AUDIT REPORT

Tennessee Education Lottery Corporation

For the Year Ended
June 30, 2007

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
Department of Audit
Division of State Audit

Arthur A. Hayes, Jr., CPA, JD, CFE
Director

Edward Burr, CPA
Assistant Director

Ronald E. Anderson, CPA, CFE
Audit Manager

Donald Vanatta
In-Charge Auditor

Mark Collins, CFE
Roger Sanders, CPA
Benjamin Wright, CFE
Staff Auditors

Gerry C. Boaz, CPA
Technical Analyst

Amy Brack
Editor

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-0264
(615) 401-7897

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STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

February 7, 2008

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, 2007. 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/cj
08/015

State of Tennessee

A u d i t   H i g h l i g h t s

Comptroller of the Treasury   Division of State Audit

Financial and Compliance Audit

Tennessee Education Lottery Corporation

For the Year Ended June 30, 2007

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, contracts, and grant agreements; 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, 2007

TABLE OF CONTENTS

	Exhibit	Page
INTRODUCTION		1
Post-Audit Authority		1
Background		1
Organization		2
AUDIT SCOPE		4
OBJECTIVES OF THE AUDIT		4
PRIOR AUDIT FINDINGS		4
OBSERVATIONS AND COMMENTS		5
Transfer of Net Lottery Proceeds		5
Management's Responsibility for Risk Assessment		5
Fraud Considerations		6
Investigative Review Performed		6
RESULTS OF THE AUDIT		7
Audit Conclusions		7
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*		8
FINANCIAL SECTION		
Independent Auditor's Report		10
Management's Discussion and Analysis		12
Financial Statements		23

TABLE OF CONTENTS (CONT.)

	Exhibit	Page
Statements of Net Assets	A	23
Statements of Revenues, Expenses, and Changes in Net Assets	B	24
Statements of Cash Flows	C	25
Notes to the Financial Statements		27

Tennessee Education Lottery Corporation
For the Year Ended June 30, 2007

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 (TEL) was created on June 11, 2003, by the Tennessee General Assembly through the Tennessee Education Lottery Implementation Law. Pursuant with the law, TEL was incorporated as a body, politic and corporate, and a quasi-public instrumentality. TEL 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. TEL 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, 2007, TEL had launched a total of 138 instant ticket games and 6 online games: Cash 3, Cash 4, Lotto 5, Hottrax Champions, Million $ Madness, and Powerball. TEL 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. TEL 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 TEL 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.

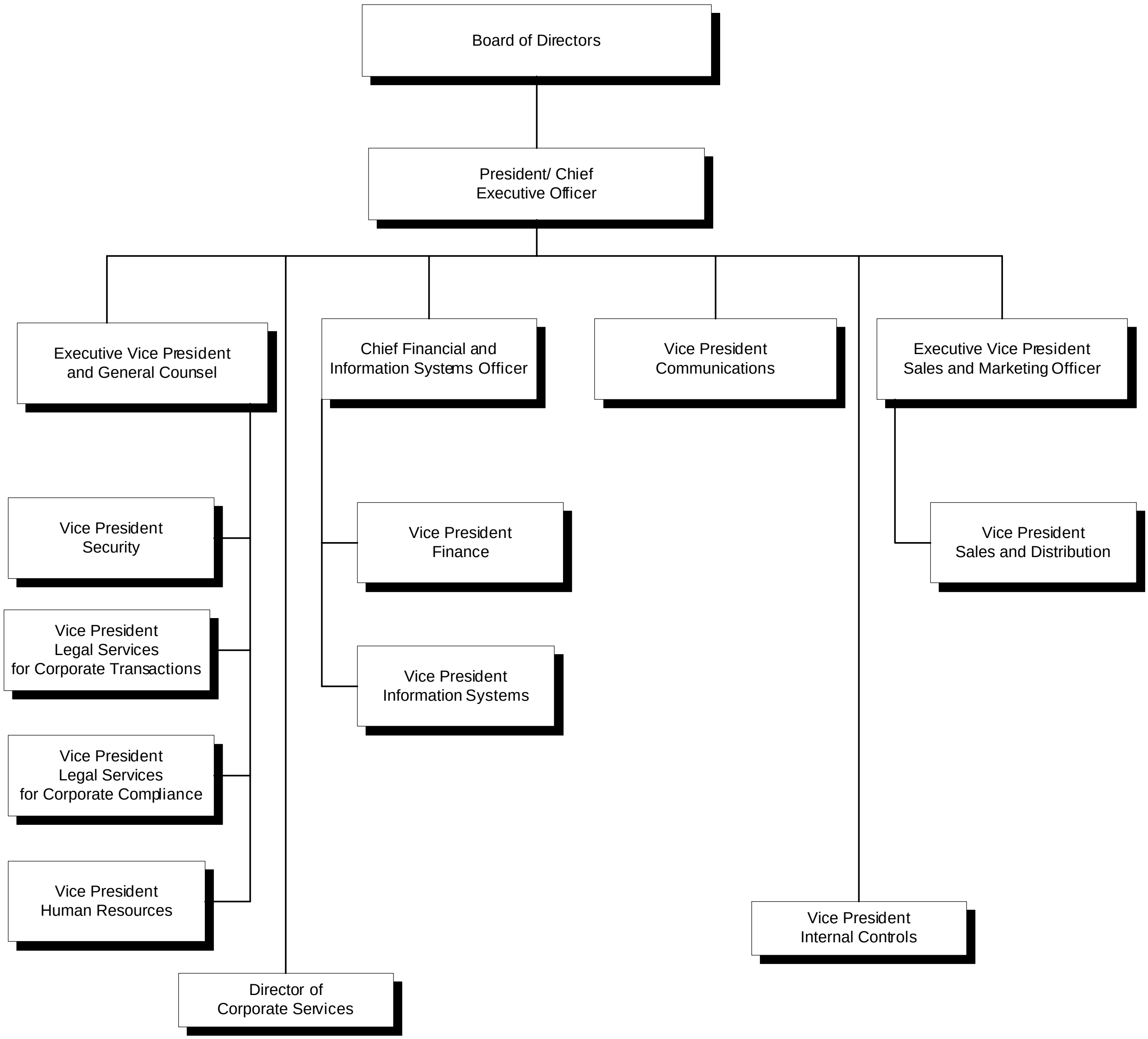
The Legal Division includes the departments of Human Resources, Legal Services, Security, and Retailer Contract Administration. The Human Resources Department manages all personnel functions. The Legal Services Department provides legal advice and assistance to management and the Board of Directors, 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.

Tennessee Education Lottery Corporation
Organization Chart



AUDIT SCOPE

The audit was limited to the period July 1, 2006, through June 30, 2007, 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, 2007, and for comparative purposes, the year ended June 30, 2006. The Tennessee Education Lottery Corporation has been included as a component unit in the *Tennessee Comprehensive Annual Financial Report*.

