AUDIT REPORT

Tennessee Education Lottery Corporation

For the Year Ended
June 30, 2005

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

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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

February 16, 2006

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
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, 2005. 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 resulted in no audit findings.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/th
05/109

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, 2005

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.

AUDIT FINDINGS

The audit report contains no findings.

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, 2005

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Tennessee Education Lottery Corporation
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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 4-51-129, *Tennessee Code Annotated*, which states that the corporation shall "be subject to audits by the Comptroller of the Treasury in accordance with Section 8-4-109."

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 Tennessee Education Lottery Corporation's lottery games include instant ticket games and online games. At June 30, 2005, TELC had launched a total of 65 instant ticket games and 4 online games: Cash 3, Cash 4, Lotto 5, 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.

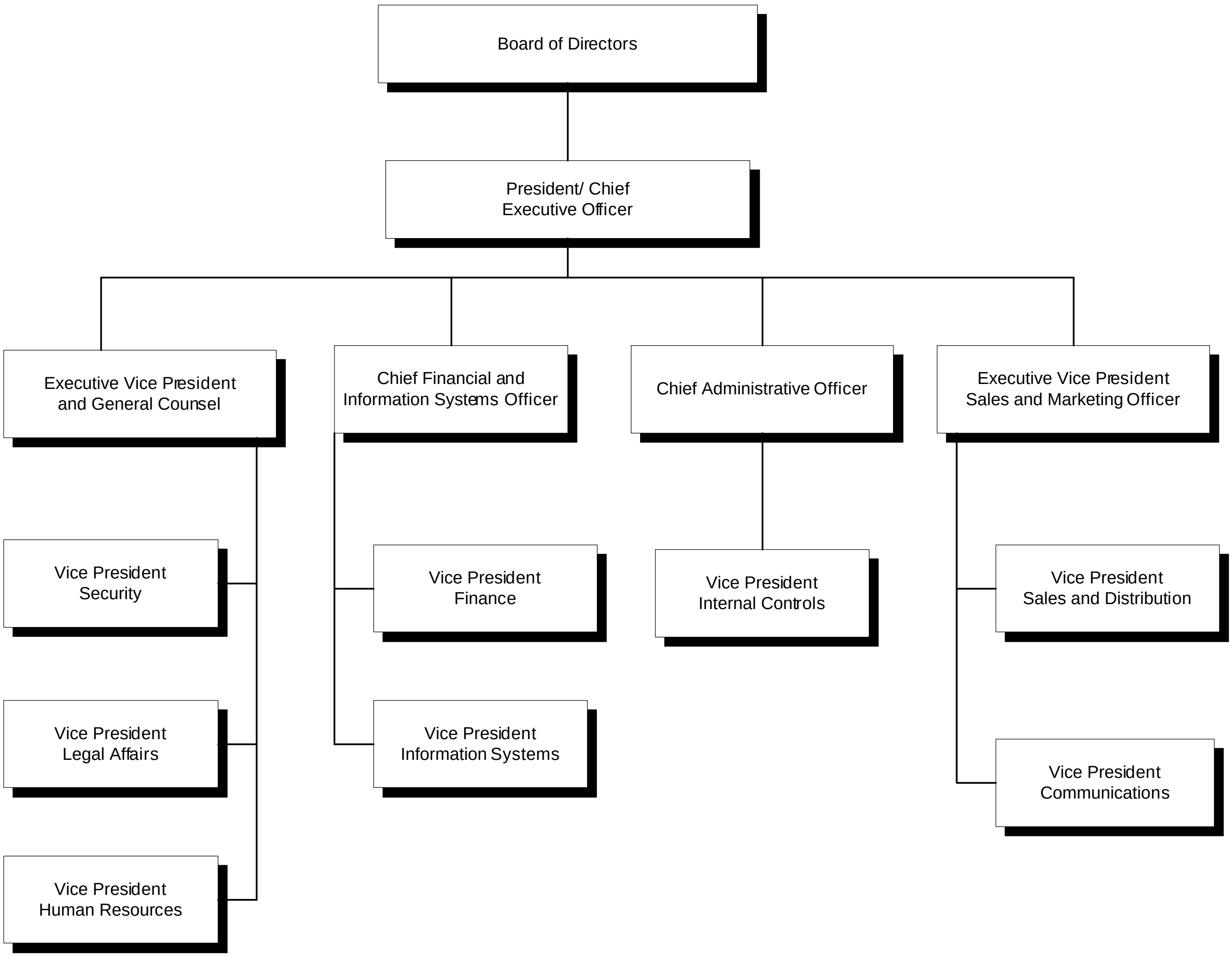
The Division of Finance and Information Systems is responsible for financial and retail accounting and reporting, cash management, budgeting, collections, procurement, technology infrastructure, and telecommunications systems.

