

AUDIT REPORT

Tennessee Education Lottery Corporation

For the Year Ended
June 30, 2012



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

Department of Audit
Division of State Audit



Deborah V. Loveless, CPA
Director

Edward Burr, CPA
Assistant Director

Aaron Jewell, CPA, CFE
Audit Manager

Randy Salt
In-Charge Auditor

Amy Brown
Staff Auditor

Gerry C. Boaz, CPA
Technical Manager

Amy Brack
Editor

Comptroller of the Treasury, Division of State Audit
1500 James K. Polk Building, Nashville, TN 37243-1402
(615) 401-7897

Financial/compliance audits of state departments and agencies are available online at
www.comptroller.tn.gov/sa/AuditReportCategories.asp.
For more information about the Comptroller of the Treasury, please visit our website at
www.comptroller.tn.gov.



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7897
FAX (615) 532-2765

January 17, 2013

The Honorable Bill Haslam, 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, 2012. 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,

Deborah V. Loveless, CPA
Director

DVL/rs
13/011

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, 2012

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, 2012

TABLE OF CONTENTS

	<u>Exhibit</u>	<u>Page</u>
INTRODUCTION		1
Post-Audit Authority		1
Background		1
Organization		1
AUDIT SCOPE		3
OBJECTIVES OF THE AUDIT		3
PRIOR AUDIT FINDINGS		5
OBSERVATIONS AND COMMENTS		5
Management's Responsibility for Risk Assessment		5
Fraud Considerations		5
RESULTS OF THE AUDIT		6
Audit Conclusions		6
Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i>		7
FINANCIAL SECTION		
Independent Auditor's Report		10
Management's Discussion and Analysis		12

TABLE OF CONTENTS (CONT.)

	<u>Exhibit</u>	<u>Page</u>
Basic Financial Statements		
Statements of Net Assets	A	24
Statements of Revenues, Expenses, and Changes in Net Assets	B	25
Statements of Cash Flows	C	26
Notes to the Financial Statements		28

Tennessee Education Lottery Corporation For the Year Ended June 30, 2012

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 to 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, 2012, TEL had launched a total of 337 instant ticket games and 9 online games: Cash 3, Cash 4, Tennessee Cash, Pick 5, Lotto Plus, Hottrax Champions, Million \$ Madness, Powerball, and MegaMillions. 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 payments of an amount representing net lottery proceeds of the immediately preceding quarter to the state treasury for credit to the “lottery for education account.” State law also requires TEL to pay 100% of moneys constituting unclaimed prizes to the state treasury to be deposited in the “after school programs account” at the end of each fiscal year.

ORGANIZATION

The Tennessee Education Lottery Corporation is organized into four major 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 a broad vision for the corporation and ensuring that strategies to achieve all corporate objectives are implemented. The division is also responsible for

- advertising strategy;
- communications, including player services, media, and public relations;
- legislative affairs;
- corporate services; and
- internal controls.

The Legal Division includes

- Human Resources—manages all personnel functions;
- Legal Services—provides legal advice and assistance to management and the board of directors, serves as the corporate record keeper, oversees litigation, and manages contract compliance;
- Security—responsible for physical and intellectual property security; and
- Retailer Contract Administration—manages all functions of retailer applications and contracts.

The Sales and Marketing Division oversees all aspects of Lottery sales operations, including

- Sales and Marketing—manages all sales activity and field marketing;
- Retailer Sales and Services—provides all facets of customer service for retailer network;
- Corporate Accounts—manages corporate office relationships;
- Promotions and Special Events—promotes the TEL at a variety of functions throughout the state;
- Warehouse Management and Distribution; and
- District Offices—manages the TEL’s four district offices.

The Division of Finance and Information Systems is responsible for the following:

- financial, product, and customer accounting;
- prize validation and statutory and financial reporting;
- cash management, budgeting, accounts receivable, and procurement;
- game drawings, including online and second-chance instant games and drawing activities;

- gaming systems and operations 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

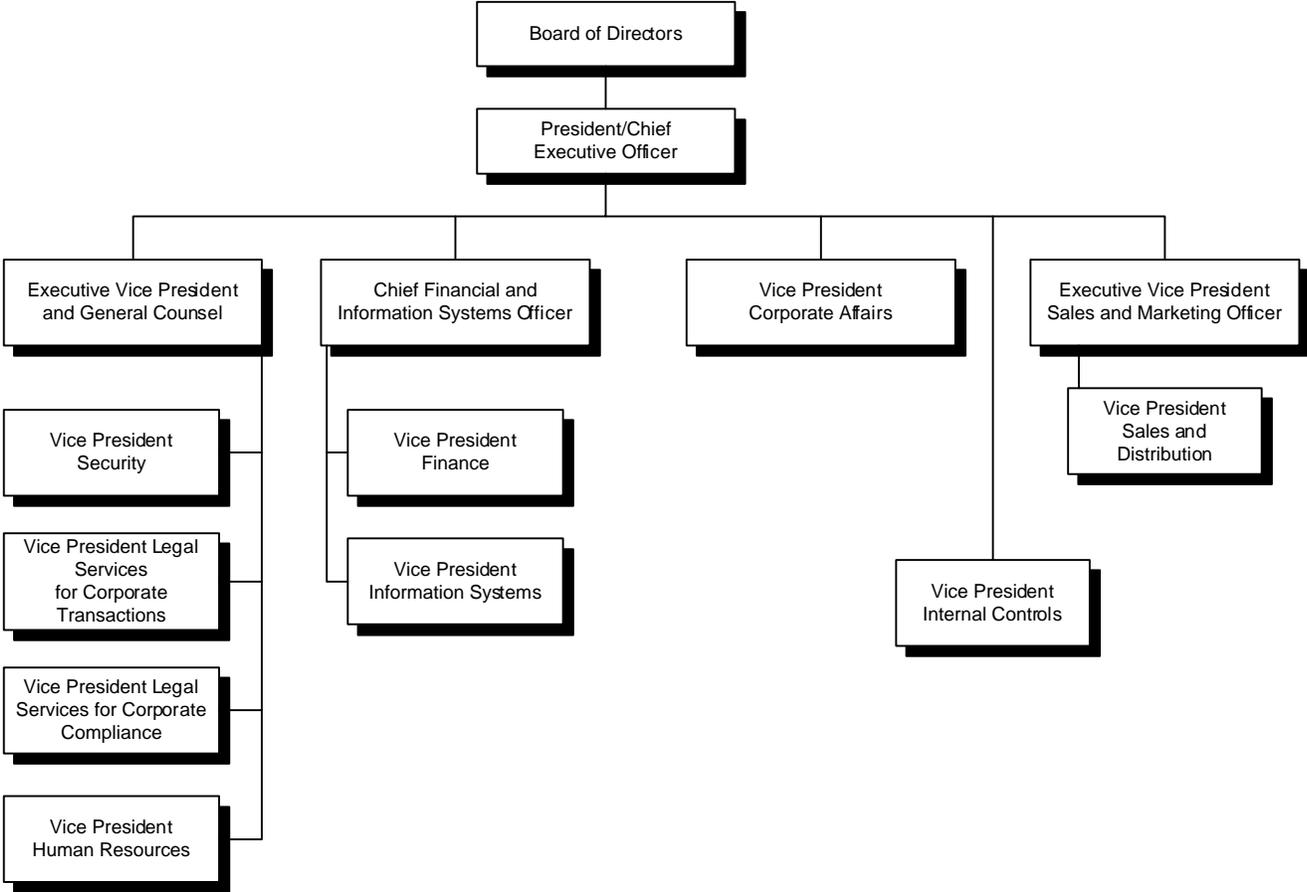
The audit was limited to the period July 1, 2011, through June 30, 2012, and was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in generally accepted government auditing standards. Financial statements are presented for the year ended June 30, 2012, and for comparative purposes, the year ended June 30, 2011. 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 as a basis for designing 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.

