AUDIT REPORT

Tennessee Education Lottery Corporation

For the Year Ended
June 30, 2006

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
(615) 741-2501

John G. Morgan
Comptroller

June 7, 2007

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, 2006. 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

John G. Morgan
Comptroller of the Treasury

JGM/to
06/108

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, 2006

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, 2006

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Tennessee Education Lottery Corporation
For the Year Ended June 30, 2006

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, 2006, TELC had launched a total of 100 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 proceeding quarter to the state treasury for credit to the "lottery for education account." State law also requires TELC to transfer 100% 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 four major organizational divisions: Executive, Legal, Sales and Marketing, and Finance and Information Systems.

The Executive Division oversees the daily operations of the corporation and is responsible for developing strategies to ensure corporate objectives are implemented. The division is also responsible for advertising strategy; communications, including player services, media, and public relations; legislative affairs; and management of all lottery facilities.

The Legal Division includes the departments of Human Resources, Legal Services, Security, and Retailer Contract Administration. The Human Resources Department manages all personnel functions. The Legal Services Department provides legal advice and assistance to management and the Board of Directors, serves as the corporate records keeper, oversees litigation, and manages contract compliance. The Security Department is responsible for physical and intellectual property security, as well as the integrity of the televised drawings. The Retailer Contract Administration Department manages all functions of retailer applications and contracts.

The Sales and Marketing Division oversees all aspects of the Lottery sales operation, including marketing, retailer sales and services, corporate accounts, promotions and special events, and warehouse management and distribution.

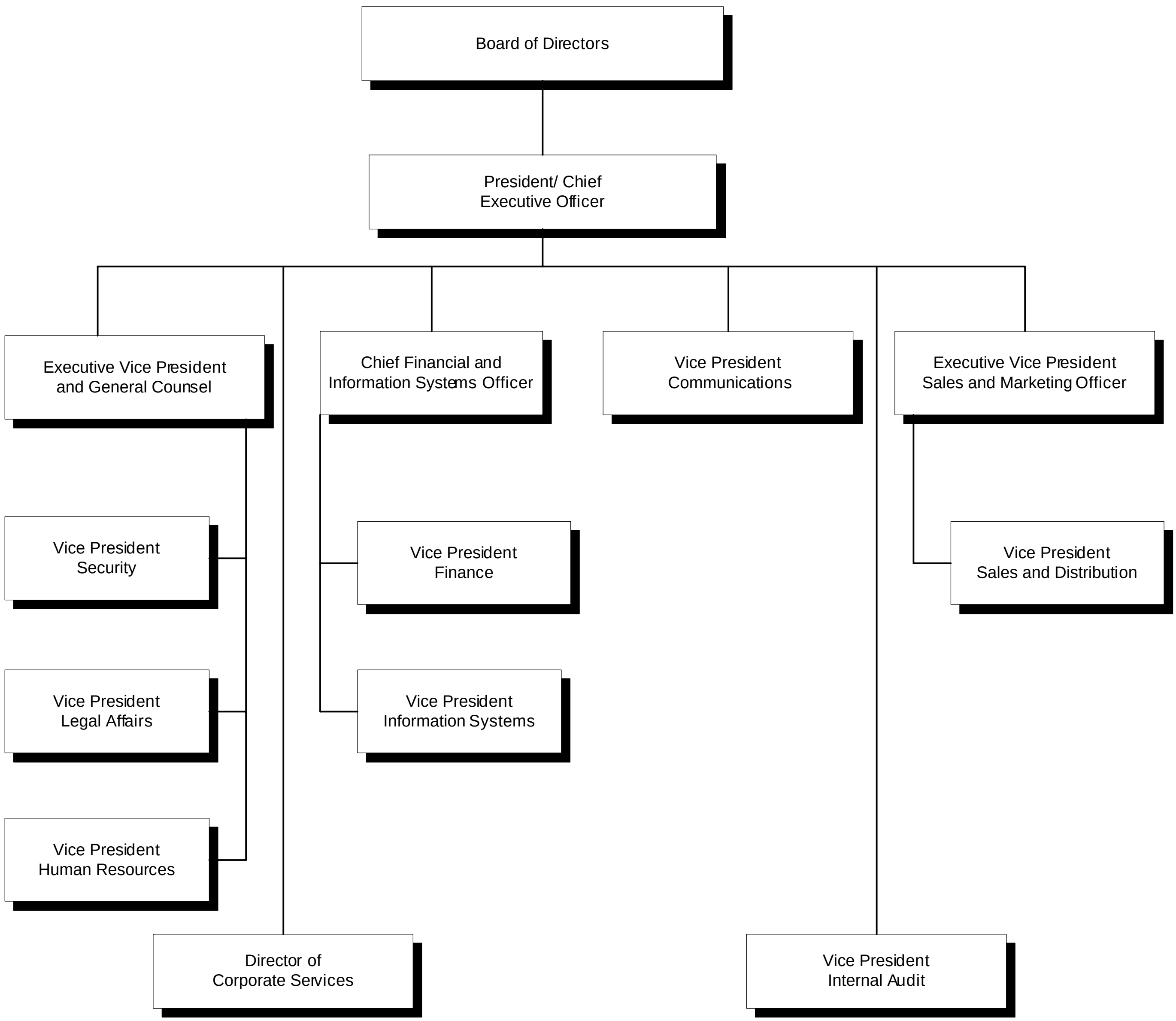
The Division of Finance and Information Systems is responsible for financial and retail accounting and reporting; prize validation; cash management; budgeting; collections; procurement; gaming systems and computer oversight; and computer systems, technology infrastructure, and telecommunications systems.

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, 2005, through June 30, 2006, 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, 2006, and for comparative purposes, 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

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

TRANSFER OF NET LOTTERY PROCEEDS

Section 4-51-111, *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 years ended June 30, 2006, and June 30, 2005, that the net lottery proceeds transferred to the lottery for education account "equal, as nearly as practical, thirty percent (30%) of the lottery proceeds." For the year ended June 30, 2006, lottery proceeds totaled $931 million and the corporation transferred $269.9 million to the lottery for education account. The amount transferred was approximately 29 percent of lottery 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 29 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. The assessment and the controls should be reviewed and approved by the head of the entity.