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

AUDIT SCOPE

The audit was limited to the period July 1, 2004, through June 30, 2005, 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, 2005. 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.

PRIOR AUDIT FINDINGS

Section 8-4-109, *Tennessee Code Annotated*, requires that each state department, agency, or institution report to the Comptroller of the Treasury the action taken to implement the recommendations in the prior audit report. The Tennessee Education Lottery Corporation filed its report with the Department of Audit on July 28, 2005. A follow-up of the prior audit finding was conducted as part of the current audit. The current audit disclosed that the Tennessee Education Lottery Corporation has corrected the previous audit finding concerning the need to improve the administration of its human resources.

OBSERVATIONS AND COMMENTS

TRANSFER OF NET LOTTERY PROCEEDS

Section 4-51-11, *Tennessee Code Annotated*, requires the Tennessee Education Lottery Corporation to transfer estimated net lottery proceeds to the lottery for education account on a quarterly basis. That same section also requires for the year ended June 30, 2005, that the net lottery proceeds transferred to the lottery education account "equal, as nearly as practical, thirty percent (30%) of the lottery for proceeds." For the year ended June 30, 2005, lottery proceeds totaled $788 million and the corporation transferred $227.4 million to the lottery for education account. The amount transferred was approximately 28.9 percent of lottery proceeds.

MANAGEMENT'S RESPONSIBILITY FOR RISK ASSESSMENT

Auditors and management are required to assess the risk of fraud in the operations of the entity. The risk assessment is based on a critical review of operations considering what frauds could be perpetrated in the absence of adequate controls. The auditors' risk assessment is limited to the period during which the audit is conducted and is limited to the transactions that the auditors are able to test during that period. The risk assessment by management is the primary method by which the entity is protected from fraud, waste, and abuse. Since new programs may be established at any time by management or older programs may be discontinued, that assessment is ongoing as part of the daily operations of the entity.

Risks of fraud, waste, and abuse are mitigated by effective internal controls. It is management's responsibility to design, implement, and monitor effective controls in the entity. Although internal and external auditors may include testing of controls as part of their audit procedures, these procedures are not a substitute for the ongoing monitoring required of management. After all, the auditor testing is limited and is usually targeted to test the effectiveness of particular controls. Even if controls appear to be operating effectively during the time of the auditor testing, they may be rendered ineffective the next day by management override or by other circumventions that, if left up to the auditor to detect, will not be noted until the next audit engagement and then only if the auditor tests the same transactions and controls. Furthermore, since staff may be seeking to avoid auditor criticisms, they may comply with the controls during the period that the auditors are on site and revert to ignoring or disregarding the control after the auditors have left the field.

The risk assessments and the actions of management in designing, implementing, and monitoring the controls should be adequately documented to provide an audit trail both for auditors and for management, in the event that there is a change in management or staff, and to maintain a record of areas that are particularly problematic.

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

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 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.

In recognition of the benefits of audit committees for government, the Tennessee General Assembly has enacted legislation known as the "State of Tennessee Audit Committee Act of 2005." This legislation requires the creation of audit committees for those entities that have governing boards, councils, commissions, or equivalent bodies that can hire and terminate employees and/or are responsible for the preparation of financial statements. Applicable entities are required to develop an audit committee charter and appoint the audit committee in accordance with the legislation.

Where entities, such as the Tennessee Education Lottery Corporation, already have audit committees, those entities should 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 creating or revising 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 agencies responsible for public funds 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.

RESULTS OF THE AUDIT

AUDIT CONCLUSIONS

Internal Control

As part of the audit of the Tennessee Education Lottery Corporation's financial statements for the year ended June 30, 2005, 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. 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*.

Fairness of Financial Statement Presentation

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

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COMPTROLLER OF THE TREASURY
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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 9, 2005

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, 2005, and have issued our report thereon dated December 9, 2005. 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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. 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. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

However, we noted certain 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 less significant instances of noncompliance or other 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/th

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
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Independent Auditor's Report

December 9, 2005

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

Dear Mr. Morgan:

We have audited the accompanying statements of net assets of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of June 30, 2005, 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 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, 2005, 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 management's discussion and analysis, as listed in the table of contents, 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 9, 2005, 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/th

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 year ended June 30, 2005. We encourage readers to consider the information presented here in conjunction with the financial statements that begin on page 21 of this report. The financial statements, notes, and this discussion are the responsibility of management.