Tennessee Education Lottery Corporation Organization Chart



PRIOR AUDIT FINDINGS

There were no findings in the prior audit report.

OBSERVATIONS AND COMMENTS

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.

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, 2012, 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 generally accepted government auditing standards. 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 generally accepted 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 37243-1402
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***

November 26, 2012

The Honorable Bill Haslam, 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:

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, 2012, and have issued our report thereon dated November 26, 2012. 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 generally accepted government auditing standards.

Internal Control Over Financial Reporting

Management of the Tennessee Education Lottery Corporation is responsible for establishing and maintaining effective 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 deficiency in internal control 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 and correct misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control over financial reporting that might be deficiencies, 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 its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under generally accepted government auditing standards.

We noted a certain matter that we reported to management of the corporation in a separate letter.

November 26, 2012
Page Three

This report is intended solely for the information and use of the General Assembly of the State of Tennessee, management, the board of directors, and others within the entity 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,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA
Director

AAH/rs



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF STATE AUDIT
SUITE 1500
JAMES K. POLK STATE OFFICE BUILDING
NASHVILLE, TENNESSEE 37243-1402
PHONE (615) 401-7897
FAX (615) 532-2765

Independent Auditor's Report

November 26, 2012

The Honorable Bill Haslam, 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:

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, 2012, and June 30, 2011, 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 generally accepted government auditing standards. 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 the 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, 2012, and June 30, 2011, 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.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 12 through 23 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during the audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

In accordance with generally accepted government auditing standards, we have also issued our report dated November 26, 2012, 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, and contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with generally accepted government auditing standards and should be considered in assessing the results of our audit.

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr." with a stylized flourish at the end.

Arthur A. Hayes, Jr., CPA
Director

AAH/rs

TENNESSEE EDUCATION LOTTERY CORPORATION MANAGEMENT'S DISCUSSION AND ANALYSIS

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, 2012, and June 30, 2011, with comparative information presented for the fiscal year ended June 30, 2010. The overview should be considered in conjunction with the independent auditor’s report, the accompanying audited financial statements, and notes to the 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, 2012, and June 30, 2011.
- **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, 2012, and June 30, 2011.
- **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, 2012, and June 30, 2011.

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

The TEL’s primary business purpose is to generate revenues to fund college scholarships for residential Tennessee students attending higher educational institutions within the state. Accordingly, the main focus of the financial statements is determining funds available for payment to the State of Tennessee’s Lottery for Education Account. Furthermore, in addition to funding this account, the TEL’s unclaimed prize funds are deposited to the After-School Programs special account, which benefits after-school programs throughout the State of Tennessee.

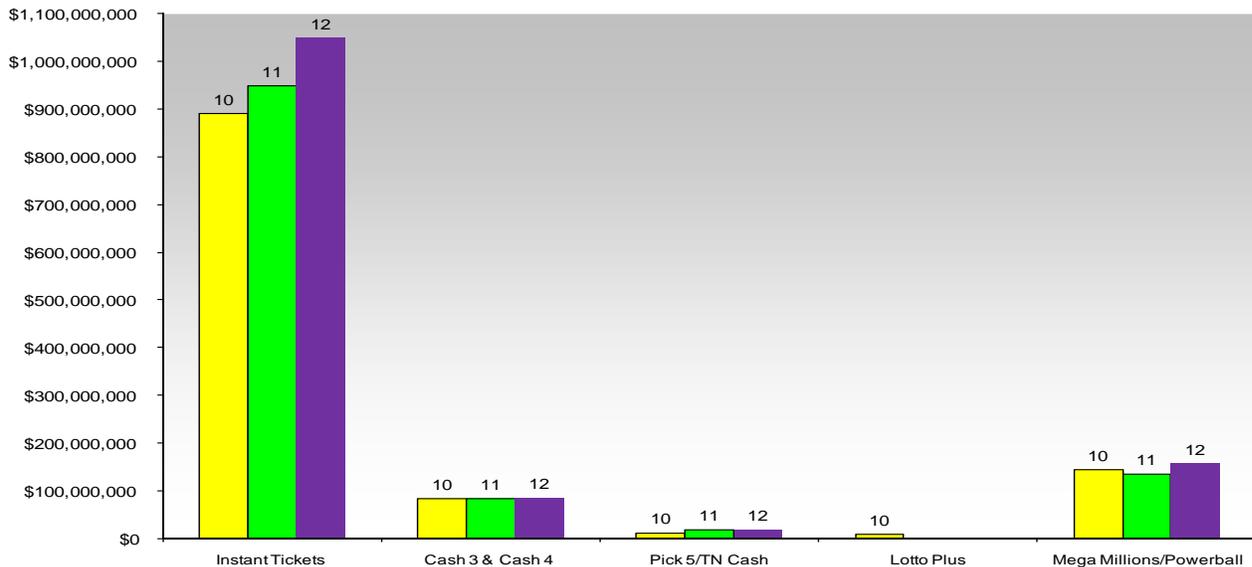
TENNESSEE EDUCATION LOTTERY CORPORATION MANAGEMENT’S DISCUSSION AND ANALYSIS (CONT.)

Fiscal Year 2012 Financial Highlights

The Tennessee Education Lottery set new records for fiscal year ended June 30, 2012. Showing impressive gains, the TEL produced more than \$323.4 million for education in the state of Tennessee for the fiscal year ended June 30, 2012. This was an increase of 10.2% over the prior year’s record-setting return of \$293.5 million for fiscal year ended June 30, 2011.

Driving the increase in education funds transferred was another record-setting achievement of over \$1.31 billion in total gross sales. This marked an impressive \$124.6 million (10.5%) increase over the previous fiscal year revenues of \$1.18 billion, not to mention the sixth straight year that the TEL has reached gross sales of over \$1 billion. Total education funding since ticket sales began in January 2004 now stands at more than \$2.39 billion, with total sales surpassing \$9.1 billion.

**Tennessee Education Lottery Gross Ticket Revenues
Fiscal Year 2012 Comparison to 2011 and 2010**



As in recent prior years, upward movement in instant ticket sales was the primary factor fueling our sales growth. Management attributes this to the effectiveness of its instant ticket marketing strategy that emphasizes offering more, as well as a broad spectrum of, games and prizes to lottery players. Accordingly, the TEL launched 43 new instant ticket games at varying price points that were met with great favor by the players during fiscal year 2012. As added variety to its traditionally themed games, the TEL also introduced several licensed property games: *Uno* (\$5), *Wheel of Fortune* (\$5), and *Camaro* (\$5). TEL also introduced *\$1,000,000 Casino* (\$20) in addition to the spotlight game *\$3,000,000 Mega Cash* (\$20), giving players more choices at the

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT’S DISCUSSION AND ANALYSIS (CONT.)**

\$20 price point. In September 2011, the TEL added *Jumbo Jumbo Bucks (\$10)* to the popular “Jumbo Bucks” family of instant ticket games, which continued to be extremely popular in fiscal year 2012. In fiscal year 2012, TEL expanded its offering in the extended-play games with *Tennessee Slingo (\$3)* and *\$100,000 Crossword (\$5)*.