FRAUD CONSIDERATIONS

Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit,* 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, 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

On May 19, 2005, the Tennessee General Assembly 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. Entities, pursuant to the act, are required to appoint the audit committee and develop an audit committee charter in accordance with the legislation. The ongoing responsibilities of an audit committee include, but are not limited to:

1. overseeing the financial reporting and related disclosures, especially when financial statements are issued;

2. evaluating management's assessment of risk and the agency's system of internal controls;

3. formally reiterating, on a regular basis, to the board, agency management, and staff their responsibility for preventing, detecting, and reporting fraud, waste, and abuse;

4. serving as a facilitator of any audits or investigations of the agency, including advising auditors and investigators of any information it may receive pertinent to audit or investigative matters;

5. informing the Comptroller of the Treasury of the results of assessment and controls to reduce the risk of fraud; and

6. promptly notifying the Comptroller of the Treasury of any indications of fraud.

The board of directors of the Tennessee Education Lottery Corporation appointed an audit committee in fiscal year 2004. In response to the "State of Tennessee Audit Committee Act of 2005," the board of directors approved a revised audit committee charter on October 30, 2006. The audit committee charter was approved by the Comptroller of the Treasury on December 7, 2006. Additionally, the audit committee has reviewed the board and agency's conflict-of-interest policies, which require conflict-of-interest forms to be completed annually.

At the end of audit fieldwork on December 11, 2006, the audit committee had received management's risk assessments and evaluated the agency's corresponding system of internal controls related to those risks. Also, the audit committee had reviewed a code of conduct for the agency and the agency's process for monitoring compliance with laws and regulations. In addition, the audit committee had established procedures for employees to notify the audit committee directly about accounting, internal controls, and auditing matters. These procedures included the methods for the receipt, retention, and treatment of complaints.

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, 2006, 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.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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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 11, 2006

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, 2006, and have issued our report thereon dated December 11, 2006. 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 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, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the 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.

Arthur A. Hayes, Jr., CPA
Director

AAH/to

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
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JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
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Independent Auditor's Report

December 11, 2006

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, 2006, and June 30, 2005, and the related statements of revenues, expenses, and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the corporation's management. Our responsibility is to express an opinion on these financial statements, based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller 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 audits provide 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, 2006, and June 30, 2005, and the changes in its financial position and cash flows for the years 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 11, 2006, 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, 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/to

The Tennessee Education Lottery Corporation ("TEL") offers the following Management Discussion and Analysis ("MD&A") to the readers of the financial statements. This narrative overview provides an objective analysis of the TEL's financial activity for the fiscal years ended June 30, 2006 and 2005. The overview should be considered in conjunction with the accompanying financial statements and notes to financial statements.

A comparison of the fiscal years ended June 30, 2005 and 2004, has not been presented due to fiscal year 2004 representing only approximately 5 ½ months of financial activity compared to 12 months in fiscal year 2005.

Understanding the TEL's Financial Statements

The TEL, a quasi-public instrumentality, is a component unit of the State of Tennessee. The TEL's activities are accounted for as a business-type activity using the full accrual basis of accounting, similar to a private business entity. In accordance with accounting principles generally accepted in the United States of America, this report consists of a series of comparative financial statements, along with notes to the financial statements designed to highlight the TEL's net assets and changes therein resulting from business operations.

The financial statements are comprised of three components:

- The Statements of Net Assets – Reflect the TEL's financial position at June 30, 2006 and 2005.
- The Statements of Revenues, Expenses, and Changes in Net Assets – Report revenues and expenses incurred in relation to the sale of lottery products, as well as other non-gaming related activity for the fiscal years ended June 30, 2006 and 2005.
- The Statements of Cash Flows - Outline the cash inflows and outflows related to the activity of selling lottery products for the fiscal years ended June 30, 2006 and 2005.

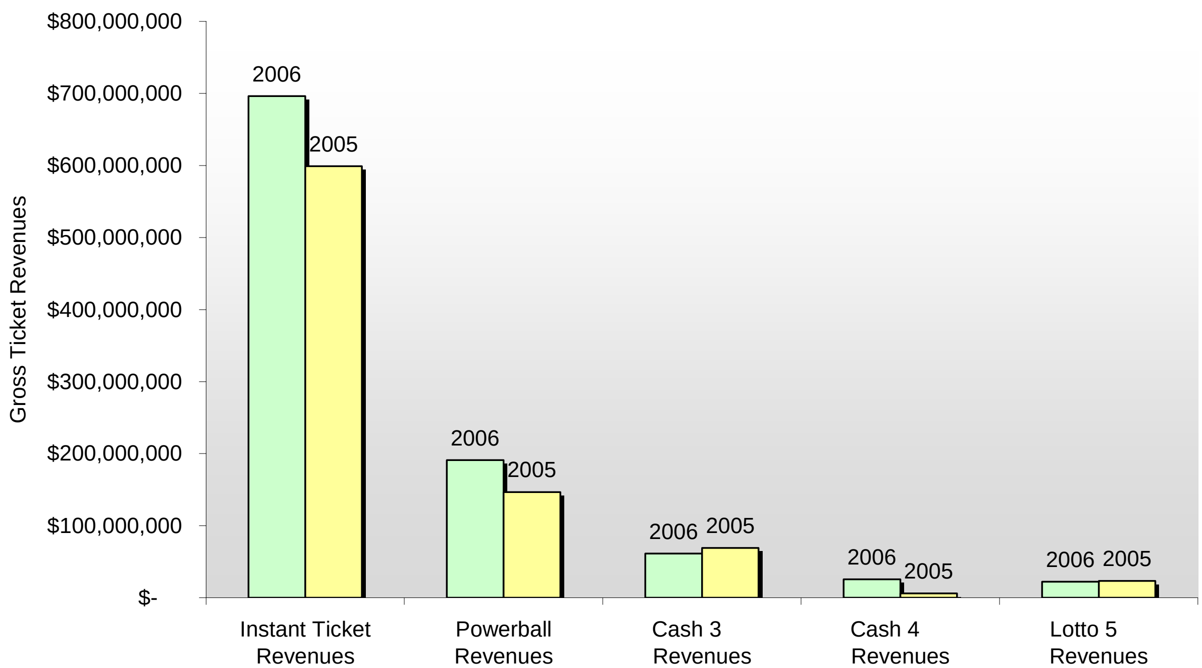
The Notes to the Financial Statements document additional information essential to readers gaining a comprehensive understanding of the data provided in the financial statements.