Upon reviewing this narrative and the corresponding financial statements, readers should note that the TEL's year ended June 30, 2005, is comprised of twelve months of operational activity whereas the previous year ended June 30, 2004, is comprised of approximately six months of operational activity. Therefore, no financial comparisons between the years ended June 30, 2005, and June 30, 2004, will be made in this discussion, as it would be misleading to our financial statement users.

Financial Highlights

As of the year ended June 30, 2005, the TEL retailer base was composed of approximately 4,350 retailers; our game roster was composed of sixty-five (65) instant games and four (4) online games noted as follows:

- CASH 3, introduced on March 1, 2004, is a computerized game consisting of a daily drawing of one three-digit number between 000 and 999. Televised drawings are conducted every evening Monday through Sunday.
- POWERBALL, introduced on April 19, 2004, is a nationally recognized multi-jurisdictional game. The game consists of a drawing whereby 5 numbers are chosen from a field of 53 and one number from a field of 42. The game gives players a chance to win prizes from $3 to a multimillion-dollar jackpot. Televised drawings are conducted on Wednesday and Saturday evenings.
- LOTTO 5, introduced on August 29, 2004, is a computerized game consisting of a drawing whereby 5 numbers are chosen from a field of 39. Prize amounts are pari-mutuel based upon sales. Televised drawings are conducted on Monday, Wednesday and Friday evenings.
- CASH 4, introduced on April 17, 2005, consists of a daily drawing of one four-digit number between 0000 and 9999. Televised drawings are conducted every evening, Monday through Sunday.

The significant financial highlights include the following:

- Gross ticket sales were $844.32 million. Ticket sales, net of free instant tickets issued as prizes, were $783.70 million.
- Gross prize expense was $457.99 million. This expense increases or decreases in direct proportion to ticket sales and represented approximately 58.4% of net ticket sales in 2005.
- Direct gaming expenses (not including prize expense) totaled $71.39 million. These expenses increase or decrease in proportion to ticket sales. Direct gaming expenses consisted of retailer commissions of $54.88 million and vendor fee payments of $16.51 million. Direct gaming expenses represented approximately 8.46% of gross ticket sales.
- Operating and other administrative expenses were $19.41 million. These expenses represented 2.3% of gross ticket sales.
- Advertising expenses were $13.83 million. These expenses represented 1.6% of gross ticket sales.
- Other operating and non-operating revenues were $4.30 million. These revenues primarily consisted of retailer service fees and interest income.

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 21; the Statement of Revenues, Expenses, and Changes in Net Assets on page 22; and the Statement of Cash Flows on pages 23 and 24.

The Statement of Net Assets reflects the TEL's financial position as of June 30, 2005.

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, 2005.

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, 2005.

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 25 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, 2005.

Financial Analysis

Current Assets

As of June 30, 2005, current assets of $93.7 million were primarily composed of cash and retailer accounts receivables. Cash totaling $54.38 million represented operating funds and funds on deposit with the State of Tennessee's Local Government Investment Pool. Retailer receivables of $35.28 million represented funds due from retailers that are generally collected within three weeks of the reporting period.

Capital Assets

Total capital assets, presented net of depreciation and amortization, were approximately $2.98 million as of the year ended June 30, 2005. These consisted of fixed assets and leasehold improvements common to a business entity.

Current Liabilities

Total current liabilities were $88.32 million at June 30, 2005. Current liabilities included $59.09 million to be transferred to the Lottery for Education Account; $6.87 million to be transferred to the After School Special Account; $16.88 million of prizes payable to prize winners; $4.69 million primarily due to vendors for goods and services performed; and $786 thousand of deferred revenues received from retailers.

Long-Term Liabilities

Total long-term liabilities at June 30, 2005, were $1.17 million. This amount represents deferred rent incurred in relation to operating leases for the TEL's office spaces and the long-term portion of compensated absences.

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 approximately $2.98 million as of the year ended June 30, 2005. Amounts represent capital assets acquired since inception, net of accumulated depreciation.

Unrestricted assets were a negative $2.98 million as of the year ended June 30, 2005, representing capital assets not restricted for use by the business entity.

Restricted assets were $7.16 million and are comprised of $288 thousand restricted for certain uncollected retailer accounts receivable as defined by statute, and $6.87 million in unclaimed prizes restricted for future prizes as mandated by statute.

Sales

Total lottery ticket sales for the fiscal year ended June 30, 2005, were $844.32 million.