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 year ended June 30, 2007, that the net lottery proceeds transferred to the lottery for education account "equal, as nearly as practical, thirty-five percent (35%) of the lottery proceeds." For prior fiscal years, the statute required lottery proceeds "equal, as nearly as practical, thirty percent (30%) of the lottery proceeds." For the year ended June 30, 2007, lottery proceeds totaled $989 million and the corporation transferred $272 million to the lottery for education account. The amount transferred was approximately 27.5 percent of 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.

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.

INVESTIGATIVE REVIEW PERFORMED

On July 28, 2007, the Tennessee Education Lottery Corporation converted from manual ball drawings to computer generated random number drawings for its Cash 3, Cash 4, and Lotto 5 online games. The Tennessee Education Lottery Corporation issued a press release on August 21, 2007, stating that a programming issue had been discovered on the previous day, August 20, 2007, and the issue had been corrected immediately. The programming issue, attributed to a human error made by an outside, third-party vendor, was that lottery players who selected two or more of the same numbers in a play for Cash 3 or Cash 4 during the period July 28 through August 20 were excluded from having an opportunity to win.

On October 3, 2007, Senator Bill Ketron, Co-Chair of the Joint Lottery Oversight Committee of the Tennessee General Assembly, sent a letter to Mr. John Morgan, Tennessee Comptroller of the Treasury, requesting that the Comptroller's Office "audit any contracts that the Tennessee Lottery has entered into that pertain to the operations of the lottery (i.e., ball machine contracts, random number generator contracts and any service contracts for such)."

Upon receipt of Senator Ketron's letter, the Special Investigations and Information Systems sections of the Division of State Audit immediately began a review of the error that affected Cash 3 and Cash 4 games for the period July 28 through August 20, 2007. The results of the review will be communicated to the Joint Lottery Oversight Committee under a separate cover.

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, 2007, we considered internal control over financial reporting as a basis for designing 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
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 401-7897
FAX (615) 532-2765

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 5, 2007

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, 2007, and have issued our report thereon dated December 5, 2007. 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the corporation's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the corporation's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the 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/cj

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-0264
PHONE (615) 401-7897
FAX (615) 532-2765

Independent Auditor's Report

December 5, 2007

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, 2007, and June 30, 2006, 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, 2007, and June 30, 2006, 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.

As discussed in Note 1 to the financial statements, the Corporation changed its method of recognizing unclaimed prizes during the year ended June 30, 2007.

The management's discussion and analysis on pages 12 through 23 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 5, 2007, on our consideration of the corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr., CPA
Director

AAH/cj

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, 2007 and 2006, with comparative information presented for the fiscal year ended June 30, 2005. The overview should be considered in conjunction with the independent auditor's report, the accompanying audited financial statements and notes to financial statements.

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 – Reflects the TEL's financial position at June 30, 2007 and 2006.
- The Statements of Revenues, Expenses, and Changes in Net Assets – Reports 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, 2007 and 2006.
- The Statements of Cash Flows - Outlines the cash inflows and outflows related to the activity of selling lottery products and other business related activities for the fiscal years ended June 30, 2007 and 2006.

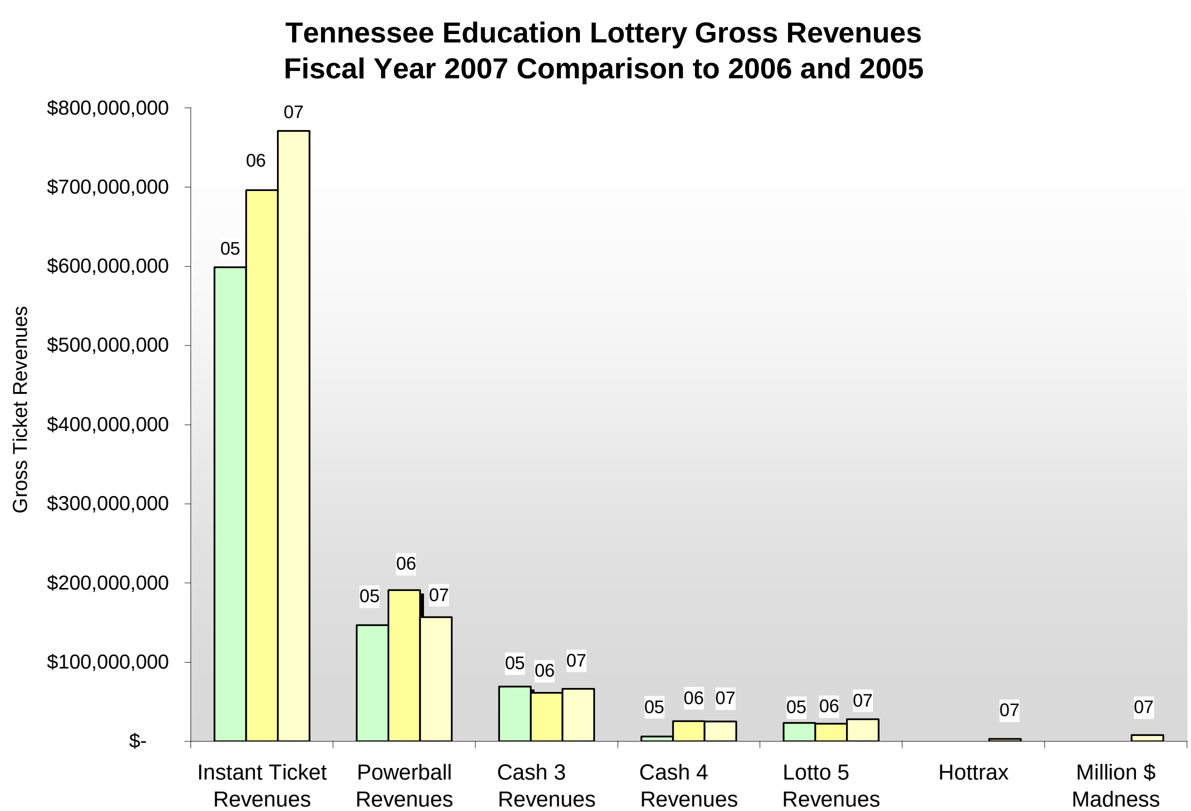
The Notes to the Financial Statements document additional information essential for readers to gain a comprehensive understanding of the data provided in the financial statements.

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. Generally, 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.

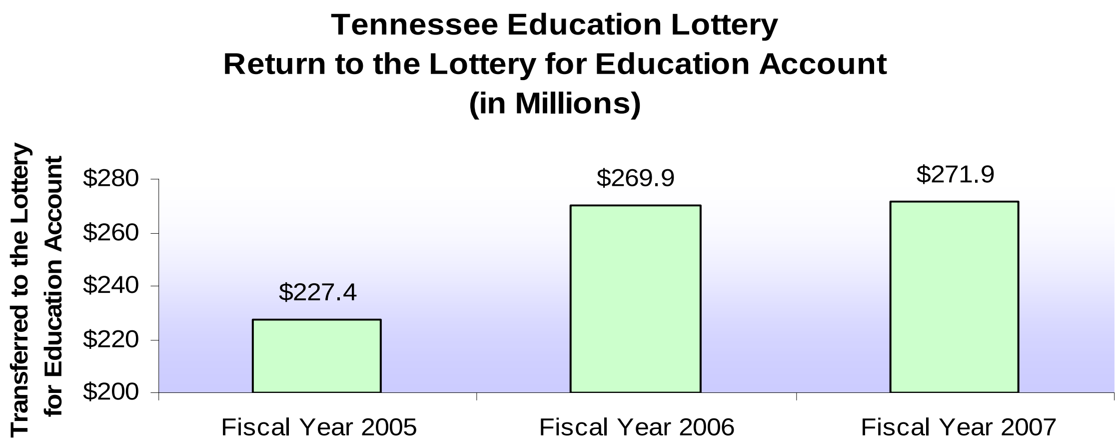
Fiscal Year 2007 Financial Highlights

The TEL experienced another record fiscal year in 2007, generating $271.9 million for the Lottery for Education Account and $12.3 million for the After-School Programs special account, bringing the total raised since inception to over $919.3 million.