The TEL's primary business purpose is to generate revenues, used to fund college scholarships for residential Tennessee students, for the state's Lottery for Education Account. Accordingly, the main focus of the financial statements is determining funds available for payment to the Lottery for Education Account. It is important to note that most financial statement balances have a direct or indirect relationship to revenue. As lottery sales increase, the amount paid to the Lottery for Education Account also increases. Similarly, increases in revenue generally result in direct increases to cost of sales—including, but not limited to, prize expense, commission expense and gaming contractor fees.

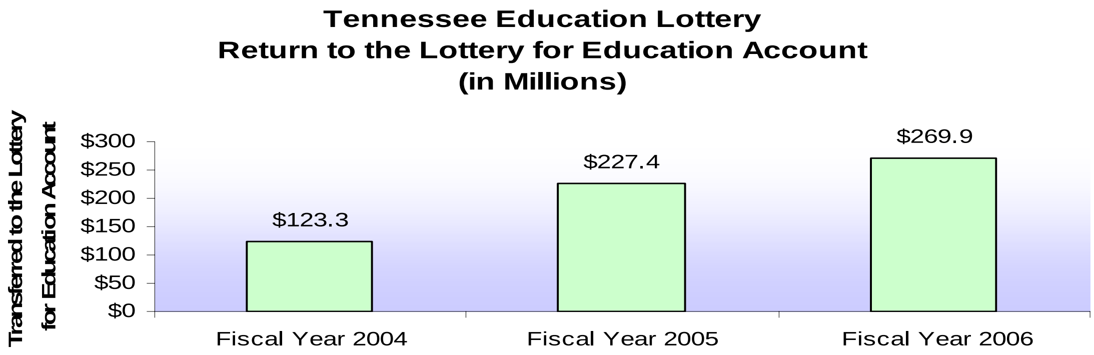
Financial Highlights

The TEL experienced an outstanding fiscal year 2006. Gross sales for all games increased 18% compared to fiscal year 2005. Instant games, which represented approximately 70% of total sales, increased 16%, due largely to the introduction of higher price point games with higher prize payouts compared to the prior year. The second largest contributing factor to the sales increase was two (2) Powerball jackpots exceeding $300 million. Powerball sales increased 30% compared to the prior year. Other contributing factors were the launch of midday drawings for Cash 3 and Cash 4 and the increase of our retailer distribution network.

Tennessee Education Lottery Gross Revenues
Fiscal Year 2006 Compared to Fiscal Year 2005



The TEL transferred $269.9 million to the Lottery for Education Account in fiscal year 2006, compared to $227.4 million in fiscal year 2005. The transfer represented 29% of total lottery proceeds for both fiscal years. The additional $42.5 million, in fiscal year 2006, represents an 18.7% increase from the prior year. Since inception, the TEL has transferred $620.6 million to the Lottery for Education Account.



Condensed Statement of Net Assets

Assets and Liabilities

	June 30, 2006	June 30, 2005	Increase/ (Decrease)
Assets:			
Current assets			
Cash	$ 57,731,000	$ 54,381,000	$ 3,350,000
Restricted cash	331,000	288,000	43,000
Retailer accounts receivable, net	38,437,000	35,284,000	3,153,000
Other	5,649,000	3,596,000	2,053,000
Total current assets	102,148,000	93,549,000	8,599,000
Noncurrent assets			
Other	1,786,000	120,000	1,666,000
Capital assets, net	2,283,000	2,981,000	(698,000)
Total noncurrent assets	4,069,000	3,101,000	968,000
Total assets	**106,217,000**	**96,650,000**	**9,567,000**
Liabilities			
Current liabilities			
Due to Lottery for Education Account	62,473,000	59,089,000	3,384,000
Due to After School Programs Account	5,518,000	6,873,000	. (1,355,000)
Prizes payable	19,426,000	16,884,000	2,542,000
Accounts payable and accrued liabilities	4,511,000	4,620,000	(109,000)
Deferred liabilities	1,165,000	854,000	311,000
Total current liabilities	93,093,000	88,320,000	4,773,000
Noncurrent liabilities			
Noncurrent portion of Due to After School Programs Account	9,265,000	-	9,265,000
Noncurrent portion of other liabilities	3,528,000	1,169,000	2,359,000
Total noncurrent liabilities	12,793,000	1,169,000	11,624,000
Total liabilities	**105,886,000**	**89,489,000**	**16,397,000**
Net Assets			
Investment in capital assets	2,283,000	2,981,000	(698,000)
Unrestricted assets	(2,283,000)	(2,981,000)	698,000
Restricted assets	331,000	7,161,000	(6,830,000)
Total net assets	**$ 331,000**	**$ 7,161,000**	**$ (6,830,000)**

Overview of Financial Position

The TEL's financial position remained strong during fiscal 2006. The $9.6 million increase in total assets primarily resulted from increased sales from our Instant Ticket and Powerball products in fiscal year 2006. Other factors included, but were not limited to, the purchase of two prize annuity investments to fund Win for Life grand prizes and the increase in the TEL's Powerball prize reserve account balances held by the Multi-State Lottery Association.

The $16.4 million increase in total liabilities relates primarily to increased sales, resulting in higher net proceeds payable to the Lottery for Education Account, higher prizes payable to players, and higher unclaimed prizes payable to the After-School Program Account. Effective in June 2006, 100% of actual unclaimed prizes were payable to the After-School Program Account in accordance with statutory requirements, compared to 50% in the prior fiscal year.