Gross instant ticket sales for 2005 were $598.97 million. This represented approximately 70.9% of the total gross sales for the year 2005. The instant ticket marketing strategy included multiple game introductions, along with $1, $2, $5, and $10 price points. The games most popular with the players were Jumbo Bucks, Lucky 7's, and $100,000 Jackpot.

Cash 3 sales for 2005 were $69.18 million and 8.2% of gross sales. Average weekly sales for Cash 3 were approximately $1.3 million.

POWERBALL sales for 2005 were $146.67 million and 17.4% of gross sales. POWERBALL is a multi-jurisdictional lottery game operated in the following jurisdictions: Arizona, Colorado, Connecticut, Delaware, Idaho, Iowa, Indiana, Kansas, Kentucky, Louisiana, Maine, 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 U.S. Virgin Islands.

The TEL's average weekly sales for POWERBALL were approximately $2.8 million.

Lotto 5 sales for 2005 were $23.4 million. This represented 2.8% of total gross sales. This game was on sale for 10 months during the fiscal year. Average weekly sales for Lotto 5 were approximately $530 thousand.

Cash 4 sales for 2005 were $6.09 million and approximately 0.7% of gross sales. This game was on sale for 2 ½ months during the fiscal year. Average weekly sales for Cash 4 were approximately $570 thousand.

Prize Expense

Total prize expense for all games was approximately $457.99 million.

Gross prize expense for instant games in 2005 was $334.07 million, representing 73% of total prize expense. 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. The aggregated prize payout for all instant games was 62% of instant game sales, net of free tickets.

The TEL utilized $2.049 million of unclaimed prizes from fiscal year 2004 to reduce the instant prize expense in fiscal year 2005 to $332.03 million.

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

- ♦ Gross prize expense for Cash 3 was approximately $35.8 million. This represented 7% of total prize expense. Historically, the industry average prize payout is approximately 50.0% of the sales for this game. TEL has experienced a rate of 51.9% since inception of this game.
- ♦ Gross prize expense for Cash 4 was approximately $3.04 million. This represented .6% of total prize expense. Historically, the industry average prize payout is approximately 50.0% of the sales for this game. The TEL is recording prize expense at the industry average for this game until we obtain historical experience.
- ♦ Gross prize expense for Lotto 5 was approximately $11.7 million. This represented 2.5% of total prize expense. Prizes for this game are paid on a pari-mutuel basis with 50% of sales available for prizes.

- Gross prize expense for POWERBALL was approximately $73.3 million. This represented 16% of total prize expense. Gross prize expense for POWERBALL is recognized at 50% of sales in accordance with the game rules established by the Multi-State Lottery Association. The jackpot prize is paid on a pari-mutuel basis. All other prizes are set prize amounts in accordance with the game prize structure.

Unclaimed Prizes

TEL recognizes a percentage of all prize expenses will remain unclaimed. For fiscal year 2005, we estimated 2% as the percentage we expect to remain unclaimed relating to all prizes for instant games. For online games, unclaimed prizes were recognized based on the actual unclaimed experience for each game, with the exception of Cash 4, which was recognized at the industry average of 2% of prize liability.

The estimated unclaimed prize percentage for Cash 3, Lotto 5, and POWERBALL were 1%, 3%, and 10%, respectively, of prize liability for these games, not including Lotto 5 and POWERBALL jackpot prizes.

Direct Gaming and Operating Expenses

Direct gaming expenses represent retailer commissions and vendor fees, which change in proportion with changes in ticket sales. 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 $25,000 bonus for selling a winning POWERBALL jackpot ticket. Retailer commissions for 2005 were $54.88 million, including one $25,000 POWERBALL jackpot bonus.

Vendor fees were $16.51 million in 2005. Vendor fees represent payments and commitments to our two major gaming related suppliers, G-Tech Corporation and Scientific Games Inc., for the online and instant gaming products, systems, and services. The amount paid to each vendor is determined based on a percentage-of-sales formula in accordance with their respective contractual payment terms.

Advertising expenses were $13.83 million in 2005. The majority of these costs represent payments to Gish, Sherwood and Friends, our major advertising partner, for media buys and production costs associated with our advertising campaigns.

Operating and other gaming expenses for 2005 were $19.41 million. The majority of these expenses were retailer merchandising costs of $1.04 million, new game development and marketing costs of $2.59 million, property expense of $1.38 million, and personnel expense of $11.85 million.

Other Revenue

Other revenues totaling $4.30 million consisted primarily of retailer service fees of $3.28 million and interest income of $714 thousand.