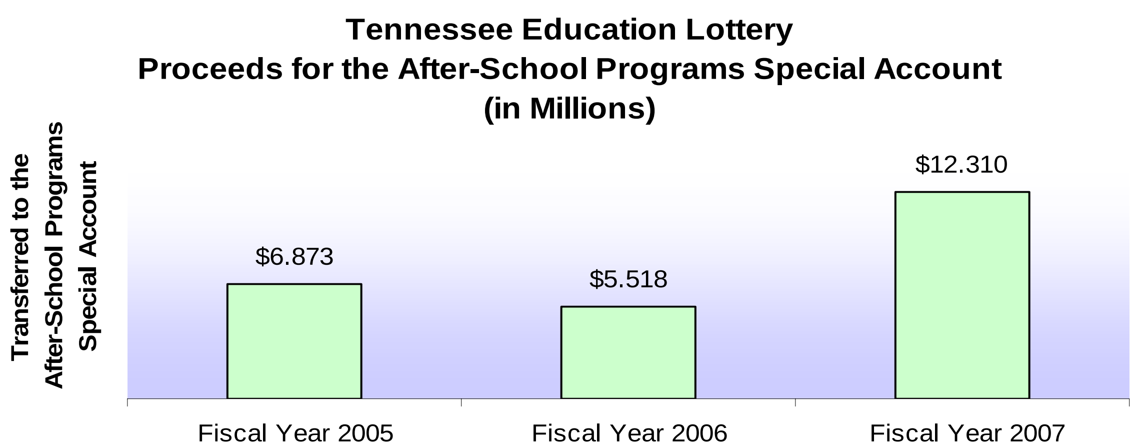
Gross sales for the fiscal year ended June 30, 2007, were over $1 billion – a 6% increase from fiscal year 2006. The TEL's 2007 success was a result of an 11% increase in instant sales and a 19% increase in non-POWERBALL online games. Instant ticket marketing strategies, along with higher price point games continue to propel sales in 2007 over 2006, and 2006 over 2005. Increases in Cash 3 (8%) and in Lotto 5 (26%) sales contributed over $10 million to the overall increase. In addition, two new online games, Hottrax Champions and Million $ Madness were introduced in 2007, providing $10.7 million of sales. Cash 4 sales were consistent year over year. POWERBALL sales decreased by 18%, as no jackpots of greater than $300 million occurred in fiscal year 2007, compared to 2 such jackpots in fiscal year 2006. In 2006, the driving factor in the 30% increase of POWERBALL sales over Fiscal Year 2005 included the larger jackpots.



The TEL transferred $271.9 million to the Lottery for Education Account in fiscal year 2007, compared to $269.9 million in fiscal year 2006 and $227.4 in fiscal year 2005. The transfer represented 27% of total lottery proceeds in fiscal year 2007, compared to 29% in both fiscal years 2006 and 2005. Since inception, the TEL has transferred $892.5 million to the Lottery for Education Account.



The amounts available for transfer to the After-School Programs special account are derived from unclaimed prizes on instant games officially closed after the 90 day claim period and online draws that have exceeded the 180 day claim period. In fiscal year 2007, the TEL generated $12.3 million for the After-School Programs special account as compared to $5.5 million in fiscal year 2006, and $6.8 million in fiscal year 2005. The amounts represented 100% of realized unclaimed prizes in fiscal years 2007 and 2006. It represented 50% of recognized unclaimed prizes in Fiscal Year 2005. Since inception, the TEL has generated $26.8 million for the After-School Programs special account.



Condensed Statement of Net Assets

Assets:	**June 30, 2007**	**Increase/ (Decrease)**	**June 30, 2006**	**Increase/ (Decrease)**	**June 30, 2005**
Current assets					
Cash	$ 62,820,000	$ 4,758,000	$ 58,062,000	$ 3,393,000	$ 54,669,000
Retailer accounts receivable, net	44,302,000	5,865,000	38,437,000	3,153,000	35,284,000
Other	7,141,000	1,492,000	5,649,000	2,053,000	3,596,000
Total current assets	114,263,000	12,115,000	102,148,000	8,599,000	93,549,000
Non-current assets					
Other	2,577,000	791,000	1,786,000	1,666,000	120,000
Capital assets, net	1,828,000	(455,000)	2,283,000	(698,000)	2,981,000
Total non-current assets	4,405,000	336,000	4,069,000	968,000	3,101,000
Total assets	**118,668,000**	**12,451,000**	**106,217,000**	**9,567,000**	**96,650,000**
Liabilities:					
Current liabilities					
Due to Lottery for Education Account	66,209,000	3,736,000	62,473,000	3,384,000	59,089,000
Due to After School Programs Account	10,436,000	4,918,000	5,518,000	(1,355,000)	6,873,000
Prizes payable	34,614,000	15,188,000	19,426,000	2,542,000	16,884,000
Accounts payable and accrued liabilities	3,068,000	(1,443,000)	4,511,000	(109,000)	4,620,000
Deferred liabilities	786,000	(379,000)	1,165,000	311,000	854,000
Total liabilities	115,113,000	22,020,000	93,093,000	4,773,000	88,320,000
Non-current liabilities					
Non-current portion of Due to After School Programs Account	-	(9,265,000)	9,265,000	9,265,000	-
Non-current portion of other liabilities	3,424,000	(104,000)	3,528,000	2,359,000	1,169,000
Total non-current liabilities	3,424,000	(9,369,000)	12,793,000	11,624,000	1,169,000
Total liabilities	**118,537,000**	**12,651,000**	**105,886,000**	**16,397,000**	**89,489,000**
Net Assets					
Investment in capital assets	1,828,000	(455,000)	2,283,000	(698,000)	2,981,000
Unrestricted assets	(1,828,000)	455,000	(2,283,000)	698,000	(2,981,000)
Restricted assets	131,000	(200,000)	331,000	(6,830,000)	7,161,000
Total net assets	**$ 131,000**	**$ (200,000)**	**$ 331,000**	**$ (6,830,000)**	**$ 7,161,000**

Overview of Financial Position

Assets

The TEL's financial position continued to strengthen during fiscal 2007. The $12.45 million increase in total assets primarily resulted from increased sales from our Instant Ticket, Cash 3, Lotto 5, and Million $ Madness products in fiscal year 2007. The impact of the sales increase is reflected in increased Cash and Retailer Accounts Receivable. Other factors included, but were not limited to, the purchase of one prize annuity investment to fund a Win for Life grand prize and the increase in the TEL's POWERBALL prize reserve account balances held by the Multi-State Lottery Association ("MUSL").

