated* Section 9-4-107, provided, however, certificates of deposit shall be collateralized in accordance with the provisions of *Tennessee Code Annotated* Section 9-4-403;
- Prime commercial paper which shall be rated in the highest category by at least two nationally recognized commercial paper rating services;
- Prime banker's acceptances that are eligible for purchase by the Federal Reserve System;
- Securities lending agreements whereby securities may be loaned for a fee; provided, however, eligible collateral as defined in *Tennessee Code Annotated*, Section 9-4-103, whose market value is at least equal to one hundred two percent (102%) of the market value of the borrowed securities shall be required for each loan. For purposes of this provision, eligible collateral shall include cash collateral, which shall be equal to at least one hundred percent (100%) of the market value of the borrowed securities; and
- Obligations of the State pursuant to *Tennessee Code Annotated*, Section 9-4-602(b).

As of June 30, 2004, the State of Tennessee's pooled investment funds net assets totaled $4.5 billion and were invested in the following financial instruments:

| | |
|---|---|
| Certificates of deposit | 45% |
| United States agencies | 33% |
| Commercial paper | 16% |
| Repurchase agreements | 6% |

The TEL's deposits with the LGIP were approximately $66.5 million at June 30, 2004. Interest earned on the TEL's deposits was approximately $177 thousand for the year ended June 30, 2004.

No allocation will be made as to the TEL's share of the types of investments or LGIP's risk categories. The TEL's share of the assets and liabilities arising from the above investments will not be presented on the Statement of Net Assets since the LGIP is operated on a pooled basis. To do so may give the misleading impression that the TEL has some controlling authority over the investment vehicles.

The custodial credit risk for the Local Government Investment Pool is presented in the Tennessee Comprehensive Annual Financial Report for the year ended June 30, 2004. This report may be obtained by contacting the Tennessee Department of Finance and Administration, Division of Accounts, 14th Floor William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, Tennessee 37243-0298.

## (3) LINE OF CREDIT

On August 29, 2003, in order to fund initial startup expenses and to provide working capital, the TEL obtained a $15.0 million revolving line of credit which expired on June 30, 2004, from First Tennessee Bank. Under this agreement, at the TEL's option, the outstanding principal balance bore interest at the Wall Street Journal Prime Rate or the Libor Rate plus 250 basis points. During the year ended June 30, 2004, the TEL borrowed and repaid $3.6 million in principal, along with interest totaling approximately $21 thousand under this line of credit.

## (4) CAPITAL ASSETS

Capital assets consisted of the following as of June 30, 2004:

| | Beginning Balance | Increases | Decreases | Ending Balance |
|---|---|---|---|---|
| Capital asset being depreciated: | | | | |
| Furniture and fixtures | $ - | $ 85,000 | $ - | $ 85,000 |
| Computer equipment | - | 273,000 | - | 273,000 |
| Vehicles | - | 884,000 | - | 884,000 |
| Leasehold improvements | - | 260,000 | - | 260,000 |
| Communication equipment | - | 677,000 | - | 677,000 |
| Software | - | 243,000 | - | 243,000 |
| Gaming equipment | - | 58,000 | - | 58,000 |
| Total capital assets | - | 2,480,000 | - | 2,480,000 |
| Less accumulated depreciation | - | (166,000) | - | (166,000) |
| Total capital assets, net | $ | $ 2,314,000 | $ | $ 2,314,000 |

## (5) OPERATING LEASES AND DEFERRED RENT

The TEL has entered into noncancelable operating leases for office space for its headquarters and district offices, and for outdoor advertising billboard space. These leases expire at various dates through 2014. Certain office space operating leases contain provisions for scheduled rental increases and are renewable at the option of the TEL. No lease renewal options were exercised during the fiscal year ending June 30, 2004.

**Office Space Leases -** As an incentive for entering into certain office space lease agreements, the TEL received rent abatements approximating $667 thousand from landlords. In accordance with Financial Accounting Standards 13, *Accounting for Leases*, and Governmental Accounting Standards 13, *Accounting for Operating Leases with Scheduled Rent Increases*, the TEL recognizes the related assets as a reduction to prepaid rent as rent becomes due and recognizes the related liabilities as a reduction to rent expense over the entire lease term on a straight line basis. As of June 30, 2004, prepaid rent relating to the lease incentives was approximately $269 thousand.

Deferred rent of approximately $983 thousand existed at June 30, 2004. Of this amount, $68 thousand is considered current and $915 thousand of this amount is non current. The non current amount is made of $554 thousand relating to rent abatements and $361 thousand relating to the straight line presentation of the escalating rent payments over the life of the Nashville office lease.

Future minimum rental payments, net of deferred rent expense, under noncancelable operating leases with original terms of one year or more are scheduled as follows:

| **Year Ending June 30:** | | |
|---|---|---|
| 2005 | $ | 998,000 |
| 2006 | | 1,356,000 |
| 2007 | | 1,356,000 |
| 2008 | | 1,356,000 |
| 2009 | | 1,316,000 |
| 2010-2014 | | 5,498,000 |
| Total minimum lease payments | $ | 11,880,000 |

Rental expense for office space under all related operating leases, net of deferred rent, totaled approximately $93 thousand, for the year ended June 30, 2004.