Significant Factors Impacting Next Year

While the Tennessee General Assembly approved several legislative changes relating to the lottery program in its most recent session, the operational impact to TEL from those changes was very minimal, with no fiscal impact as of the date of this report.

The state of North Carolina recently passed legislation to establish a lottery in that state. TEL management does not expect this action to negatively impact next year's financial results due to the limited number of retailers operating near the North Carolina border.

The TEL will continue to introduce new product offerings for instant games, including licensed property games, which are gaining nationwide popularity.

The TEL will also research new online terminal-based games, as well as evaluate possible enhancements to our existing games. One such enhancement was introduced in August 2005 to the POWERBALL game. This enhancement should help increase sales for this game in the next fiscal year.

Contacting the TEL's Financial Management

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, 2005

ASSETS		
Current assets:		
Cash (Note 2)	$	54,381,000
Restricted fidelity fund cash		288,000
Retailer accounts receivable, net of commissions due to retailers		35,284,000
Prepaid expenses and other assets		3,603,000
Prepaid rent		113,000
Total current assets		93,669,000
Noncurrent assets:		
Capital assets, net of depreciation of $928,000		2,981,000
Total assets		96,650,000
LIABILITIES		
Current liabilities:		
Due to Lottery for Education Account (Note 6)		59,089,000
Due to After School Program Account		6,873,000
Prizes payable		16,884,000
Accounts payable		183,000
Accrued liabilities		4,437,000
Deferred rent		68,000
Deferred revenue		786,000
Total current liabilities		88,320,000
Noncurrent liabilities:		
Noncurrent portion of accrued liabilities		226,000
Noncurrent portion of deferred rent		943,000
Total noncurrent liabilities		1,169,000
Total liabilities		89,489,000
NET ASSETS		
Investment in capital assets		2,981,000
Unrestricted assets		(2,981,000)
Restricted assets:		
Restricted for uncollectible retailer receivables		288,000
Restricted for future prizes		6,873,000
Total net assets	$	7,161,000

See notes to financial statements.

Exhibit B

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2005

OPERATING REVENUES	
Ticket sales	$ 844,319,000
Less instant tickets provided as prizes	(60,620,000)
Net ticket sales	783,699,000
Retailer service fees	3,288,000
Other	322,000
Total operating revenues	787,309,000
OPERATING EXPENSES	
Available prizes	457,989,000
Prizes recognized as unclaimed	(13,746,000)
Net prizes	444,243,000
Retailer commissions and bonuses	54,878,000
Contractor fees	16,511,000
Advertising	13,829,000
Salaries and benefits	11,854,000
Retailer merchandising and marketing	3,808,000
Rent, utilities, and maintenance	1,376,000
Depreciation	769,000
Professional fees	467,000
Other	1,168,000
Total operating expenses	548,903,000
Operating income	238,406,000
NONOPERATING REVENUES (EXPENSES)	
Interest revenue	714,000
Retailer fees for future uncollectible retailer receivables	23,000
Proceeds to After School Program Account	(6,873,000)
Proceeds to Lottery for Education Account	(227,423,000)
Total nonoperating revenues (expenses)	(233,559,000)
Change in net assets	4,847,000
Total net assets, July 1	2,314,000
Total net assets, June 30	$ 7,161,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2005

Cash flows from operating activities:	
Cash received from customers	$ 759,691,000
Other operating cash received	3,486,000
Cash paid to prize winners	(444,019,000)
Cash paid to/on behalf of gaming vendors	(16,387,000)
Cash paid to retailers	(54,895,000)
Cash paid for advertising	(13,416,000)
Cash paid to/on behalf of contractors and employees	(10,150,000)
Other operating payments	(6,731,000)
Net cash provided by operating activities	217,579,000
Cash flows from non-capital financing activities:	
Payments to Lottery for Education Account	(227,832,000)
Payments to the After School Program Account	(2,049,000)
Fidelity fund cash received from retailers	37,000
Fidelity fund cash refunded to retailers	(14,000)
Net cash used by noncapital financing activities	(229,858,000)
Cash flows from capital and related financing activities:	
Purchase of property and equipment	(1,832,000)
Proceeds from disposal of capital assets	13,000
Net cash used by capital and related financing activities	(1,819,000)
Cash flows from investing activities:	
Interest income	773,000
Net cash provided by investing activities	773,000
Net decrease in cash	(13,325,000)
Cash, July 1	67,994,000
Cash, June 30	$ 54,669,000