As of the year ended June 30, 2006, the $9.6 million increase in total assets primarily resulted from increased sales of our Instant Ticket and POWERBALL products. 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 MUSL.

Liabilities

The $12.65 million increase in total liabilities at June 30, 2007 from the prior year, relates primarily to increased sales, resulting in higher net proceeds payable to the Lottery for Education Account, and more prizes payable to players.

The $16.4 million increase in total liabilities at June 30, 2006, related primarily to increased sales, resulting in higher net proceeds payable to the Lottery for Education Account and higher prizes payable to players.

Net Assets

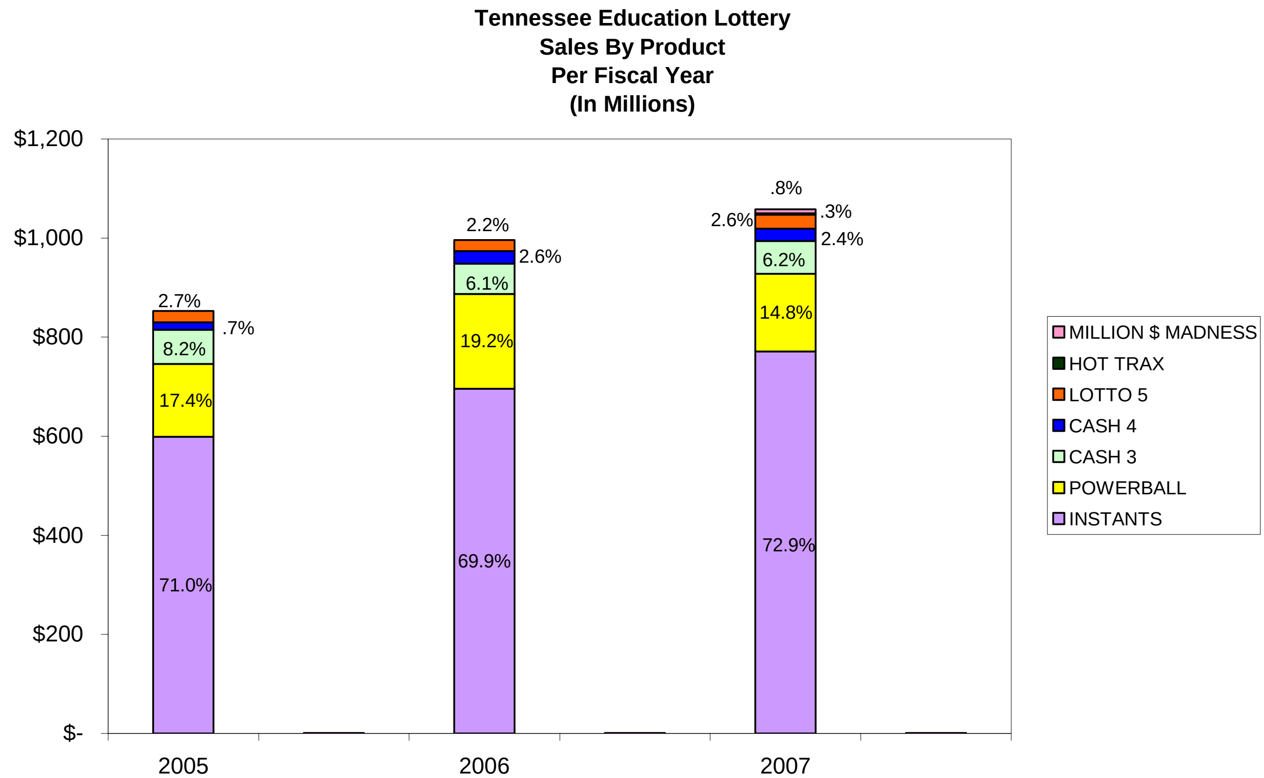
The $6.8 million decrease in restricted net assets as of June 30, 2006, resulted from a statutory change in Tennessee Education Lottery Implementation Law, effective June 2006, that requires 100% of unclaimed prize monies be deposited in the After School Programs Account. Prior to the change, 50% of unclaimed prizes were available to the TEL to fund future prizes in accordance with the originating lottery statute.

Condensed Statement of Revenues & Expenses

	June 30, 2007	Increase/ (Decrease)	June 30, 2006	Increase/ (Decrease)	June 30, 2005
Revenues:					
Instant games	$ 771,125,000	$ 74,909,000	$ 696,216,000	$ 97,251,000	$ 598,965,000
Online games	287,007,000	(13,045,000)	300,052,000	54,698,000	245,354,000
Less instant tickets provided as prizes	(73,474,000)	(5,211,000)	(68,263,000)	(7,643,000)	(60,620,000)
Games revenue, net	984,658,000	56,653,000	928,005,000	144,306,000	783,699,000
Bad debt recoveries/(expense), net	223,000	646,000	(423,000)		-
Retailer service fees	3,267,000	101,000	3,166,000	(122,000)	3,288,000
Interest income	2,095,000	99,000	1,996,000	1,282,000	714,000
Other revenue	1,064,000	749,000	315,000	(30,000)	345,000
Total revenues	**991,307,000**	**58,248,000**	**933,059,000**	**145,436,000**	**788,046,000**
Expenses:					
Cost of sales	692,218,000	52,083,000	640,135,000	106,866,000	533,269,000
General, administrative and other operating expenses	14,749,000	(360,000)	15,109,000	(525,000)	15,634,000
Other expenses	261,000	261,000	-	-	-
Total expenses	**707,228,000**	**51,984,000**	**655,244,000**	**106,341,000**	**548,903,000**
Transfers:					
Proceeds to After School Program Account					
Current	12,310,000	6,792,000	5,518,000	(1,355,000)	6,873,000
Deferred	-	(9,265,000)	9,265,000	9,265,000	-
Proceeds to Lottery for Education Account	271,969,000	2,107,000	269,862,000	42,439,000	227,423,000
Total transfers	**284,279,000**	**(366,000)**	**284,645,000**	**50,349,000**	**234,296,000**
Change in net assets	(200,000)	6,630,000	(6,830,000)	(11,254,000)	4,847,000
Total net assets, beginning of year	331,000	(6,830,000)	7,161,000	4,847,000	2,314,000
Total net assets, end of year	**$ 131,000**	**$ (200,000)**	**$ 331,000**	**$ (6,407,000)**	**$ 7,161,000**

Revenues

Total gross lottery ticket sales for the fiscal years ended June 30, 2007, 2006, and 2005 were $1.06 billion, $996.27 million, and $844.32 million, respectively. The following chart depicts the distribution of sales by product for the three fiscal years ended June 30:



Gross instant ticket sales for 2007 grew to $771.13 million, which represents an 11% increase over 2006 instant ticket sales of $696.22 million. Gross instant ticket sales for 2006 grew to $696.22 million, which represented a 16% increase over 2005 instant sales of $598.97 million. Instant tickets increased to approximately 73% of total gross sales in the year 2007 from approximately 70% in the years 2006 and 2005. The year over year increase in gross instant ticket sales is attributed to the instant ticket marketing strategy which involves ongoing introduction of multiple games, including special themed games, along with the introduction of higher price point games with higher prize payouts. The games most popular with the players in 2007 were Junior Jumbo Bucks, Jumbo Bucks, Giant Jumbo Bucks and Sparkling Diamonds.