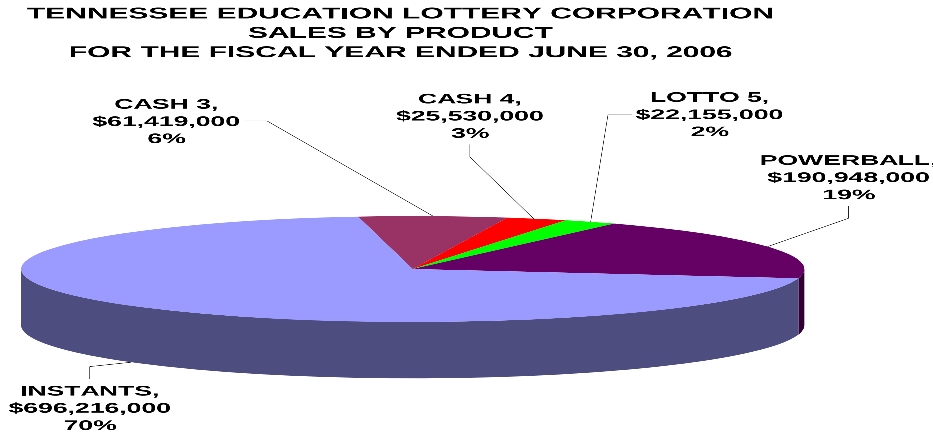
The $6.8 million decrease in restricted net assets results from a statutory change in Tennessee Education Lottery Implementation Law, effective June 2006, that requires 100% of unclaimed prize monies be deposited in the After School Program Account. Prior to the change, 50% of unclaimed prizes were available to the TEL to fund future prizes in accordance with the originating lottery statute.

Condensed Statement of Revenues & Expenses

Revenues and Expenses	**June 30, 2006**	**June 30, 2005**	**Increase/ (Decrease)**
Revenues:			
Instant games	$ 696,216,000	$ 598,965,000	$ 97,251,000
Online games	300,052,000	245,354,000	54,698,000
Retailer service fees	3,166,000	3,288,000	(122,000)
Interest income	1,996,000	714,000	1,282,000
Other revenue	315,000	345,000	(30,000)
Total revenues	**1,001,745,000**	**848,666,000**	**153,079,000**
Expenses:			
Cost of sales	708,398,000	593,889,000	114,509,000
General, administrative and other operating expenses	15,532,000	15,634,000	(102,000)
Proceeds to After School Program Account			
Current	5,518,000	6,873,000	(1,355,000)
Deferred	9,265,000	-	9,265,000
Proceeds to Lottery for Education Account	269,862,000	227,423,000	42,439,000
Total expenses	**1,008,575,000**	**843,819,000**	**164,756,000**
			-
Change in net assets	(6,830,000)	4,847,000	(11,677,000)
Total net assets, beginning of year	7,161,000	2,314,000	4,847,000
Total net assets, end of year	**$ 331,000**	**$ 7,161,000**	**$ (6,830,000)**

Revenues

Total gross lottery ticket sales for the fiscal years ended June 30, 2006 and 2005, were $996.27 million and $844.32 million, respectively. The following chart depicts the distribution of sales by product for the fiscal year ended June 30, 2006:



Gross instant ticket sales for 2006 grew to $696.22 million, which represents a 16% increase over 2005 instant sales of $598.97 million. Instant tickets remained approximately 70% of total gross sales in the year 2006. 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 Junior Jumbo Bucks.

POWERBALL sales for the year 2006 were $190.95 million, or 19.1% of gross ticket sales. This represents a 30% increase over year 2005 sales of $146.67 million. This can be attributed primarily to the two large jackpots exceeding $300 million in fiscal year 2006.

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, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Vermont, Wisconsin, West Virginia, the District of Columbia, and the U.S. Virgin Islands. The TEL's average weekly sales for POWERBALL were approximately $3.7 million in 2006.

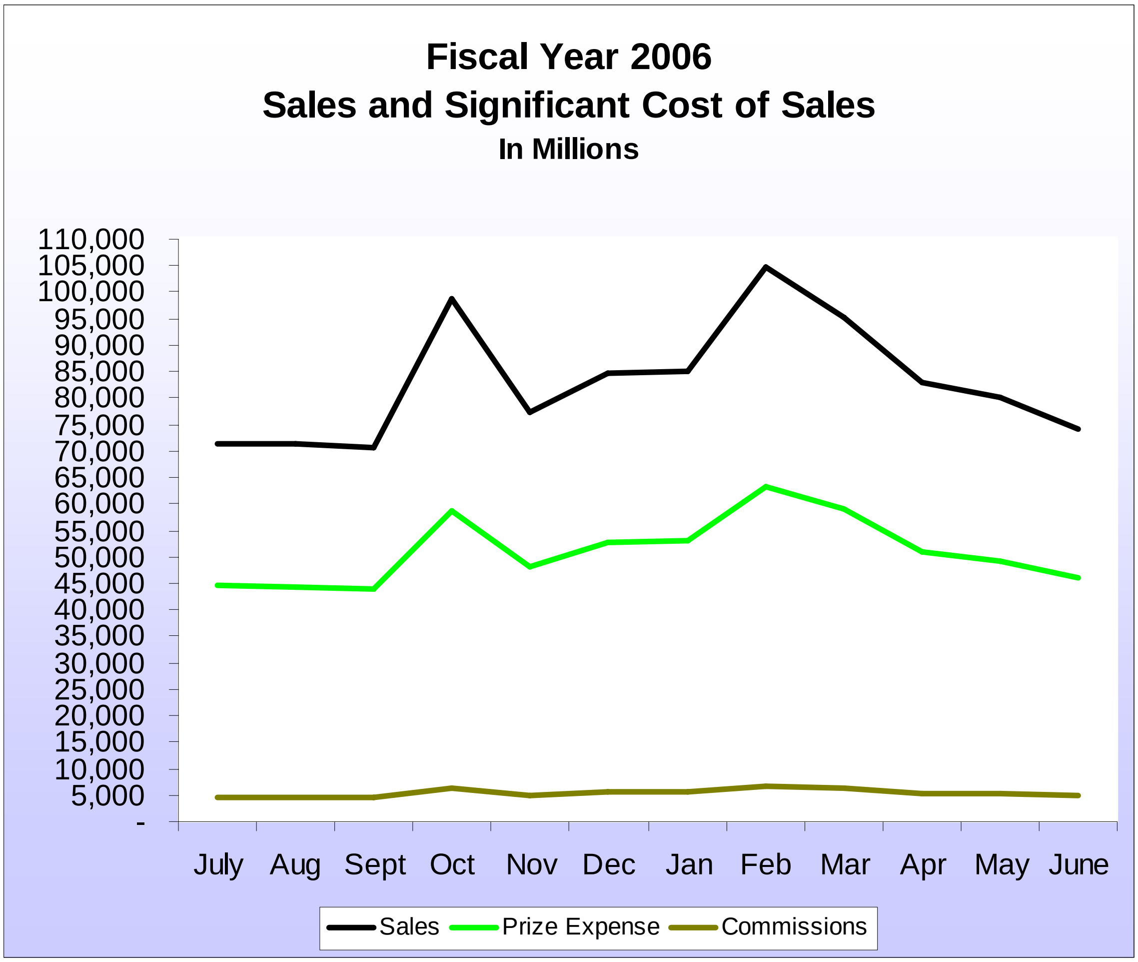
Cash 3 sales for 2006 and 2005, respectively, were $61.42 million and $69.18 million, or 6.2% and 8.2% of gross sales for the years 2006 and 2005, respectively. Average weekly sales for Cash 3 were approximately $1.2 million in 2006.