Reconciliation of cash on the statement of net assets

Cash	$ 54,381,000
Restricted fidelity fund cash	288,000
Cash at end of year	$ 54,669,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENT OF CASH FLOWS (CONTINUED)
FOR THE YEAR ENDED JUNE 30, 2005

Reconciliation of operating revenue to net cash provided by operating activities:	
Operating income	$ 238,406,000
Adjustments to reconcile operating income to net cash provided by operating activities:	
Depreciation	769,000
Gain on disposal of vehicle	(4,000)
Changes in assets and liabilities:	
Retailer accounts receivable	(24,240,000)
Prepaids and other assets	(2,290,000)
Accounts payable and accrued liabilities	2,323,000
Prizes payable	2,355,000
Deferred rent	28,000
Deferred revenue	232,000
Net cash provided by operating activities	$ 217,579,000

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 as 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 TEL property 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.

On January 20, 2004, the TEL began lottery ticket sales. As of June 30, 2005, the TEL's lottery sales include a variety of instant ticket games and four terminal-based online ticket games: Cash 3, Cash 4, Lotto 5, 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 elected to follow 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 accrual basis of accounting and the economic resource measurement focus 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 deposits on account in the State of Tennessee Local Government Investment Pool (LGIP) (see Note 2).

Retailer Accounts Receivable – Retailer accounts receivable represents lottery proceeds due from retailers for ticket sales net of commissions due to 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. The TEL's general threshold for capitalization is assets valued at $500 or greater.

Deferred Revenue – Funds collected from retailers for online game tickets sold in advance of the game 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 $500,000 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, 2005, 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 $25,000 bonus is paid to any retailer who sells a winning Powerball jackpot ticket. During the year ended June 30, 2005, one $25,000 bonus was earned by and paid to a retailer.

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

> GTECH operates the gaming network that consists of over 4,350 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.
>
> SGI prints, warehouses, and distributes the instant game tickets to retailers. SGI 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 in accordance with the approved game working papers when tickets are activated for sale. Gross prize expense for online games, Cash 3, Cash 4 and Lotto 5, is recognized based on industry average or historical payout experience when tickets are actually sold.

Powerball prizes are shared based on contributions made 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 are funded from pooled contributions by MUSL. The contributions are held by MUSL in trust for the TEL and are paid, at the option of the prize winner, in either a lump-sum or 29 annual installments. Lump-sum payments are discounted to present value, as calculated by MUSL. As of the year ended June 30, 2005, one grand prize of $25 million, discounted to a lump-sum payment of $13,851,000, was awarded to a winning player in Tennessee.

Unclaimed Prizes – Prizes not claimed within 90 days of the game-end date for instant games, and within 180 days of a game draw date for online games are forfeited as unclaimed prizes. Prior to August 17, 2004, the claim period for online prizes was 365 days from the game draw date.

For instant games, unclaimed prizes are recognized based on the actual unclaimed aggregate experience for all instant games officially ended by the TEL. For 2005, the instant unclaimed prize was 2%.

For online games, unclaimed prizes are recognized based on the actual unclaimed experience for each game, with the exception of Cash 4, which is recognized at the industry average of 2% of prize liability. For 2005, the online unclaimed prizes as a percentage of prize liability (excluding Powerball grand and Lotto 5 jackpot prizes) were 1% for Cash 3, 3% for Lotto 5 and 10% for Powerball.

In accordance with the Act, fifty percent (50%) of unclaimed prizes recognized at the fiscal year end must be transferred to the State of Tennessee After School Program Special Account. The remaining 50% of unclaimed prizes is used to fund future prizes or special prize promotions, as defined by the statute.

The TEL transferred $6.873 million for the year ended June 30, 2005 to the After School Program Special Account. Additionally, the TEL utilized $2.049 million of prior year unclaimed prizes to fund fiscal year 2005 higher instant prize payouts.

Budget – Pursuant with the Act, annually by June 30th, 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 – The TEL is subject to various claims and contingencies related to litigation, fines and penalties, assessments and other matters arising out of the normal course of business. Liabilities related to contingencies are recognized when a loss is probable and reasonably estimable. As of the year ended June 30, 2005, the TEL has not incurred any related liabilities.