POWERBALL sales for the fiscal years 2007, 2006 and 2005, were $156.85 million, $190.95 million, and $146.67 million, respectively. These amounts respectively represent approximately

15%, 19%, and 17% of gross ticket sales. The significant increase in the 2006 POWERBALL sales as compared to 2007 and 2005 sales can be attributed to the occurrence of 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; District of Columbia and US Virgin Islands. The TEL's average weekly sales for POWERBALL were approximately $3.0 million, $3.7 million and $2.8 million in 2007, 2006 and 2005, respectively.

Cash 3 sales for 2007 and 2006, were $66.29 million and $61.42 million or 6% of gross sales in both years. Average weekly sales for Cash 3 were approximately $1.3 million in 2007, compared to $1.2 million in 2006. The increase in 2007 Cash 3 sales is related to the availability of sales for the midday drawing. Specifically, the midday drawing for this game was launched and on sale for 7½ months in 2006, as compared to 12 months in 2007.

Cash 3 sales for 2005, were $69.18 million or 8.2% of gross sales. The $7.76 million decrease in 2006 Cash 3 sales from 2005 Cash 3 sales reflects players shifting dollars from this game to Cash 4, as public awareness of the then recently introduced game grew, and to POWERBALL, as larger jackpots were available during fiscal year 2006.

Cash 4 sales were $25.3 million, $25.5 million, and $6.09 million in the years 2007, 2006, and 2005, respectively. Average weekly sales for Cash 4 were approximately $486 thousand and $489 thousand in 2007 and 2006, respectively. The $19.41 million increase realized in 2006 from the prior year is due to this game being on sale for only 2½ months in fiscal year 2005, as compared to 12 months in fiscal year 2006.

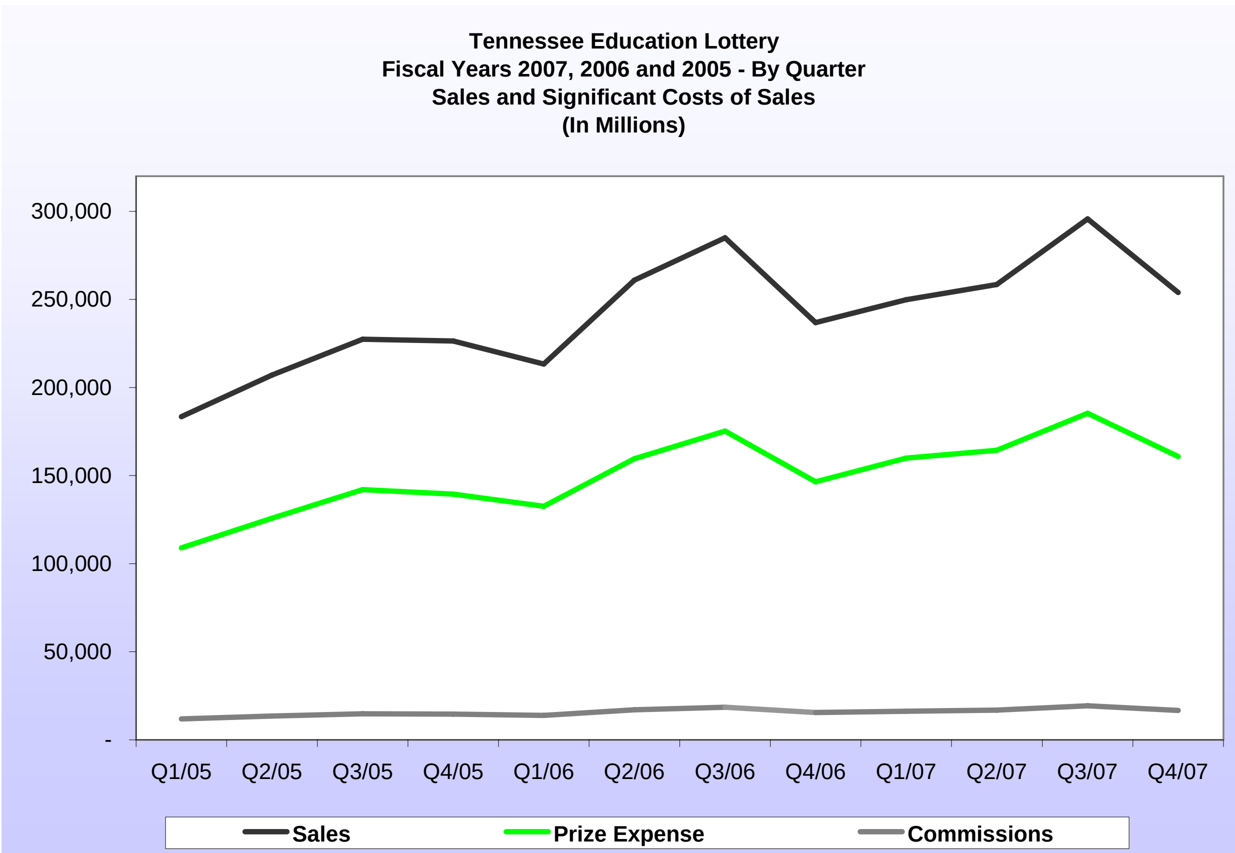
Lotto 5 sales were $27.8 million, $22.2 million and $23.4 million in the years 2007, 2006 and 2005, respectively. Fiscal year 2007 sales increased to approximately 3% of total gross sales from 2% in the prior fiscal year largely as a result of the existence of higher Lotto 5 jackpots occurring during the fiscal year. Average weekly sales for Lotto 5 were approximately $535 thousand, $425 thousand, and $530 thousand in 2007, 2006, and 2005, respectively.

Hottrax Champions, an online game, was introduced in November 2006. Sales were $2.7 million in 2007. Average weekly sales for Hottrax were approximately $52 thousand in 2007.

Million $ Madness, a raffle-style online game, was introduced and fully executed in 2007. Sales from this game were $8.0 million in 2007.

Cost of Sales

Cost of sales is comprised of prize expense net of unclaimed prizes, retailer commissions, contractor fees, and other marketing costs. As the following chart depicts, these expenses are relational to and change in direct proportion with changes in ticket sales:



Gross prize expense was $597.23 million, $552.53 million and $457.99 million in the years 2007, 2006 and 2005, respectively. As noted above, the increases of $44.70 million in 2007 and $94.54 million in 2006 are reflective of the increases in overall ticket sales realized in the noted period.