Other innovations in fiscal year 2012 included the TEL’s launch of “*VIP Rewards*,” a popular program allowing lottery players to earn points for non-winning instant tickets and then redeem these points for a wide range of merchandise in the “VIP Store.” This program enhanced the benefits currently offered in our popular *Play It Again* second-chance program.

Cash 3 sales in fiscal year 2012 remained relatively consistent with those of fiscal year 2011.

Cash 4 sales increased by 8.4%, largely in part due to higher payouts during fiscal year 2012.

Sales for *Tennessee Cash* increased \$3.2 million year-over-year as a result of a full year of sales. *Tennessee Cash* is TEL’s in-state, cash jackpot, drawing-style game. The sales for this game are driven by the size of the jackpot. In fiscal year 2012, TEL experienced ten jackpots in excess of \$300,000 compared to seven during the prior years for this game.

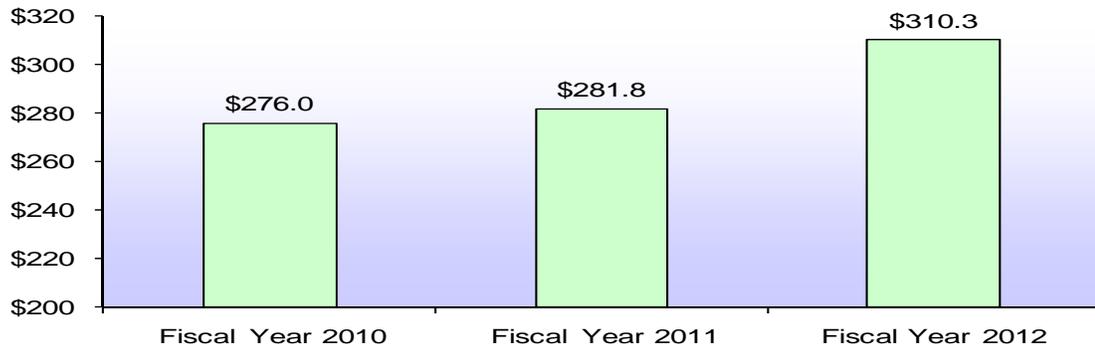
In January 2010, the TEL introduced to the market an additional multijurisdictional jackpot game, *Mega Millions*. In March of fiscal year 2012, *Mega Millions* experienced a world record jackpot of \$656 million, which significantly contributed to the 19% sales increase for this game in fiscal year 2012. Sales for *Mega Millions* in fiscal year 2012 were \$53.9 million compared to \$45.3 million the prior year.

In January 2012, *Powerball* was relaunched at the \$2 price point. Along with the price point change, three *Powerball* jackpots exceeding \$225 million plus one exceeding \$336 million contributed to the 13.6% increase in *Powerball* sales in fiscal year 2012. *Powerball* sales were \$102.8 million in fiscal year 2012 compared to \$90.4 million in fiscal year 2011.

The TEL generated \$310.3 million for the Lottery for Education Account in fiscal year 2012, compared to \$281.8 million in fiscal year 2011 and \$276.0 million in fiscal year 2010.

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT’S DISCUSSION AND ANALYSIS (CONT.)**

**Tennessee Education Lottery
Proceeds for the Lottery for Education Account
(in Millions)**



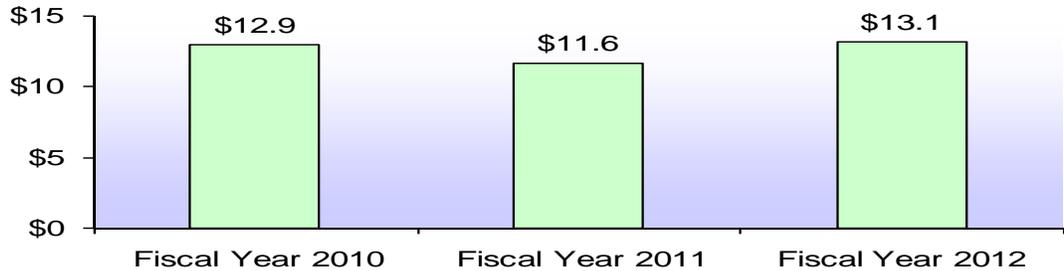
The amounts deposited to the After-School Programs special account are derived from unclaimed instant and drawing-style game prizes at fiscal year end. Prizes not claimed within 90 days of the announced game-end date for instant games, and within 180 days for all drawing-style games, are forfeited as unclaimed prizes.

The TEL records estimated unclaimed prizes for each instant game within the month the game is closed and reconciles the actual amounts when the claim period ends. For drawing-style games, the TEL records the actual unclaimed amounts determined after the expiration of the related claim period for the draw.

In fiscal year 2012, the TEL recognized \$13.1 million for the After-School Programs special account as compared to \$11.6 million in fiscal year 2011 and \$12.9 million in fiscal year 2010. The increase in fiscal year 2012 After-School Programs special account resulted primarily from three large unclaimed jackpot prizes, two in *Tennessee Cash* and one in *Powerball*.

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONT.)**

**Tennessee Education Lottery
Proceeds for the After School Programs Special Account
(in Millions)**



Condensed Statement of Net Assets

	June 30, 2012	Increase/ (Decrease)	June 30, 2011	Increase/ (Decrease)	June 30, 2010
Assets:					
<i>Current assets</i>					
Cash	\$ 72,227,000	\$ 5,813,000	\$ 66,414,000	\$ (1,908,000)	\$ 68,322,000
Retailer accounts Receivable, net	60,046,000	6,536,000	53,510,000	5,804,000	47,706,000
Other	7,752,000	744,000	7,008,000	521,000	6,487,000
Total current assets	140,025,000	13,093,000	126,932,000	4,417,000	122,515,000
<i>Non-current assets</i>					
Other	2,904,000	559,000	2,345,000	48,000	2,297,000
Capital assets, net	1,101,000	81,000	1,020,000	(339,000)	1,359,000
Total non-current assets	4,005,000	640,000	3,365,000	(291,000)	3,656,000
Total assets	144,030,000	13,733,000	130,297,000	4,126,000	126,171,000
Liabilities:					
<i>Current liabilities</i>					
Due to Lottery for Education Account	76,350,000	6,069,000	70,281,000	(1,385,000)	71,666,000
Due to After School Program Account	13,089,000	1,445,000	11,644,000	(1,250,000)	12,894,000
Prizes Payable	45,759,000	4,862,000	40,897,000	6,595,000	34,302,000
Accounts payable and accrued liabilities	5,009,000	1,377,000	3,632,000	(27,000)	3,659,000
Deferred liabilities	720,000	(272,000)	992,000	226,000	766,000
Total current liabilities	140,927,000	13,481,000	127,446,000	4,159,000	123,287,000
<i>Non-current liabilities</i>					
Non-current portion of other liabilities	3,090,000	240,000	2,850,000	(27,000)	2,877,000
Total non-current liabilities	3,090,000	240,000	2,850,000	(27,000)	2,877,000
Total liabilities	144,017,000	13,721,000	130,296,000	4,132,000	126,164,000
Net Assets:					
Investment in capital assets	1,101,000	81,000	1,020,000	(339,000)	1,359,000
Unrestricted assets	(1,101,000)	(81,000)	(1,020,000)	339,000	(1,359,000)
Restricted assets	13,000	12,000	1,000	(6,000)	7,000
Total net assets	\$ 13,000	\$ 12,000	\$ 1,000	\$ (6,000)	\$ 7,000

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONT.)**

Overview of Financial Position

Assets

The \$13.7 million increase in total assets at June 30, 2012, and \$4.13 million increase in total assets at June 30, 2011, were primarily due to the noted increase in lottery ticket sales for the related fiscal years resulting in increased cash and the subsequent timing of collection of the relevant Retailer Accounts Receivable balances.