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. For the year ended June 30, 2005, in the event of loss, coverage was provided as follows:

- Employee dishonesty – aggregate of $500,000 total
- Business personal property – limit of $1,827,000 per occurrence
- Automobile – limit of $1,000,000 combined single limit (bodily injury/property damage)
- General liability – aggregate of $2,000,000
- Worker's compensation – up to statutory limits
- Director's and officer's liability – aggregate of $5,000,000
- Umbrella coverage – aggregate of $5,000,000

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

Compensated Absences – Effective November 29, 2004, the TEL implemented an attendance and leave policy allowing employees to earn vacation and sick leave during their employment. The corporation recognizes expense for accrued but unused vacation leave for all employees who have completed one year of service. No such expense exists for accrued but unused sick leave. (Note 7)

Employment Separation – Corporate officers earn separation pay for each year of employment with the TEL. Such expense is accrued in the period it is earned. (Note 7)

(2) CASH

The TEL has implemented Governmental Accounting Standards Board No. 40, *Deposits and Investment Risk Disclosure*, which established and modified the disclosure requirements for deposits and investments.

The TEL's deposits are in financial institutions that participate in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregated rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assess agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. At June 30, 2005, bank balances of approximately $820 thousand were insured by the bank collateral pool.

The TEL also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. The TEL's deposits with the LGIP were approximately $54.3 million at June 30, 2005. The LGIP is part of the Pooled Investment Fund. The Pooled Investment Fund is authorized by statute to invest funds in accordance with policy guidelines approved by the State Funding Board. The State Treasurer's Pooled Investment Fund is not rated by a nationally recognized statistical rating organization. The Pooled Investment Fund's investment policy and required risk disclosures are presented in the *Tennessee Comprehensive Annual Financial Report.* That 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 or by calling (615) 741-2140.

(3) CAPITAL ASSETS

Capital assets consisted of the following as of June 30, 2005:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	$ 85,000	$ 797,000	$ (16,000)	$ 866,000
Computer equipment	273,000	96,000	(3,000)	366,000
Vehicles	200,000	-	-	200,000
High Mileage Vehicles - Vans	684,000	198,000	(17,000)	865,000
Leasehold improvements	260,000	47,000	-	307,000
Communication equipment	677,000	182,000	-	859,000
Software	243,000	15,000	-	258,000
Gaming equipment	58,000	130,000	-	188,000
Total capital assets	2,480,000	1,465,000	(36,000)	3,909,000
Less accumulated depreciation	(166,000)	(769,000)	7,000	(928,000)
Total capital assets, net	$ 2,314,000	$ 696,000	$ (29,000)	$ 2,981,000

(4) LEASING ARRANGEMENTS

The TEL's leasing arrangements consist of noncancelable operating leases for office space and outdoor advertising billboards and related equipment which expire at various dates through 2014. Certain of these leases contain provisions for scheduled rental increases and are renewable at the option of the TEL. No lease renewal options were exercised during the year ended June 30, 2005.

In addition, the TEL subleases office space to certain related parties under operating leases expiring through 2014. These subleases contain provisions for scheduled rental increases and are subordinate to the related lease agreement held by TEL.

The following is a schedule by years of future minimum rental payments required of TEL under all noncancelable operating leases with original terms of one year or more as of June 30, 2005:

Year Ending June 30:		
2006	$	2,225,000
2007		1,762,000
2008		1,746,000
2009		1,653,000
2010		1,228,000
2011-2014		4,318,000
Total minimum lease payments	$	12,932,000

Minimum rental payments have not been reduced by minimum sublease rentals of $1.72 million due in future years under noncancelable subleases.

The following is a schedule by years of future minimum sublease rental payments due to TEL under all noncancelable operating leases with original terms of one year or more as of June 30, 2005:

Year Ending June 30:		
2006	$	188,000
2007		188,000
2008		188,000
2009		194,000
2010		206,000
2011-2014		756,000
Total minimum lease payments	$	1,720,000

The following schedule shows the composition of total rental expense, net of deferred rent expense and income, for all operating leases for the year ended June 30, 2005:

Minimum rentals	$	997,852
Less: Sublease rentals		125,200
Total minimum rentals	$	872,652

(5) DEFERRED RENT

As an incentive for entering into certain lease agreements, the TEL received rent abatements approximating $667,000 from landlords. In accordance with Financial Accounting Standards 13 (FAS 13), *Accounting for Leases*, and Governmental Accounting Standards Board Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, the TEL defers rent incentives over the entire lease term on a straight-line basis. Additionally, where lease agreements stipulate escalation of rental payments over the term of the lease, the TEL recognizes related rental expense on a straight-line basis over the entire term of the lease.

At June 30, 2005, total deferred rent of $1,011,000 consisted of $554,441 related to rent abatements and $456,766 to the straight-lining of rental expense over the life of the related lease terms.