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 65% in 2007, 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 and is recorded at the time of the related draw, with the exception of Million $ Madness. Gross prize expense for Million $ Madness is recognized in an amount equal to the total value of all prizes available for this online game. As tickets were sold by retailers, gross prize expense was recognized for each ticket sold in an amount equal to the proportionate share of the total value of available prizes.

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 earned by retailers for cashing Cash 3 and Cash 4 prizes below $600. In addition, retailers can receive a $25,000 bonus for selling a winning POWERBALL jackpot ticket; no bonuses were paid in 2007 or 2006, one bonus was paid in 2005. A $5,000 bonus is awarded to retailers selling a $1 million POWERBALL PowerPlay ticket; bonuses totaling $10,000 were awarded in 2007, whereas none were awarded in 2006 and 2005. A $5,000 bonus was awarded to the retailers selling grand prize Million $ Madness winning tickets; four bonuses totaling $20,000 were awarded in 2007.

Retailer commissions were $69.16 million, $64.95 million, and $54.88 million for the years ended June 30, 2007, 2006, and 2005, respectively. Consistent with the cost driver relationship of ticket sales to retailer commissions, the increases of $4.21 million in 2007 and $10.07 million in 2006 are reflective of the increases in overall ticket sales realized in the noted period.

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 all online tickets sold, .6% of the selling price of Hottrax Champions online tickets sold, and 1.24% 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 were $20.97 million for fiscal year 2007, $19.41 million for fiscal year 2006, and $16.51 million for the fiscal year 2005.

Advertising costs were $12.83 million, $14.11 million, and $13.83 million for the fiscal years 2007, 2006, and 2005, respectively. The $1.3 million decrease in 2007, resulted from a change in marketing strategy between print, radio and television advertising.

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 2007 and 2006. General, administrative, and other operating expenses were $15.01 million, $15.53 million, and $15.6 million for the years 2007, 2006, and 2005, respectively. Salaries and benefits represent the major component of these expenses in all three fiscal years presented.

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 seasonal themed games, as well as consider the expansion of our licensed property games, which are gaining nationwide popularity.

- The TEL will review the prize payout percentages for its instant game products to determine if an increase in prize payouts will result in higher actual net proceeds.

- The TEL plans to introduce a new online game in fiscal year 2008 to increase our online sales. We will also research possible enhancements of existing online games to expand the play options and winning opportunities available to players.

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, 2007, AND JUNE 30, 2006

	2007	2006
ASSETS		
CURRENT ASSETS:		
Cash (Note 2)	$ 62,689,000	$ 57,731,000
Restricted fidelity fund cash	131,000	331,000
Retailer accounts receivable, net	44,302,000	38,437,000
Prepaid expenses and other assets	7,037,000	5,545,000
Prize annuity investments (Note 3)	104,000	104,000
Total current assets	114,263,000	102,148,000
NONCURRENT ASSETS:		
Prepaid expenses and other assets	120,000	108,000
Prize annuity investments (Note 3)	2,457,000	1,678,000
Capital assets, net of depreciation of $2,377,000 and $1,742,000 (Note 4)	1,828,000	2,283,000
TOTAL ASSETS	118,668,000	106,217,000
LIABILITIES		
CURRENT LIABILITES:		
Due to Lottery for Education Account (Note 7)	66,209,000	62,473,000
Due to After School Programs Account (Note 8)	10,436,000	5,518,000
Prizes payable	34,510,000	19,270,000
Accounts payable	34,000	734,000
Prize annuities payable (Note 3)	104,000	156,000
Accrued liabilities	3,034,000	3,777,000
Deferred rent (Note 6)	68,000	68,000
Deferred revenue	718,000	1,097,000
Total current liabilities	115,113,000	93,093,000
NONCURRENT LIABILITIES		
Due to After School Programs Account (Note 8)	-	9,265,000
Prize annuities payables (Note 3)	2,457,000	2,417,000
Accrued liabilities (Note 10)	145,000	228,000
Deferred rent (Note 6)	822,000	883,000
Total noncurrent liabilities	3,424,000	12,793,000
TOTAL LIABILITIES	118,537,000	105,886,000
NET ASSETS:		
Investment in capital assets	1,828,000	2,283,000
Unrestricted assets:		
Capital assets	(1,828,000)	(2,283,000)
Restricted assets:		
Restricted for uncollectible retailer receivables	131,000	331,000
TOTAL NET ASSETS	$ 131,000	$ 331,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2007, AND JUNE 30, 2006

	2007	2006
OPERATING REVENUES:		
Ticket sales, net	$ 1,058,355,000	$ 995,845,000
Less instant tickets provided as prizes	(73,474,000)	(68,263,000)
Net ticket sales	984,881,000	927,582,000
Retailer service fees	3,267,000	3,166,000
Other	1,003,000	272,000
Net operating revenues	989,151,000	931,020,000
OPERATING EXPENSES:		
Available prizes	597,231,000	552,528,000
Current year actual unclaimed prizes (Note 8)	(12,310,000)	-
Prizes estimated as unclaimed (Note 8)	-	(14,783,000)
Net prizes	584,921,000	537,745,000
Retailer commissions and bonuses	69,159,000	64,950,000
Contractor fees	20,971,000	19,406,000
Advertising	12,828,000	14,111,000
Salaries and benefits	10,946,000	11,392,000
Retailer merchandising and marketing	4,339,000	3,923,000
Rent, utilities, and maintenance	1,809,000	1,816,000
Depreciation	706,000	816,000
Professional fees	401,000	317,000
General administrative and other operating	887,000	768,000
Total operating expenses	706,967,000	655,244,000
Operating income	282,184,000	275,776,000
NONOPERATING REVENUES (EXPENSES):		
Interest revenue	2,095,000	1,996,000
Retailer fees for future uncollectible retailer receivables	61,000	43,000
Fidelity fund retailer non-feasance recoupments (Note 1)	(261,000)	-
Proceeds to After School Programs Account (Note 8)		
Current	(12,310,000)	(5,518,000)
Deferred	-	(9,265,000)
Proceeds to Lottery for Education Account (Note 8)	(271,969,000)	(269,862,000)
Total nonoperating revenues(expenses)	(282,384,000)	(282,606,000)
Change in Net Assets	(200,000)	(6,830,000)
NET ASSETS, beginning of year	331,000	7,161,000
NET ASSETS, end of year	$ 131,000	$ 331,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2007, AND 2006