Liabilities

The \$13.7 million increase in total liabilities at June 30, 2012, relates primarily to increased fiscal year 2012 ticket sales, resulting in higher net proceeds payable to the Lottery for Education Account and more prizes payable to players.

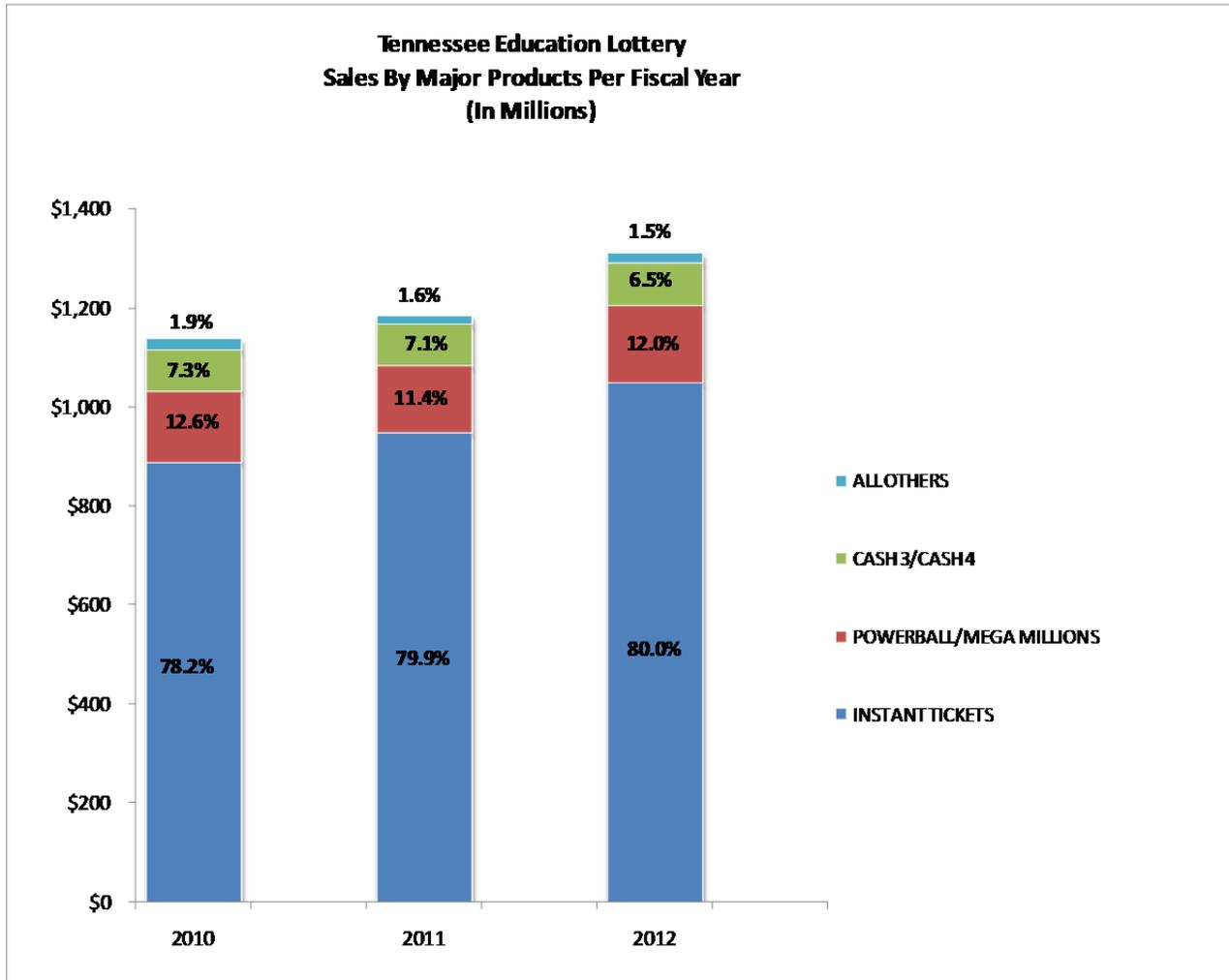
The \$4.13 million increase in total liabilities at June 30, 2011, related primarily to increased fiscal year 2011 ticket sales and more prizes payable to players.

	<i>Condensed Statement of Revenues and Expenses</i>				
	June 30, 2012	Increase/ (Decrease)	June 30, 2011	Increase/ (Decrease)	June 30, 2010
<i>Revenue:</i>					
Instant games	\$ 1,049,604,000	\$ 100,894,000	\$ 948,710,000	\$ 58,437,000	\$ 890,273,000
Online games	261,600,000	23,753,000	237,847,000	(10,270,000)	248,117,000
Less instant/promotional tickets provided as prizes	(94,350,000)	(10,372,000)	(83,978,000)	(6,068,000)	(77,910,000)
Games revenue, net	1,216,854,000	114,275,000	1,102,579,000	42,099,000	1,060,480,000
Bad debt recoveries/(expense), net	(999,000)	(760,000)	(239,000)	135,000	(374,000)
Retailer service fees	3,197,000	(199,000)	3,396,000	(14,000)	3,410,000
Interest income	68,000	(42,000)	110,000	(101,000)	211,000
Other revenue	1,505,000	866,000	639,000	143,000	496,000
Total revenues	1,220,625,000	114,140,000	1,106,485,000	42,262,000	1,064,223,000
<i>Expenses:</i>					
Cost of sales	880,922,000	83,432,000	797,490,000	36,951,000	760,539,000
General, administrative and other operating expenses	16,217,000	756,000	15,461,000	695,000	14,766,000
Other expenses	36,000	(14,000)	50,000	12,000	38,000
Proceeds to After-School Program Account	13,089,000	1,445,000	11,644,000	(1,250,000)	12,894,000
Proceeds to Lottery for Education Account	310,349,000	28,503,000	281,846,000	5,867,000	275,979,000
Total expenses	1,220,613,000	114,122,000	1,106,491,000	42,275,000	1,064,216,000
Change in net assets	12,000	18,000	(6,000)	(13,000)	7,000
Total net assets, beginning of year	1,000	(6,000)	7,000	7,000	-
Total net assets, end of year	\$ 13,000	\$ 12,000	\$ 1,000	\$ (6,000)	\$ 7,000

Revenues

Gross lottery ticket sales for the fiscal years ended June 30, 2012, 2011, and 2010, were \$1.311 billion, \$1.187 billion, and \$1.138 billion, respectively. The following chart depicts the distribution of sales by product for the three fiscal years ended June 30:

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT’S DISCUSSION AND ANALYSIS (CONT.)**



Gross instant ticket sales for fiscal year 2012 were \$1.049 billion, which represents a 10.6% increase over fiscal year 2011’s instant ticket sales of \$948.7 million, which represented a 6.6% increase over 2010 instant ticket sales of \$890.3 million. Instant tickets represent approximately 80% of total gross sales in fiscal years 2012 and 2011, and approximately 78% in 2010. 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, and higher price point games with higher prize payouts. The games most popular with the players in 2012 were the six games within the “*Jumbo Bucks*” family of games, followed by \$3,000,000 *Mega Cash*.