(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, 2005 is summarized as follows:

	2005
Operating revenues:	
Ticket sales	$844,319,000
Less instant tickets provided as prizes	(60,620,000)
Net ticket sales	783,699,000
Service fees and other revenue	3,610,000
Net operating revenues	787,309,000
Operating expenses, as defined:	
Gaming	544,966,000
Operating	15,634,000
Total operating expenses, as defined	560,600,000
Net proceeds before distribution of unrestricted net assets	226,709,000
Non-operating revenue and expenses	
Interest income	714,000
Total non-operating revenue and expenses	714,000
Net proceeds subject to transfer	227,423,000
Amount due to Lottery for Education Account for year	227,423,000
Amount paid during year	(168,334,000)
Amount due to Lottery for Education Account, end of year	$ 59,089,000

All amounts due at June 30, 2005, were transferred to the Lottery for Education Account in July 2005.

(7) EMPLOYEE BENEFITS

A. Deferred Compensation

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 is available to all eligible employees at their option and 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, 2005, employees contributed approximately $344,000 to the 457 Plan.

The aggregate fair value of the plan's assets was approximately $666,000, net of forfeitures and administrative fees, as of June 30, 2005.

B. 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 eligible 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, 2005, the TEL contributed approximately $571,000 to the 401(a) Plan on behalf of its employees. Of these contributions, approximately $40,000 was forfeited by separated employees as of June 30, 2005.

In accordance with the 401(a) Plan, forfeitures of employer contributions may be used to offset plan administrative expenses and/or reduce future contribution costs. As of the year ended June 30, 2005, forfeited amounts of approximately $36,000 were used to offset employer contributions and plan administrative expenses.

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 John Hancock Financial, the plans' custodian.

The aggregate fair value of the plan's assets was approximately $825,000, net of forfeitures and administrative fees, as of June 30, 2005.

C. Compensated Absences

Vacation leave can be earned at various rates depending on the employee's position and years of service. Carryover of vacation leave is limited to the number of hours earned in the prior year. Employees must complete twelve months of service from the date of hire before they receive termination payment for any unused vacation hours. The current portion of the compensated absence liability, expected to be due within one year of the statement date, June 30, 2005, is estimated using historical trends. At June 30, 2005, the estimated current portion of the compensated absences liability was $188 thousand.

Sick leave is earned at the end of each month at the rate of four hours per month for all employees. Sick leave may be carried over from year to year, but all such accrued sick leave is forfeited upon separation of employment.

D. Employment Separation

Corporate officers accrue forty hours of severance pay for every year of employment with TEL. As of June 30, 2005, $36 thousand was accrued for employment separation obligations.

(8) COMMITMENTS AND CONTINGENCIES

Win for Life Winner – On December 22, 2004, a prize of $1,000 a week for life, to be paid in installments of $52,000 per year, was awarded to a prize winner. The winner will receive the annual payment for the remainder of their life, with a guarantee of a minimum of twenty annual payments totaling $1,040,000. As of June 30, 2005, the TEL was obligated to pay a minimum of 19 remaining installment payments to this winner. The TEL will purchase a single premium annuity in fiscal year 2006 to fund all future payments required after December 2005.

Corvette Grand Prize Drawing – The TEL has committed to conducting a drawing whereby $100,000 or a Corvette automobile will be awarded to one individual. The TEL anticipates completion of this drawing to occur during the fiscal year ending June 30, 2006.

Harley Davidson Prize Drawing – The TEL has committed to conducting a drawing whereby $25,000 or a Harley Davidson motorcycle will be awarded to one individual. The

TEL anticipates completion of this drawing to occur during the fiscal year ending June 30, 2006.

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

Advertising Billboards – In July 2005, the TEL entered into operating lease agreements for outdoor billboard advertising space. In relation to these billboards, the TEL will incur expense of approximately $48,000 during the fiscal year ending June 30, 2006.

Insurance – Effective July 31, 2005, the TEL became a member of the State of Tennessee liability insurance coverage pool. This pool provides coverage that replaces current coverage for business/personal property liability, general liability, directors and officers' liability, and umbrella coverage.

Millionaire Live Drawing – On October 22, 2005, the TEL conducted this special lottery drawing whereby prizes totaling $1,035,000 were awarded to three individuals.

Win for Life Winner – In July 2005, a prize of $1,000 a week for life was awarded to a prize winner. The winner will receive $52,000 a year for the remainder of their life, with a minimum guarantee of 20 annual payments totaling $1,040,000. The TEL made the first payment related to this prize in August 2005. The TEL will purchase a single premium annuity in fiscal year 2006 to fund all future payments.