	2007	2006
OPERATING ACTIVITIES:		
Cash received from customers	$ 978,636,000	$ 924,740,000
Other operating cash received	4,252,000	3,441,000
Cash paid for prizes	(580,422,000)	(534,635,000)
Cash paid to/on behalf of gaming vendors	(21,371,000)	(19,354,000)
Cash paid to retailers	(69,132,000)	(64,969,000)
Cash paid for advertising	(13,423,000)	(14,130,000)
Cash paid to/on behalf of contractors and employees	(11,380,000)	(11,287,000)
Other operating payments	(7,703,000)	(7,232,000)
Net cash provided by operating activities	279,457,000	276,574,000
NONCAPITAL FINANCING ACTIVITIES:		
Payments to Lottery for Education Account	(268,233,000)	(266,478,000)
Payments to After School Program Account	(7,392,000)	(6,873,000)
Fidelity fund cash received from retailers	69,000	42,000
Fidelity fund cash refunded to retailers	(8,000)	(1,000)
Fidelity fund cash non-feasance recoupments	(261,000)	-
Net cash used in noncapital financing activities	(275,825,000)	(273,310,000)
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Purchase of property and equipment	(266,000)	(115,000)
Proceeds from disposal of capital assets	36,000	-
Net cash used in capital and related financing activities	(230,000)	(115,000)
INVESTING ACTIVITIES:		
Interest income	2,095,000	1,996,000
Purchase of prize annuity investments	(739,000)	(1,752,000)
Net cash provided by investing activities	1,356,000	244,000
Net Cash Provided by all Activites	4,758,000	3,393,000
Cash at beginning of year	58,062,000	54,669,000
Cash at end of year	$ 62,820,000	$ 58,062,000

Reconciliation of cash on the statement of net assets

	2007	2006
Cash	$ 62,689,000	$ 57,731,000
Restricted fidelity fund cash	131,000	331,000
Cash at end of year	$ 62,820,000	$ 58,062,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2007, AND 2006

RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:

	2007	2006
Operating income	$ 282,184,000	$ 275,776,000
Adjustments to reconcile operating income to net cash provided by operating activities:		
Bad debt expense	(223,000)	423,000
Depreciation	706,000	816,000
(Gain)/Loss on disposal of capital assets	(22,000)	1,000
Changes in assets and liabilities:		
Retailer accounts receivable	(5,867,000)	(3,576,000)
Prepaids and other assets	(1,504,000)	(1,937,000)
Accounts payable and accrued liabilities	(1,526,000)	(107,000)
Prizes payable	15,240,000	2,386,000
Deferred due to After School Program Account	(9,265,000)	-
Prize annuities payable	174,000	2,542,000
Deferred rent	(61,000)	(61,000)
Deferred revenue	(379,000)	311,000
Net cash provided by operating activities	$ 279,457,000	$ 276,574,000

NONCASH INVESTING ACTIVITIES:

	2007	2006
Increase in fair value of prize annuity investments	$ 195,000	$ 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 discreetly 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, 2007, the TEL's lottery sales include a variety of instant ticket games and five terminal-based online ticket games: Cash 3, Cash 4, Lotto 5, Powerball and Hottrax Champions. Also, during the year ended June 30, 2007, the TEL offered Million $ Madness, a raffle style, terminal-based online game.

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.

Recognition of Unclaimed Prizes - Change in Accounting Estimate Effected by Change in Accounting Principle – Effective August 23, 2006, the TEL elected to change its method of recognizing unclaimed prizes for instant and online games from estimation to amounts realized. For instant games, the TEL determines realized unclaimed prizes at the time when games are closed and reconciled. For online games, the realized unclaimed amounts are determined after the expiration of the related claim period draw.

This change to the recognition of unclaimed prizes was made in relation to the June 20th, 2006 revision to the Tennessee Education Lottery Implementation Law (the "Act"), Tennessee Code Annotated §§ 4-51-111(f)1 requiring 100% of any unclaimed prize monies be deposited in the After School Programs special account created in accordance with §§ 4-51-111. Prior to the statute change, 50% of monies constituting unclaimed prizes were required to be transferred to the After School Programs special account. The revision was effective for the fiscal year ending June 30, 2006.

In light of this legislative action, the new method of accounting for unclaimed prizes was adopted to provide financial statement users an accurate accounting of realized amounts owed to the After School Programs Account. As a result of this change, in the year ended June 30, 2007, the TEL reclassified a $4,366,000 non-cash liability estimated as unclaimed prizes under the previous method of accounting to prizes payable on the Statement of Net Assets. There was no other impact to the TEL's net assets, nor did this change affect any component of the Statement of Revenues, Expenses and Changes in Net Assets.

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. 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.

Revenue is recognized for online games, with the exception of Million $ Madness, when tickets are sold to players and the related draw occurs. Revenue for Million $ Madness sales is recognized as tickets are sold by retailers.

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. At June 30, 2007, and 2006, the Allowance for Doubtful Accounts was $164 thousand and $423 thousand, respectively.

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, with the exception of Million $ Madness.

Fidelity Fund - In accordance with the Tennessee Code Annotated §§ 4-51-118 (a), TEL retailers are assessed a one-time fidelity fee of $50. 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. These funds may be used to cover losses incurred as a result of the nonfeasance, malfeasance, or misfeasance of TEL retailers. During the years ended June 30, 2007, and June 30, 2006, $261 thousand and none were respectively used to cover losses incurred as a result of uncollected accounts of TEL retailers.

At the end of each fiscal year, fidelity funds 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, 2007, and 2006, 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 years ended June 30, 2007, and 2006, no related bonuses were paid to any retailer for Powerball.

As of the year ended June 30, 2007, four (4) bonuses of $5,000, totaling $20,000, were paid to retailers selling the grand prize Million $ Madness tickets.

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 4,750 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. GTECH also receives an additional .6% of the selling price of Hottrax Champions tickets sold.

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 Cash 3, Cash 4, Lotto 5, and Hottrax Champions 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 years ended June 30, 2007, and June 30, 2006, there were no grand prize winners in Tennessee.

Gross prize expense for Million $ Madness is based on a predetermined prize structure based on the total value of all prizes available for the online game. As sold by retailers, gross prize expense is recognized for each ticket sold in an amount equal to the proportionate share of the total value of available prizes. As of the year ended June 30, 2007, gross prize expense for Million $ Madness was recognized in the amount of $4,150,000.

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.

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, 2007, and 2006, the TEL has not incurred, nor was it aware of 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*, with the exception of outdoor billboards advertising leases which are accordingly expensed in accordance with FASB 13 (Note 5), 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, property and automobile liability 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 years ended June 30, 2007, and June 30, 2006, additional insurance coverage was provided at the following maximum amounts:

Coverage	2007	2006
Employee fidelity	$ 500,000	$ 500,000
Automobile	2,000,000	1,000,000
Workers' compensation	1,000,000	1,000,000
Directors & officers/Employment practices liability	5,000,000	-
General liability	2,000,000	2,000,000
Umbrella	5,000,000	5,000,000

Over the past three fiscal years, in the ordinary course of business, the TEL has filed automobile and workers' compensation settlement claims with the commercial insurers. None of these claims exceeded the provided insurance coverage.

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)

(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, 2007, and 2006, TEL's bank balances of approximately $1.228 million and $1.342 million, 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 $62.1 million and $57.4 million at June 30, 2007, and 2006, 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 2007, the TEL purchased one (1) single premium, sum certain lifetime annuity contract for approximately $739,000, in its name from Aviva Life, and appointed the respective Win for Life prize winner as the beneficiary.

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 Metropolitan Life (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 to those financially rated "A" or better by a nationally recognized rating agency. Consistent with this policy, the annuities purchased from Met Life were rated A+ superior by A.M. Best as of June 30, 2007, and June 30, 2006. The annuity purchased from Aviva was rated A+ superior by A.M. Best as of June 30, 2007.