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONT.)**

Powerball sales for the fiscal years 2012, 2011, and 2010 were \$102.8 million, \$90.4 million, and \$127.9 million, respectively. These amounts represent approximately 8%, 8%, and 11% of gross ticket sales, respectively, for each fiscal year.

Powerball is a multi-jurisdictional drawing-style lottery game operated in the following jurisdictions in addition to Tennessee: Arizona, Arkansas, Colorado, Connecticut, Delaware, District of Columbia, Florida, Idaho, Iowa, Indiana, Kansas, Kentucky, Louisiana, Maine, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, US Virgin Islands, Vermont, Wisconsin, and West Virginia. Starting on January 31, 2010, ten states in the *Mega Millions* lottery consortium group began selling Powerball tickets as part of a cross-sell agreement with MUSL members. Those states were Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Texas, Virginia, and Washington. On April 16, 2010, Ohio, also a member of the Mega Millions consortium, started cross-selling Powerball as well.

Mega Millions is a multi-jurisdictional drawing-style lottery game administered by a lottery consortium group. The group includes the following state lotteries: California, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, and Washington. Tennessee and certain other MUSL lottery members are authorized to sell the *Mega Millions* game by the consortium as part of a cross-sell agreement. Tennessee began sales for the game in January 2010. Sales for fiscal years 2012, 2011, and 2010 were \$53.9 million, \$45.3 million, and \$15.9 million, respectively.

Cash 3 sales for fiscal years 2012, 2011, and 2010, were \$57.9 million, \$58.1 million, and \$57.2 million, respectively. These amounts represent approximately 5% of gross ticket sales, respectively, for each of the noted fiscal years.

Cash 4 sales were \$27.7 million, \$25.5 million, and \$25.6 million, in the years 2012, 2011, and 2010, respectively. These amounts represent approximately 2% of gross ticket sales for each of the noted fiscal years.

Tennessee Cash, a drawing-style, jackpot driven game, was introduced on October 3, 2010. Ticket sales for 2012 were \$19.2 million and for 2011, were \$16.0 million.

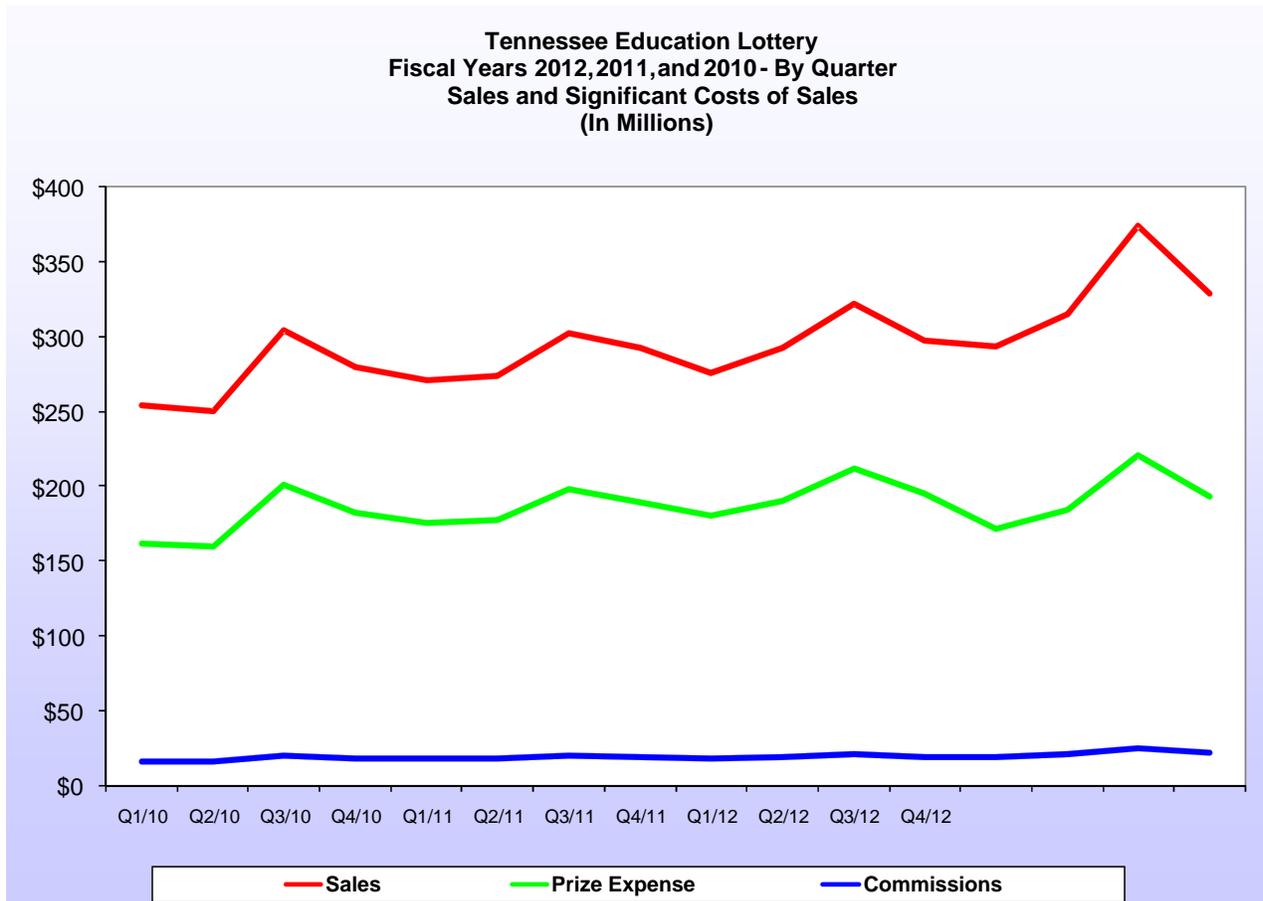
Pick 5 sales were \$2.5 million in fiscal year 2011. The game was ended in October 2010.

Lotto Plus, a TEL drawing-style game, was ended in January 2010, due to the declining profitability and the conflicting draw schedule with Mega Millions. Sales were \$9.5 million in fiscal year 2010.

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT’S DISCUSSION AND ANALYSIS (CONT.)**

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 \$770.6 million, \$695.1 million, and \$664.0 million in the years 2012, 2011, and 2010, respectively. Increases of \$75.5 million in 2012 and \$31.1 million in 2011 reflect the increases in overall ticket sales realized in the related 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

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONT.)**

for all instant games was 67.0 %, 66.6%, and 66.4% of instant game sales, net of free tickets for 2012, 2011, and 2010, respectively.

Gross prize expense for drawing-style 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. The aggregated prize payout for all drawing-style games was 50.3%, 50.2%, and 50.1%, for 2012, 2011, and 2010, respectively.

Retailer commissions were \$85.5 million, \$77.5 million, and \$74.3 million, for the years ended June 30, 2012, 2011, and 2010, respectively. Consistent with the cost driver relationship of ticket sales to retailer commissions, the increases of \$8.0 million in 2012 and \$3.2 million in 2011 reflect the increases in overall ticket sales realized in the related period.