Lotto 5 sales were $22.2 million and $23.4 million in the years 2006 and 2005, respectively. Fiscal year 2006 sales represented approximately 2% of total gross sales. Average weekly sales for Lotto 5 were approximately $425 thousand in 2006.

Cash 4 sales were $25.5 million and $6.09 million in the years 2006 and 2005, respectively. This game was on sale for 2 ½ months during fiscal year 2005 as compared to 12 months in fiscal year 2006. Average weekly sales for Cash 4 were approximately $489 thousand in 2006.

Cost of Sales

Cost of sales is comprised of prize expense net of unclaimed prizes, retailer commissions, contractor fees, and other marketing costs. These expenses change in direct proportion with changes in ticket sales.



Gross prize expense was $552.53 million and $457.99 million in the years 2006 and 2005, respectively.

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 recorded 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 64% in 2006 and 62% in 2005 of instant game sales, net of free tickets.

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

The TEL compensates its retailers through a set commission percentage of 6.5% on all instant tickets settled and online tickets sold. There is a 1% cashing bonus retailers earn by cashing Cash 3 and Cash 4 prizes below $600. In addition, retailers will receive a $25,000 bonus for selling a winning POWERBALL jackpot ticket. Retailer commissions were $64.95 million and $54.88 million for the years ended June 30, 2006 and 2005, respectively. In the year 2005, there was one $25,000 POWERBALL jackpot bonus received by a retailer. No jackpot bonus was paid in fiscal year 2006.

The TEL has retained two contractors for the operation of its online gaming network and the manufacturing, warehousing and distribution of its instant ticket games. The online contractor is compensated at a rate of 1.24% of the selling price of online tickets sold, and of instant ticket activations, net of free tickets available as prizes; whereas the instant contractor receives a fee of 1.139% of the selling price of instant ticket activations by retailers. Contractor fees for the fiscal year 2006 were $19.41 million, as compared to $16.51 million for the fiscal year 2005.

Advertising costs were $14.11 million and $13.83 million for fiscal years 2006 and 2005, respectively.

General, Administrative and Other Operating Expenses

These expenses do not change in direct proportion with revenues. In accordance with budget directives, these expenses remained relatively consistent in fiscal years 2006 and 2005. General, administrative, and other operating expenses were $15.53 million and $15.6 million for the years 2006 and 2005, respectively. Salaries and benefits represent the major component of these expenses in both fiscal years 2006 and 2005.

Potential Factors Impacting Future Results

The TEL's mission is to maximize revenues for the purpose of maximizing payments to the Lottery for Education Account. A continuous assessment of Tennessee's financial environment and the TEL's own product lines and operations are essential to accomplish this mission. The following considerations have been presented to inform those interested in the TEL's operations about factors that could potentially affect future results:

- The TEL will continue to introduce new instant game product offerings, including expansion of our licensed property games, which are gaining nationwide popularity.

- The TEL will introduce a new online game in fiscal year 2007 to increase our online sales and retailer distribution network. We will also research possible enhancements of existing online games to expand the play options available to players.

- The statutory change in June 2006, requiring 100% of realized unclaimed prize monies to be deposited to the After School Program Special Account, will affect the TEL's ability to increase instant game prize payout and may decrease the net proceeds available for transfer to the Lottery for Education Account in fiscal year 2007.

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 Metro Center
200 Athens Way, Suite 200
Nashville, Tennessee 37228

Exhibit A

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF NET ASSETS
AS OF JUNE 30, 2006, AND JUNE 30, 2005

	2006	2005
ASSETS		
Current assets:		
Cash (Note 2)	$ 57,731,000	$ 54,381,000
Restricted fidelity fund cash	331,000	288,000
Retailer accounts receivable, net of commissions due to retailers	38,437,000	35,284,000
Prepaid expenses and other assets	5,545,000	3,596,000
Prize annuity investments (Note 3)	104,000	-
Total current assets	102,148,000	93,549,000
Noncurrent assets:		
Prepaid expenses and other assets	108,000	120,000
Prize annuity investments (Note 3)	1,678,000	-
Capital assets, net of depreciation of $1,742,000 and $928,000 (Note 4)	2,283,000	2,981,000
Total noncurrent assets	4,069,000	3,101,000
Total assets	106,217,000	96,650,000
LIABILITIES		
Current liabilities:		
Due to Lottery for Education Account (Note 7)	62,473,000	59,089,000
Due to After School Program Account (Note 8)	5,518,000	6,873,000
Prizes payable	19,270,000	16,884,000
Accounts payable	734,000	183,000
Prize annuities payable (Note 3)	156,000	-
Accrued liabilities	3,777,000	4,437,000
Deferred rent (Note 6)	68,000	68,000
Deferred revenue	1,097,000	786,000
Total current liabilities	93,093,000	88,320,000
Noncurrent liabilities:		
Due to After School Programs Account (Note 8)	9,265,000	-
Prize annuities payable (Note 3)	2,417,000	-
Accrued liabilities	228,000	226,000
Deferred rent (Note 6)	883,000	943,000
Total noncurrent liabilities	12,793,000	1,169,000
Total liabilities	105,886,000	89,489,000
NET ASSETS		
Investment in capital assets	2,283,000	2,981,000
Unrestricted assets	(2,283,000)	(2,981,000)
Restricted assets:		
Restricted for uncollectible retailer receivables	331,000	288,000
Restricted for future prizes	-	6,873,000
Total net assets	$ 331,000	$ 7,161,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2006, and JUNE 30, 2005