**Outdoor Billboard Leases -** Future minimum rental payments under noncancelable operating leases with original terms of one year or more are scheduled as follows:

| **Year Ending June 30:** | | |
|---|---|---|
| 2005 | $ | 835,000 |
| 2006 | | 220,000 |
| 2007 | | 213,000 |
| 2008 | | 213,000 |
| 2009 | | 195,000 |
| Total minimum lease payments | $ | 1,676,000 |

Rental expense for outdoor billboards under all related operating leases totaled approximately $95 thousand for the year ended June 30, 2004.

## (6) DUE TO LOTTERY FOR EDUCATION ACCOUNT

In accordance with the Act, all net proceeds of the TEL are due to the Lottery for Education Account. "Net proceeds" is defined under the Act as "all revenue derived from the sale of lottery tickets or shares and all other monies derived from lottery games less operating expenses."

"Operating expenses" are defined under the Act as "all costs of doing business, including, but not limited to, prizes, commissions, and other compensation paid to lottery retailers, advertising and marketing costs, rental fees, personnel costs, capital costs, depreciation of property and equipment, amounts held in or paid from a fidelity fund, and all other operating costs." All other expenses are considered non operating.

Net proceeds and operating expenses for the year ended June 30, 2004, are summarized as follows:

| | | **2004** |
|---|---|---|
| Operating revenues: | | |
| Ticket sales | $ | 427,686,000 |
| Less instant tickets provided as prizes | | (35,937,000) |
| Net ticket sales | | 391,749,000 |
| Service fees and other revenue | | 1,261,000 |
| Net operating revenues | | 393,010,000 |
| Operating expenses, as defined: | | |
| Gaming | | 260,249,000 |
| Operating | | 9,662,000 |
| Total operating expenses, as defined | | 269,911,000 |
| Net proceeds before distribution of unrestricted net assets | | 123,099,000 |
| Non-operating revenue and expenses | | |
| Interest income | | 195,000 |
| Interest expense | | (21,000) |
| Total non-operating revenue and expenses | | 174,000 |
| Net proceeds subject to transfer | $ | 123,273,000 |
| Amount due to Lottery for Education Account for year | $ | 123,273,000 |
| Amount paid during year | | (63,774,000) |
| Amount due to Lottery for Education Account, end of year | $ | 59,499,000 |

All amounts due at June 30, 2004, were transferred to the Lottery for Education Account in July 2004.

## (7) EMPLOYEE BENEFITS

**457 Employees Deferred Compensation Plan -** Effective September 22, 2003, the TEL provided its employees with a deferred compensation plan created in accordance with Internal Revenue Code Section 457 (the "457 Plan"). The 457 Plan, available to all employees at their option, permits participants to defer a portion of their salary until future years. The deferred compensation is not available to participants until termination, retirement, death, or unforeseeable emergency. During the year ended June 30, 2004, employees contributed approximately $166 thousand to the 457 Plan.

**401(a) Employer Defined Contribution Plan –** Effective September 22, 2003, the TEL established a defined contribution plan in accordance with Internal Revenue Code Section 401(a) (the "401(a) Plan"). Under the 401(a) Plan all employees receive compensation from the TEL in the form of non-voluntary deferrals to their individual 401(a) accounts as follows:

1. Contribution of five percent (5%) of employee's compensation, and
2. Matching contribution of seventy-five percent (75%) of the participant's contributions to the 457 Plan up to the first five (5) percent of the participant's compensation.

These contributions vest over a 4-year period at a rate of twenty-five percent (25%) per year and are not available to participants until termination, retirement, death, or unforeseeable emergency. During the year ended June 30, 2004, TEL contributed approximately $262 thousand to the 401(a) Plan on behalf of its employees. Forfeitures of plan contributions will be used to offset administrative expenses and/or reduce future contribution costs.

Section 1448 of the Small Business Job Protection Act of 1996 added Subsection (g) to Section 457 of the Internal Revenue Code to provide that all assets and income under a Section 457(b) plan that are maintained by a state or local government employer must be held in trust for the exclusive benefit of plan participants and their beneficiaries. The 457 Plan and 401(a) Plan assets are held in aggregate by Manulife Financial, the plans' custodian.

The aggregate fair value of the plans' assets was $398 thousand, net of forfeitures and administrative fees, as of June 30, 2004.

## (8) COMMITMENTS AND CONTINGENCIES

**Millionaire Drawings -** The TEL has committed to conducting two special lottery drawings whereby prizes totaling approximately $2.07 million will be awarded to six individuals. The TEL anticipates completing these drawings by June 30, 2005.

**Legal -** The TEL is subject to litigation in the ordinary course of its business. In the opinion of management and legal counsel, the outcome of such litigation will not have a material impact on the financial position or cash flows of the TEL.

## (9) SUBSEQUENT EVENTS

During the month of July 2004, the TEL entered into 3 one-year, operating lease agreements for outdoor billboard advertising space. In relation to these billboards, the TEL expects to incur expense of approximately $27 thousand, during the fiscal year ending June 30, 2005.

On July 1, 2004, the claim period for online games was changed from 365 days to 180 days.