Retailers are compensated a set commission percentage of 6.5% on all instant tickets settled and drawing-style tickets sold. They also receive an additional 1% bonus for cashing *Cash 3* and *Cash 4* ticket prizes. Additionally, the TEL will pay a bonus of \$25,000 to a retailer who sells a single jackpot winning ticket for *Powerball* or *Mega Millions*; however, if there are multiple winning *Powerball* or *Mega Millions* jackpot winning tickets sold in Tennessee in a single drawing, the \$25,000 selling bonus will be proportionately divided among the respective retailers based on the number of winning tickets sold by the retailer. The TEL will also pay a \$5,000 bonus to retailers selling any drawing-style game ticket where the prize won is equal to or greater than \$1 million. No *Powerball* or *Mega Millions* jackpot ticket selling bonuses were paid during the last three fiscal years. Drawing-style game ticket selling bonuses equaling \$15,000, \$50,000, and \$60,000 were awarded for fiscal years 2012, 2011, and 2010, respectively.

Contractor fees for fiscal years 2012, 2011, and 2010 were \$26.3 million, \$23.8 million, and \$22.6 million, respectively. The TEL has retained two contractors, one for the operation of its gaming systems and network; and one for the manufacturing, warehousing, and distribution of its instant ticket games. As compensation, the instant ticket vendor receives 1.07% of the selling price of all instant ticket activations, whereas the gaming systems and network vendor receives 1.24% of the selling price of drawing-style gaming tickets sold, and on instant ticket activations net of free instant tickets available as prizes.

Advertising costs incurred by the TEL were \$8.3 million, \$9.4 million, and \$9.4 million, for the fiscal years 2012, 2011, and 2010, respectively. These costs are significantly influenced by budget directives and constraints. On a continuous basis, management strives to achieve an optimal balance between these costs and obtained benefits while keeping the costs relatively consistent with prior-year amounts. The decrease in fiscal year 2012 is directly attributable to the execution and timing of contracts during the latter part of the fiscal year.

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONT.)**

General, Administrative, and Other Operating Expenses

General, administrative, and other operating expenses were \$16.2 million, \$15.5 million, and \$14.8 million for the fiscal years 2012, 2011, and 2010, respectively. For each of these years, the five major expense components were depreciation, personnel, professional fees, property, and telecommunications expenses. These expenses do not change in direct proportion with revenues, but are instead significantly influenced by budget directives and constraints, and current business and economic conditions. In view of these factors, moderate variances in these expenses are expected to occur over fiscal periods. Nevertheless, to the most reasonable extent possible, TEL's management team works diligently to control these expenses to be relatively consistent year-over-year.

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 economic environment and the TEL's own product lines and operations is 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 and/or enhanced instant and drawing-style game product offerings, as well as explore the expansion of our licensed property games that are gaining nationwide popularity.
- The TEL will continually review the prize payout percentages for its instant game products to ensure we are receiving the highest actual net proceeds for each game and/or price point category.
- The TEL will continue to enhance its promotional offerings and player affinity programs to improve brand awareness and increase player participation in our games.

**TENNESSEE EDUCATION LOTTERY CORPORATION
MANAGEMENT'S DISCUSSION AND ANALYSIS (CONT.)**

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

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF NET ASSETS
AS OF JUNE 30, 2012, AND JUNE 30, 2011

	<u>June 30, 2012</u>	<u>June 30, 2011</u>
ASSETS		
CURRENT ASSETS:		
Cash (Note 2)	\$ 72,214,000	\$ 66,413,000
Restricted fidelity fund cash	13,000	1,000
Retailer accounts receivable, net	60,046,000	53,510,000
Prepaid expenses and other assets	7,608,000	6,904,000
Prize annuity investments (Note 3)	<u>144,000</u>	<u>104,000</u>
Total current assets	<u>140,025,000</u>	<u>126,932,000</u>
NONCURRENT ASSETS:		
Prepaid expenses and other assets	15,000	35,000
Prize annuity investments (Note 3)	2,889,000	2,310,000
Capital assets, net of depreciation of \$4,356,000 and \$4,149,000 (Note 4)	<u>1,101,000</u>	<u>1,020,000</u>
Total noncurrent assets	<u>4,005,000</u>	<u>3,365,000</u>
TOTAL ASSETS	<u>144,030,000</u>	<u>130,297,000</u>
LIABILITIES		
CURRENT LIABILITIES		
Due to Lottery for Education Account (Note 7)	76,350,000	70,281,000
Due to After-School Programs Account (Note 8)	13,089,000	11,644,000
Prizes payable	45,615,000	40,793,000
Accounts payable	480,000	173,000
Prize annuities payable (Notes 3 and 10)	144,000	104,000
Accrued liabilities (Note 10)	4,529,000	3,459,000
Deferred rent (Notes 6 and 10)	61,000	61,000
Deferred revenue	<u>659,000</u>	<u>931,000</u>
Total current liabilities	<u>140,927,000</u>	<u>127,446,000</u>
NONCURRENT LIABILITIES:		
Prize annuities payable (Notes 3 and 10)	2,889,000	2,310,000
Accrued liabilities (Note 10)	-	181,000
Deferred rent (Notes 6 and 10)	<u>201,000</u>	<u>359,000</u>
Total noncurrent liabilities	<u>3,090,000</u>	<u>2,850,000</u>
TOTAL LIABILITIES	<u>144,017,000</u>	<u>130,296,000</u>
NET ASSETS		
Investment in capital assets	1,101,000	1,020,000
Unrestricted assets:		
Capital assets	(1,101,000)	(1,020,000)
Restricted assets:		
Restricted for uncollectible retailer receivables	<u>13,000</u>	<u>1,000</u>
TOTAL NET ASSETS	<u>\$ 13,000</u>	<u>\$ 1,000</u>

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

	<u>Year Ended June 30, 2012</u>	<u>Year Ended June 30, 2011</u>
OPERATING REVENUES:		
Ticket sales, net	\$ 1,310,205,000	\$ 1,186,318,000
Less instant/promotional tickets provided as prizes	(94,350,000)	(83,978,000)
Net ticket sales	1,215,855,000	1,102,340,000
Retailer service fees	3,197,000	3,396,000
Other	1,457,000	594,000
Net operating revenues	<u>1,220,509,000</u>	<u>1,106,330,000</u>
OPERATING EXPENSES:		
Available prizes	770,568,000	695,149,000
Current year actual unclaimed prizes (Note 8)	(13,089,000)	(11,644,000)
Net prizes	757,479,000	683,505,000
Retailer commissions and bonuses	85,526,000	77,457,000
Contractor fees	26,280,000	23,794,000
Advertising	8,289,000	9,393,000
Salaries and benefits	12,682,000	11,755,000
Retailer merchandising and marketing	3,348,000	3,341,000
Rent, utilities, and maintenance	1,712,000	1,659,000
Depreciation	495,000	740,000
Professional fees	286,000	346,000
General administrative and other operating	1,042,000	961,000
Total operating expenses	<u>897,139,000</u>	<u>812,951,000</u>
Operating income	<u>323,370,000</u>	<u>293,379,000</u>
NONOPERATING REVENUES (EXPENSES):		
Interest revenue	68,000	110,000
Retailer fees for future uncollectible retailer receivables	48,000	45,000
Fidelity fund retailer non-feasance recoupments (Note 1)	(36,000)	(50,000)
Proceeds to After-School Programs Account (Note 8)	(13,089,000)	(11,644,000)
Proceeds to Lottery for Education Account (Note 7)	(310,349,000)	(281,846,000)
Total nonoperating revenues (expenses)	<u>(323,358,000)</u>	<u>(293,385,000)</u>
Change in net assets	12,000	(6,000)
NET ASSETS, beginning of year	<u>1,000</u>	<u>7,000</u>
NET ASSETS, end of year	<u>\$ 13,000</u>	<u>\$ 1,000</u>