	2006	2005
OPERATING REVENUES		
Ticket sales	$ 995,845,000	$ 844,319,000
Less instant tickets provided as prizes	(68,263,000)	(60,620,000)
Net ticket sales	927,582,000	783,699,000
Retailer service fees	3,166,000	3,288,000
Other	272,000	322,000
Total operating revenues	931,020,000	787,309,000
OPERATING EXPENSES		
Available prizes	552,528,000	457,989,000
Prizes estimated as unclaimed (Note 8)	(14,783,000)	(13,746,000)
Net prizes	537,745,000	444,243,000
Retailer commissions and bonuses	64,950,000	54,878,000
Contractor fees	19,406,000	16,511,000
Advertising	14,111,000	13,829,000
Salaries and benefits	11,392,000	11,854,000
Retailer merchandising and marketing	3,923,000	3,808,000
Rent, utilities, and maintenance	1,816,000	1,694,000
Depreciation	816,000	769,000
Professional fees	317,000	467,000
General administrative and other operating	768,000	850,000
Total operating expenses	655,244,000	548,903,000
Operating income	275,776,000	238,406,000
NONOPERATING REVENUES (EXPENSES)		
Interest revenue	1,996,000	714,000
Retailer fees for future uncollectible retailer receivables	43,000	23,000
Proceeds to After School Program Account (Note 8)		
Current	(5,518,000)	(6,873,000)
Deferred	(9,265,000)	-
Proceeds to Lottery for Education Account (Note 7)	(269,862,000)	(227,423,000)
Total nonoperating revenues (expenses)	(282,606,000)	(233,559,000)
Change in net assets	(6,830,000)	4,847,000
Total net assets, July 1	7,161,000	2,314,000
Total net assets, June 30	$ 331,000	$ 7,161,000

See notes to financial statements.

Exhibit C

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2006, and JUNE 30, 2005

	2006	2005
Cash flows from operating activities:		
Cash received from customers	$ 924,740,000	$ 759,691,000
Other operating cash received	3,441,000	3,486,000
Cash paid to prize winners	(534,635,000)	(444,019,000)
Cash paid to/on behalf of gaming vendors	(19,354,000)	(16,387,000)
Cash paid to retailers	(64,969,000)	(54,895,000)
Cash paid for advertising	(14,130,000)	(13,416,000)
Cash paid to/on behalf of contractors and employees	(11,287,000)	(10,150,000)
Other operating payments	(7,232,000)	(6,731,000)
Net cash provided by operating activities	276,574,000	217,579,000
Cash flows from non-capital financing activities:		
Payments to Lottery for Education Account	(266,478,000)	(227,832,000)
Payments to the After School Program	(6,873,000)	(2,049,000)
Fidelity fund cash received from retailers	42,000	37,000
Fidelity fund cash refunded to retailers	(1,000)	(14,000)
Net cash used by noncapital financing activities	(273,310,000)	(229,858,000)
Cash flows from capital and related financing activities:		
Purchase of property and equipment	(115,000)	(1,832,000)
Proceeds from disposal of capital assets	-	13,000
Net cash used by capital and related financing activities	(115,000)	(1,819,000)
Cash flows from investing activities:		
Interest income	1,996,000	773,000
Purchase of prize annuity investments	(1,752,000)	-
Net cash provided by investing activities	244,000	773,000
Net increase/(decrease) in cash	3,393,000	(13,325,000)
Cash, July 1	54,669,000	67,994,000
Cash, June 30	$ 58,062,000	$ 54,669,000

Reconciliation of cash on the statement of net assets

	2006	2005
Cash	$ 57,731,000	$ 54,381,000
Restricted fidelity fund cash	331,000	288,000
Cash at end of year	$ 58,062,000	$ 54,669,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENT OF CASH FLOWS (CONTINUED)
FOR THE YEARS ENDED JUNE 30, 2006 AND 2005

Reconciliation of operating revenue to net cash provided by operating activities:	2006	2005
Operating income	$ 275,776,000	$ 238,406,000
Adjustments to reconcile operating income to net cash provided by operating activities:		
Bad debt expense	423,000	-
Depreciation	816,000	769,000
Loss/(Gain) on disposal of capital assets	1,000	(4,000)
Changes in assets and liabilities:		
Retailer accounts receivable, net	(3,576,000)	(24,240,000)
Prepaids and other assets	(1,937,000)	(2,290,000)
Accounts payable and accrued liabilities	(107,000)	2,323,000
Prizes payable	2,386,000	2,355,000
Prize annuities payable	2,542,000	-
Deferred rent	(61,000)	28,000
Deferred revenue	311,000	232,000
Net cash provided by operating activities	$ 276,574,000	$ 217,579,000

Noncash Investing Activities

Increase in fair value of prize annuity investments	$ 31,000	$ -

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, 2006, 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 resources 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. Revenues are presented net of Bad Debt Expense.

Net Assets - Net assets represent cumulative revenues less expenses and required transfers in accordance with the Act (see Notes 7 and 8). 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, and allowance for bad debt.

Lottery proceeds are collected weekly from retailer bank accounts established in trust for the TEL. Amounts not collected upon the established collection date are deemed delinquent. Delinquent accounts are reviewed periodically by TEL management. Accounts outstanding more than 180 days from the most recent date of delinquency are considered doubtful. As of June 30, 2006, the Allowance for Doubtful Accounts was $423 thousand. No allowance existed as of June 30, 2005.

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 cost and related accumulated depreciation is 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 years ended June 30, 2006 and 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. In addition, retailers cashing Cash 3 and Cash 4 tickets receive an additional 1% for amounts cashed. 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, 2006, no related bonuses were earned by or paid to any retailer. 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 approximately 4,470 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 net instant ticket activations, net of free tickets available as prizes.

SGI prints, warehouses, and distributes the net 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, 2006, there were no grand prize winners in Tennessee. 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.

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, by September 1, the TEL is required to submit a proposed operating budget for the succeeding fiscal year to the Tennessee Department of Finance and Administration for informational purposes.

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 years ended June 30, 2006 and 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 - Effective July 31, 2005, the TEL became a member of the Risk Management Fund, an internal service fund of the State of Tennessee. This self-insurance risk pool provides general liability, professional malpractice and automobile liability coverage up to $300,000 per person and $1,000,000 per occurrence.