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 and Aviva are 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 years ended June 30, 2007, and June 30, 2006.

The TEL records all investments purchased to fund annuity prizes at fair value.

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.

Changes in the fair market value of the prize annuity investments are deferred as noncurrent prize annuities payable. As of the years ended June 30, 2007, and 2006, the TEL respectively deferred $195 thousand and $31 thousand increases in the fair market value of the prize annuity investments.

(4) CAPITAL ASSETS

Capital assets consisted of the following as of June 30, 2007:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	$ 873,000	$ 8,000	$	$ 881,000
Computer equipment	375,000	12,000		387,000
Vehicles	200,000			200,000
High mileage vehicles - vans	945,000	239,000	(83,000)	1,101,000
Leasehold improvements	307,000			307,000
Communication equipment	877,000	2,000		879,000
Software	259,000			259,000
Gaming equipment	189,000	5,000	(2,000)	192,000
Total capital assets	4,025,000	266,000	(85,000)	4,206,000
Less accumulated depreciation	(1,742,000)	(706,000)	70,000	(2,378,000)
Total capital assets, net	$ 2,283,000	$ (440,000)	$ (15,000)	$ 1,828,000

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 - Vans	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

(5) LEASING ARRANGEMENTS

The TEL’s leasing arrangements consist of non-cancelable operating leases for office space, outdoor advertising billboards, and related equipment that 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 years ended June 30, 2007, and 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:	**2007**	**2006**
2007	$ -	$ 2,024,000
2008	2,450,000	1,845,000
2009	2,083,000	1,737,000
2010	1,479,000	1,264,000
2011	1,179,000	1,178,000
2012	1,178,000	1,178,000
2013-2014	1,962,000	1,963,000
Total minimum rental payments	$ 10,331,000	$ 11,189,000

Minimum rental payments at June 30, 2007, and 2006, have not been reduced by minimum sublease rentals of $1.34 million and $1.53 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:	**2007**	**2006**
2007	$ -	$ 188,000
2008	188,000	188,000
2009	194,000	194,000
2010	206,000	206,000
2011	206,000	206,000
2012	206,000	206,000
2013-2014	343,000	344,000
Total minimum lease payments	$ 1,343,000	$ 1,532,000

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:

	2007	**2006**
Minimum rentals:		
Property	$ 1,358,000	$ 1,357,000
Billboards	1,264,000	1,162,000

Less: Sublease rentals	(188,000)	(188,000)
Total minimum rentals	$ 2,434,000	$ 2,331,000

(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, 2007, total deferred rent of $890,000 consisted of $419,000 related to rent abatements and $471,000 to the straight-lining of rental expense over the life of the related lease terms.

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.

(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, 2007, and June 30, 2006, is summarized as follows:

	2007	2006
Operating revenues:		
Ticket sales (Net)	$1,058,355,000	$995,845,000
Less instant tickets provided as prizes	(73,474,000)	(68,263,000)
Net ticket sales	984,881,000	927,582,000
Service fees and other revenue	4,270,000	3,438,000
Total lottery proceeds	989,151,000	931,020,000
Operating expenses, as defined:		
Gaming	704,528,000	648,045,000
Operating	14,749,000	15,109,000
Total operating expenses, as defined	719,277,000	663,154,000
Net proceeds before distribution of unrestricted net assets	269,874,000	267,866,000
Non-operating revenue and expenses		
Interest income	2,095,000	1,996,000
Total non-operating revenue and expenses	2,095,000	1,996,000
Net proceeds subject to transfer	$271,969,000	$269,862,000
Amount due to Lottery for Education Account for year	271,969,000	269,862,000
Amount paid during year	(205,760,000)	(207,389,000)
Amount due to Lottery for Education Account, end of year	$66,209,000	$62,473,000

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 PROGRAMS ACCOUNT

During fiscal year 2007, the TEL implemented a change in accounting principle (Note 1) resulting in the recording of realized unclaimed prizes for each instant game at the time the game is closed and reconciled. For online games, the realized unclaimed amounts are determined after the expiration of the related claim period draw.

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 2007, realized unclaimed prizes were $12,310,000, of which $10,436,000 was current and payable to the After School Programs special account at June 30, 2007.

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.

At June 30, 2007, the deferred portion of unclaimed prizes was zero.

The deferred portion of unclaimed prizes was $9,265,000 at June 30, 2006.

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, 2007, and 2006, employees contributed approximately $412,000 and $390,000, respectively to the 457 Plan.

The aggregate fair value of the plan's assets was approximately $1,691,000 and $1,151,000, net of forfeitures and administrative fees, as of June 30, 2007, and 2006, 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 $626,000 and $611,000 to the 401(a) Plan on behalf of its employees in the years ended June 30, 2007, and 2006, respectively. Of these contributions, approximately $76,000 and $57,000 were forfeited by separated employees as of June 30, 2007, and June 30, 2006, 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, 2007, and 2006, forfeited amounts of approximately $76,000 and $61,000, 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 plan's assets was approximately $2,224,000 and $1,453,000, net of forfeitures and administrative fees, as of June 30, 2007, and 2006, 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 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, 2007, is estimated using historical trends. At June 30, 2007, and 2006, the estimated current portion of the compensated absences liability was $253 thousand and $172 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 forty hours of severance pay for every year of employment with TEL. The TEL accrued $109 thousand and $69 thousand for employment separation obligations for each of the years ending June 30, 2007, and 2006, respectively.

(10) LONG-TERM LIABILITIES

Long-term liabilities consisted of the following as of June 30, 2007:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Due to After School Program Account	$ 14,783,000	$ 3,044,000	$(7,391,000)	$10,436,000	$ 10,436,000
Prize annuities payable	2,573,000	196,000	(208,000)	2,561,000	104,000
Compensated absences	400,000	372,000	(374,000)	398,000	253,000
Deferred rent	951,000	7,000	(68,000)	890,000	68,000
Total long-term liabilities	$ 18,707,000	$ 3,619,000	$(8,041,000)	$14,285,000	$ 10,861,000

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 Program Account	$ 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

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

(11) COMMITMENTS AND CONTINGENCIES

Hold 'Em Poker Second Chance Drawings – The TEL has committed to conducting a second chance drawing whereby a $100,000 grand prize will be awarded to one player. The TEL anticipates completion of this drawing to occur during the fiscal year ending June 30, 2008.

Deal or No Deal Second Chance Drawings – The TEL has committed to conducting second chance drawings whereby cash prizes totaling $115,000, will be awarded to players. The TEL anticipates completion of these drawings to occur during the fiscal year ending June 30, 2008.

Play-It-Again! Drawings – During the fiscal year ended June 30, 2007, the TEL launched its *Play-It-Again!* program designed to reduce instant ticket litter throughout the state of Tennessee. In connection with this program, each fiscal year the TEL plans to conduct a series of second-chance drawings awarding various prizes to players.

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

On July 9, 2007, the TEL conducted its first *Play-It-Again!* second chance drawing awarding a total of $40,000 to twelve players.