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

	Year Ended June 30, 2012	Year Ended June 30, 2011
OPERATING ACTIVITIES:		
Cash received from customers	\$ 1,209,093,000	\$ 1,096,798,000
Other operating cash received	4,578,000	3,934,000
Cash paid for prizes	(752,440,000)	(677,295,000)
Cash paid to/on behalf of gaming vendors	(26,213,000)	(23,701,000)
Cash paid to retailers	(85,513,000)	(77,467,000)
Cash paid for advertising	(8,164,000)	(9,938,000)
Cash paid to/on behalf of employees	(12,481,000)	(11,563,000)
Other operating payments	(6,325,000)	(6,285,000)
Net cash provided by operating activities	<u>322,535,000</u>	<u>294,483,000</u>
NONCAPITAL FINANCING ACTIVITIES:		
Payments to Lottery for Education Account	(304,280,000)	(283,231,000)
Payments to After-School Programs Account	(11,644,000)	(12,894,000)
Fidelity fund cash received from retailers	57,000	50,000
Fidelity fund cash refunded to retailers	(9,000)	(6,000)
Fidelity fund cash non-feasance recoupments	(36,000)	(50,000)
Net cash used in noncapital financing activities	<u>(315,912,000)</u>	<u>(296,131,000)</u>
CAPITAL AND RELATED FINANCING ACTIVITIES:		
Purchase of property and equipment	(295,000)	(409,000)
Proceeds from disposal of capital assets	51,000	39,000
Net cash used in capital and related financing activities	<u>(244,000)</u>	<u>(370,000)</u>
INVESTING ACTIVITIES:		
Purchase of prize annuity	(634,000)	-
Interest income	68,000	110,000
Net cash provided by investing activities	<u>(566,000)</u>	<u>110,000</u>
NET CASH PROVIDED/(USED) BY ALL ACTIVITIES	<u>5,813,000</u>	<u>(1,908,000)</u>
CASH at beginning of year	<u>66,414,000</u>	<u>68,322,000</u>
CASH at end of year	<u>\$ 72,227,000</u>	<u>\$ 66,414,000</u>
Reconciliation of cash on the statement of net assets		
Cash	\$ 72,214,000	\$ 66,413,000
Restricted fidelity fund cash	<u>13,000</u>	<u>1,000</u>
Cash at end of year	<u>\$ 72,227,000</u>	<u>\$ 66,414,000</u>

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

	<u>Year Ended</u> <u>June 30, 2012</u>	<u>Year Ended</u> <u>June 30, 2011</u>
RECONCILIATION OF NET OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	\$ 323,370,000	\$ 293,379,000
Adjustments to reconcile operating income to net cash provided by operating activities:		
Bad debt expense	998,000	239,000
Depreciation	495,000	740,000
Gain on disposal of capital assets	(50,000)	(34,000)
Changes in assets and liabilities:		
Retailer accounts receivable	(7,536,000)	(6,044,000)
Prepays and other assets	(684,000)	(500,000)
Accounts payable and accrued liabilities	914,000	40,000
Prize annuity investments	634,000	-
Prizes payable	4,823,000	6,595,000
Deferred rent	(157,000)	(158,000)
Deferred revenue	(272,000)	226,000
Net cash provided by operating activities	<u>\$ 322,535,000</u>	<u>\$ 294,483,000</u>
NONCASH INVESTING ACTIVITIES:		
(Decrease) increase in fair value of prize annuity investments	<u>\$ 141,000</u>	<u>\$ 225,000</u>

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

(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*, Sections 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 deposit 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*, which may be viewed at <http://www.tn.gov/finance/act/cafr.shtml>.

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. During the years ended June 30, 2012 and 2011, the TEL’s lottery sales included a variety of instant ticket games and online, terminal-based ticket games: Cash 3, Cash 4, Pick 5, Tennessee Cash, Powerball, and Mega Millions. Effective October 1, 2010, Pick 5 was discontinued and replaced with the in-state jackpot game Tennessee Cash.

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 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.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

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 for terminal-based online games is recognized based on the game characteristics. For online games where the prize expense is determinable only upon occurrence of the related draw, revenues for sold tickets are recognized when the related drawing occurs. Also, amounts collected from retailers in advance of the draw are recorded as deferred revenue and recognized once the drawing occurs.

Revenues for online games where both prize expense and the draw date are known prior to ticket sales occurring are recognized at the time of the sale.

Certain instant and online games include free ticket prizes that entitle the holder to exchange a winning ticket for another of equal value. The selling price of the game ticket awarded as a prize reduces ticket revenue when the related winning ticket is validated.

Revenues are presented net of bad debt expense.

Net Assets – Net assets represent cumulative revenues less expenses and required beneficiary program payments 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.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

Delinquent accounts are reviewed periodically by TEL management. Accounts outstanding more than 180 days from the most recent date of delinquency or date of last payment are considered doubtful. At June 30, 2012 and 2011, the Allowance for Doubtful Accounts was \$236,000 and \$270,000, 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 three to seven 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 *Tennessee Code Annotated*, Section 4-51-118(a), TEL retailers are assessed a one-time fidelity fund 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, 2012, and June 30, 2011, \$36,000 and \$50,000 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 deposit to the Lottery for Education Account. As of the years ended June 30, 2012 and 2011, there were no fidelity funds available for deposit 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.

The TEL will pay a bonus of \$25,000 to a retailer who sells a single jackpot winning ticket for Powerball or Mega Millions; however, if there are multiple winning Powerball or Mega Millions jackpot winning tickets sold in Tennessee in a single drawing, the \$25,000 selling

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

bonus will be divided proportionately (based on the number of winning tickets sold by each retailer) between or among the respective retailers.

The TEL will pay a selling bonus of \$5,000 to a retailer who sells a winning Powerball PowerPlay or Mega Millions Megaplier ticket if the prize is equal to or greater than \$1 million.

The TEL will pay a selling bonus of \$5,000 to a retailer who sells an online game winning ticket other than Powerball and Mega Millions if the prize is equal to or greater than \$1 million.

Bonuses were earned as follows during the years ended June 30:

<u>On-Line Game</u>	<u>2012</u>	<u>2011</u>
Powerball	\$ 15,000	\$ 30,000
Mega Millions	-	10,000
Tennessee Cash	-	10,000
Total Retailer Bonuses	\$ <u>15,000</u>	\$ <u>50,000</u>

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 5,000 instant and online retailer ticket terminals and associated software. Effective March 3, 2009, the TEL renegotiated its contract with GTECH to extend through April 9, 2015. Terms of this contract include the continuation of the contractor service fee rate of 1.24%, on the selling price of online tickets sold and on instant ticket activations net of free tickets available as prizes. Accordingly, during fiscal years 2012 and 2011, GTECH was compensated at the rate of 1.24% for all online and instant ticket game sales. Additionally, contractual terms include GTECH’s agreement to provide, install, and maintain up to 800 instant ticket vending machines (ITVMs) for the TEL.

SGI prints, warehouses, and distributes the instant ticket games to retailers. Effective April 1, 2009, the TEL renegotiated its contract with SGI to extend through April 9, 2015. In accordance with this contract, SGI receives the negotiated fee of 1.07% on the selling price of all instant ticket activations. During the years ended June 30, 2012 and 2011, SGI was compensated at this rate for all instant ticket activations.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

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, Pick 5, and Tennessee Cash is recognized based on historical payout experience when the related drawings occur.