Additionally, 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 maintains insurance from various other providers. For the year ended June 30, 2006, additional coverage was provided as follows:

- Employee dishonesty - aggregate of $500,000 total
- Automobile - limit of $1,000,000 combined single limit (bodily injury/property damage)
- Worker's compensation - up to statutory limits
- Umbrella coverage - aggregate of $5,000,000

Non-Operating Revenues and Expenses - Revenues and expenses resulting from activities not directly associated with the sale of lottery tickets are reflected as non-operating revenues and expenses.

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 9)

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 9)

Reclassifications - Certain amounts presented in the prior periods have been reclassified to conform to the current period financial statement presentation. These reclassifications have no effect on previously reported operating income and are noted as follows:

- Prepaid expenses and other assets at June 30, 2005, of $3,716,000 are reclassified as current assets of $3,596,000 and noncurrent assets of $120,000. The $120,000 represents the proper classification of the long term portion of deferred sub lease income.
- Rent, utilities, and maintenance expenses in fiscal year 2005 is increased by $318,000 of utility costs previously classified as general, administrative and other operating expenses.

(2) CASH

The TEL has implemented Governmental Accounting Standards Board Statement No. 40, *Deposit 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 aggregate 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 assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. At June 30, 2006 and 2005, TEL's bank balances of approximately $1.342 million and $820 thousand, respectively, 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 $57.4 million and $54.3 million at June 30, 2006 and 2005, respectively. 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) PRIZE ANNUITY INVESTMENTS

The prize structure of the Win for Life instant ticket game included three grand prizes in the form of lifetime annuities. These grand prizes guarantee the winner will receive $52,000 a year for the remainder of his/her life, with a minimum of 20 annual payments totaling $1,040,000. As of June 30, 2006, all of the grand prizes have been claimed by and awarded to winners.

In fiscal year 2006, the TEL purchased two (2) single premium, sum certain lifetime annuity contracts for approximately $904,000 and $848,000, in its name from Met Life, and appointed the respective Win for Life prize winners as the beneficiaries.

In accordance with its investment policy, the TEL may enter into insurance annuity contracts in order to fund annuity prizes. All life insurance annuity contracts must be issued by companies which are financially rated A or better by a nationally recognized rating agency and duly licensed, admitted and authorized to transact business in the State of Tennessee.

Credit risk. This is the risk that a counterparty will fail to fulfill its obligation. The TEL mitigates this risk through its investment policy, which limits purchase of investments which are financially rated A or better by a nationally recognized rating agency. Consistent with this policy, both annuities were purchased from Met Life, which is rated A+ Superior by A.M. Best as of June 30, 2006.

Concentration of credit risk. This risk relates to an investor's failure to adequately diversify its investments and is specifically defined as investments of 5 percent or more in the securities of a single issuer. Though the TEL does not have a policy specific to this risk, as a condition of the purchase, and for the duration of the contract, Met Life is required to maintain insurance sufficient to reimburse the TEL for any losses resulting from its failure or inability to meet related obligations.

Custodial credit risk. For an investment, this is the risk that in the event of the failure of the counterparty to a transaction, the investor will not be able to recover the value of its investments that are in the possession of an outside party. Investments are subject to custodial credit risk only if they are evidenced by securities that exist in physical or book entry form. Given that annuity contracts do not meet this condition, no related custodial credit risk exists as of the year ended June 30, 2006.

The TEL records all investments purchased to fund annuity prizes at fair value. Increases and decreases in the fair market value of these investments are deferred as noncurrent prize annuities payable.

Liabilities for annuity prizes are recorded at their discounted present value as prize annuities payable. In relation to both the prize annuity investments and prize annuities payables, payments due from insurance companies and due to prize winners within the next fiscal year are classified as current, whereas the remaining portion is classified as noncurrent on the Statement of Net Assets.

As of the year ended June 30, 2006, the TEL deferred a $31 thousand increase in the fair market value of the prize annuity investments.

(4) CAPITAL ASSETS

Capital assets consisted of the following as of June 30, 2006:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	$ 866,000	$ 7,000	$ -	$ 873,000
Computer equipment	366,000	18,000	(9,000)	375,000
Vehicles	200,000	-	-	200,000
High mileage vehicles	865,000	80,000	-	945,000
Leasehold improvements	307,000	-	-	307,000
Communication equipment	859,000	19,000	(1,000)	877,000
Software	258,000	1,000	-	259,000
Gaming equipment	188,000	1,000	-	189,000
Total capital assets	3,909,000	126,000	(10,000)	4,025,000
Less accumulated depreciation	(928,000)	(816,000)	2,000	(1,742,000)
Total capital assets, net	$ 2,981,000	$ (690,000)	$ (8,000)	$ 2,283,000

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	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

(5) LEASING ARRANGEMENTS

The TEL's leasing arrangements consist of non-cancelable operating leases for office space, 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 as of the year ended June 30, 2006.

In addition, the TEL subleases office space to three of its vendors, GTECH, SGI, and Gish, Sherwood and Friends, 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 non-cancelable operating leases with original terms of one year or more as of June 30:

Year Ending June 30:	**2006**	**2005**
2006	$ -	$ 2,225,000
2007	2,024,000	1,762,000
2008	1,845,000	1,746,000
2009	1,737,000	1,653,000
2010	1,264,000	1,228,000
2011	1,178,000	1,178,000
2012-2014	3,141,000	3,140,000
Total minimum rental payments	$ 11,189,000	$ 12,932,000

Minimum rental payments at June 30, 2006 and 2005, have not been reduced by minimum sublease rentals of $1.53 million and $1.72 million, respectively, due in future years under non-cancelable subleases.

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

Year Ending June 30:	**2006**	**2005**
2006	$ -	$ 188,000
2007	188,000	188,000
2008	188,000	188,000
2009	194,000	194,000
2010	206,000	206,000
2011	206,000	206,000
2012-2014	550,000	550,000
Total minimum lease payments	$ 1,532,000	$ 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 years ended June 30:

	2006	**2005**
Minimum rentals	$ 1,356,858	$ 997,852
Less: Sublease rentals	188,000	125,200
Total minimum rentals	$ 1,168,858	$ 872,652

(6) 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, 2006, total deferred rent of $951,000 consisted of $487,000 related to rent abatements and $464,000 to the straight-lining of rental expense over the life of the related lease terms.

At June 30, 2005, total deferred rent of $1,011,000 consisted of $554,000 related to rent abatements and $457,000 to the straight-lining of rental expense over the life of the related lease terms.

(7) 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 years ended June 30, 2006, and June 30, 2005, are summarized as follows:

	2006	2005
Operating revenues:		
Ticket sales	$995,845,000	$844,319,000
Less instant tickets provided as prizes	(68,263,000)	(60,620,000)
Net ticket sales	927,582,000	783,699,000
Service fees and other revenue	3,438,000	3,610,000
Total lottery proceeds	931,020,000	787,309,000
Operating expenses, as defined:		
Gaming	648,045,000	544,966,000
Operating	15,109,000	15,634,000
Total operating expenses, as defined	663,154,000	560,600,000
Net proceeds before distribution of unrestricted net assets	267,866,000	226,709,000
Non-operating revenue and expenses		
Interest income	1,996,000	714,000
Total non-operating revenue and expenses	1,996,000	714,000
Net proceeds subject to transfer	269,862,000	227,423,000
Amount due to Lottery for Education Account for year	269,862,000	227,423,000
Amount paid during year	(207,389,000)	(168,334,000)
Amount due to Lottery for Education Account, end of year	$62,473,000	$59,089,000

All amounts due at the end of each fiscal year were transferred to the Lottery for Education Account in July of the subsequent fiscal year.

(8) DUE TO AFTER SCHOOL PROGRAM ACCOUNT

On June 20, 2006, the Tennessee Education Lottery Implementation Law (the “Act”), *Tennessee Code Annotated* §§ 4-51-111(f)1, was revised to require 100% of any unclaimed prize monies be deposited in the After School Program special account created in accordance with §§ 4-51-111; provided however, if such unclaimed prizes in any fiscal year total more than $18,000,000, then such excess shall accrue to the fund balance of the lottery for education account. The revision was effective for the fiscal year ending June 30, 2006. Prior to the statute change, 50% of monies constituting unclaimed prizes were required to be transferred to the After School Program special account.

The Tennessee Education Lottery Corporation (TEL) records, for accounting purposes, unclaimed prizes in the period when revenues and related prize expense is recognized. Revenue recognition for instant games occurs upon pack activation by the retailer, and on the day of the drawing for online games.

For instant games, players have 90 days after the announced game-end date to claim a prize. For online games, players have 180 days after the related draw has occurred to claim a prize.

For fiscal year 2006, unclaimed prizes were $14,783,000, of which $5,518,000 was current and payable to the After School Programs special account at June 30, 2006, resulting from closed instant games or expired online draws.

The deferred portion of unclaimed prizes was $9,265,000 at June 30, 2006. These funds will be due and payable to the After School Program special account after the applicable claim periods have expired.

A summary of the $5,518,000 due at June 30, 2006, is as follows:

Fiscal Year	Unclaimed Prizes from closed games and draws	Due to After School
2004	$ 0	$ 0
2005	$ 5,581,000	2,791,000
2006	$11,649,000	11,649,000
Amount due to After School Program, since inception		$14,440,000

Amounts transferred as of June 30, 2006:

Fiscal Year	Amount
2004	$ 2,049,000
2005	6,873,000
Total Amounts transferred, since inception	$ 8,922,000
Current amount due to After School Program Account, end of year	$ 5,518,000

All amounts due at the end of each fiscal year were transferred to the Lottery for Education Account in July of the subsequent fiscal year.

(9) 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 years ended June 30, 2006 and 2005, employees contributed approximately $390,000 and $344,000, respectively, to the 457 Plan.

The aggregate fair value of the plan's assets was approximately $1,151,000 and $666,000, net of forfeitures and administrative fees, as of June 30, 2006 and 2005, respectively.

B. Defined Contribution Plan

Effective September 22, 2003, the TEL Board of Directors 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. The TEL contributed approximately $611,000 and $571,000 to the 401(a) Plan on behalf of its employees in the years ended June 30, 2006 and 2005, respectively. Of these contributions, approximately $57,000 and $40,000 was forfeited by separated employees as of June 30, 2006, and June 30, 2005, respectively.

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 years ended June 30, 2006 and 2005, forfeited amounts of approximately $61,000 and $36,000, respectively, 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 plans' assets was approximately $1,453,000 and $825,000, net of forfeitures and administrative fees, as of June 30, 2006 and 2005, respectively.

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 12 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, 2006, is estimated using historical trends. At June 30, 2006 and 2005, the estimated current portion of the compensated absences liability was $172 thousand and $188 thousand, respectively.

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 40 hours of severance pay for every year of employment with TEL. The TEL accrued $69 thousand and $36 thousand for employment separation obligations at June 30, 2006 and 2005, respectively.

(10) LONG-TERM LIABILITIES

Long-term liabilities consisted of the following as of June 30, 2006:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Due to After School Programs	$ 6,873,000	$14,783,000	$(6,873,000)	$14,783,000	$ 5,518,000
Prize Annuities Payable	-	2,573,000	-	2,573,000	156,000
Compensated Absences	414,000	411,000	(425,000)	400,000	172,000
Deferred Rent	1,011,000	8,000	(68,000)	951,000	68,000
Total long-term liabilities	$ 8,298,000	$17,775,000	$(7,366,000)	$18,707,000	$ 5,914,000

Long-term liabilities consisted of the following as of June 30, 2005:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Compensated Absences	$ -	$ 584,000	$(170,000)	$ 414,000	$ 188,000
Deferred Rent	983,000	96,000	(68,000)	1,011,000	68,000
Total long-term liabilities	$ 983,000	680,000	(238,000)	1,425,000	$ 256,000

Compensated absences presented within the noted schedules are included in accrued liabilities presented on the Statement of Net Assets.

(11) COMMITMENTS AND CONTINGENCIES

Corvette Grand Prize Drawing - The TEL has committed to conducting a drawing whereby prizes totaling $100,000 will be awarded to one individual. The TEL anticipates completion of this drawing to occur during the fiscal year ending June 30, 2007.

Hold 'Em Poker Second Chance Drawings - The TEL has committed to conducting second chance drawings whereby prizes totaling approximately $160,000 will be awarded to five winners. The TEL anticipates completion of these drawings to occur during the fiscal year ending June 30, 2007.

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 in fiscal year 2007.

(12) SUBSEQUENT EVENTS

Annuity Prize Investment Purchase - In July 2006, the TEL purchased a single premium, sum certain lifetime annuity contract for $739,000, to fund all future payments for the final, remaining Win for Life grand prize awarded.