Powerball and Mega Millions prizes are shared based on contributions made to the prize pool by all member lotteries of the Powerball Group and the Mega Millions Group of the Multi-State Lottery Association (“MUSL”). All Powerball and Mega Millions grand prizes won by players who purchase tickets in Tennessee are funded from pooled contributions by all participating lottery states. 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 thirty (30) annual installments for Powerball or twenty-six (26) annual payments for Mega Millions. Lump-sum payments are discounted to present value, as calculated by MUSL for the Powerball game and the Mega Millions Consortium Group for the Mega Millions game. As of the years ended June 30, 2012, and June 30, 2011, there were no grand prize winners 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.

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 can be reasonably estimated. As of the years ended June 30, 2012 and 2011, 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

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

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 expensed in accordance with FASB 13 (Note 5), advertising costs are expensed when the related advertising takes place.

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

A significant portion of TEL's deposits are in a financial institution that participates 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, 2012 and 2011, bank balances of approximately \$1.829 million and \$1.477 million, respectively, were insured by the bank collateral pool.

Additionally, for both the years ended June 30, 2012 and 2011, the bank balances for the fidelity fund account were \$22,000 and maintained in a demand deposit account that was insured by the Federal Deposit Insurance Corporation for up to a maximum of \$250,000.

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 \$70.7 million and \$65.3 million at June 30, 2012 and 2011, respectively. The LGIP is part of the State

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

Pooled Investment Fund. The fund is not rated by a nationally recognized statistical rating organization. The fund's investment policy and required risk disclosures are presented in the *State of Tennessee Treasurer's Report*. That report is available on the state's website at <http://treasury.tn.gov/> or by calling (615) 741-2956.

(3) PRIZE ANNUITY INVESTMENTS

TEL has games where the prize structure allows for specific prizes to be paid in a cash value or annuity option. Prize annuity investments represent investments TEL has made to pay the winners entitled to multiyear payments.

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 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 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.

The prize structure of the Millionaire Jumbo Bucks instant ticket game includes 11 top prizes of \$1 million. Winners have the option to choose the annuity or take cash option when the prize is claimed. The annuity option guarantees the winner would receive annual payments of \$40,000 for 25 years. As of June 30, 2012, one top prize winner elected the annuity option. The TEL purchased one single-premium, sum-certain annuity contract for approximately \$634,000 in its name from Metropolitan Life (Met Life) and appointed the respective winner as the beneficiary.

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 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

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

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, 2012, and June 30, 2011. The annuity purchased from Aviva was rated A (Excellent) by A.M. Best as of June 30, 2012, and June 30, 2011.

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, 2012, and June 30, 2011.

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, 2012 and 2011, the fair market value of the prize annuity investments respectively increased by \$141,000 and \$225,000, respectively.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

(4) CAPITAL ASSETS

Capital assets consisted of the following as of June 30, 2012:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	\$ 893,000	\$ 2,000	\$ -	\$ 895,000
Computer equipment	406,000	93,000	(25,000)	474,000
Vehicles	225,000	35,000	-	260,000
High mileage vehicles - Vans	1,055,000	390,000	(270,000)	1,175,000
Leasehold improvements	400,000	2,000	-	402,000
Communication equipment	904,000	15,000	-	919,000
Software	713,000	17,000	(2,000)	728,000
Gaming equipment	573,000	32,000	(1,000)	604,000
Total capital assets	5,169,000	586,000	(298,000)	5,457,000
Less accumulated depreciation	(4,149,000)	(495,000)	288,000	(4,356,000)
Total capital assets, net	\$ 1,020,000	\$ 91,000	\$ (10,000)	\$ 1,101,000

Capital assets consisted of the following as of June 30, 2011:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	\$ 903,000	\$ 2,000	\$ (12,000)	\$ 893,000
Computer equipment	436,000	8,000	(38,000)	406,000
Vehicles	261,000	37,000	(73,000)	225,000
High mileage vehicles - Vans	1,016,000	281,000	(242,000)	1,055,000
Leasehold improvements	401,000	31,000	(32,000)	400,000
Communication equipment	891,000	13,000	-	904,000
Software	686,000	27,000	-	713,000
Gaming equipment	567,000	6,000	-	573,000
Total capital assets	5,161,000	405,000	(397,000)	5,169,000
Less accumulated depreciation	(3,802,000)	(740,000)	393,000	(4,149,000)
Total capital assets, net	\$ 1,359,000	\$ (335,000)	\$ (4,000)	\$ 1,020,000

(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 2018. Certain of these leases contain provisions for scheduled rental increases and are

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

renewable at the option of the TEL. No options were exercised during the years ended June 30, 2012, and June 30, 2011. The TEL also subleases office space under operating leases expiring through 2015 to its major vendors.

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:

<u>Year Ending June 30:</u>	<u>2012</u>	<u>2011</u>
2012	\$ -	\$ 2,562,000
2013	2,640,000	2,099,000
2014	1,586,000	1,372,000
2015	418,000	323,000
2016	129,000	129,000
2017	132,000	383,000
2018 and thereafter	251,000	-
Total minimum rental payments	\$ <u>5,156,000</u>	\$ <u>6,868,000</u>

Minimum rental payments at June 30, 2012 and 2011, have not been reduced by minimum sublease rentals of \$334,000 and \$531,000, 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:

<u>Year Ending June 30:</u>	<u>2012</u>	<u>2011</u>
2012	\$ -	\$ 203,000
2013	197,000	197,000
2014	131,000	131,000
Total minimum sublease payments	\$ <u>328,000</u>	\$ <u>531,000</u>

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:

	<u>2012</u>	<u>2011</u>
Minimum rentals:		
Property	\$ 1,480,000	\$ 1,427,000
Billboards	1,274,000	1,248,000
Less: Sublease rentals	(203,000)	(203,000)
Total minimum rentals	\$ <u>2,551,000</u>	\$ <u>2,472,000</u>

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

(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, 2012, total deferred rent of \$263,000 consisted of \$102,000 related to rent abatements and \$161,000 to the straight-lining of rental expense over the life of the related lease terms.

At June 30, 2011, total deferred rent of \$420,000 consisted of \$162,000 related to rent abatements and \$258,000 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, 2012, and June 30, 2011, are summarized as follows:

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

	<u>2012</u>	<u>2011</u>
Operating revenues:		
Ticket sales (Net)	\$ 1,310,205,000	\$ 1,186,318,000
Less tickets provided as prizes	(94,350,000)	(83,978,000)
Net ticket sales	1,215,855,000	1,102,340,000
Fees and other revenue	4,654,000	3,990,000
Total lottery proceeds	<u>1,220,509,000</u>	<u>1,106,330,000</u>
Operating expenses, as defined:		
Gaming	894,011,000	809,134,000
Operating	16,217,000	15,460,000
Total operating expenses, as defined	<u>910,228,000</u>	<u>824,594,000</u>
Net proceeds before distribution of unrestricted net assets	310,281,000	281,736,000
Non-operating revenue and expenses		
Interest income	68,000	110,000
Total non-operating revenue and expenses	<u>68,000</u>	<u>110,000</u>
Net proceeds	<u>\$ 310,349,000</u>	<u>\$ 281,846,000</u>
Amount due to Lottery for Education Account for year	310,349,000	281,846,000
Amount paid during year	(233,999,000)	(211,565,000)
Amount due to Lottery for Education Account, end of year	<u>\$ 76,350,000</u>	<u>\$ 70,281,000</u>

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

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

(8) DUE TO AFTER-SCHOOL PROGRAMS SPECIAL ACCOUNT

In accordance with the Act, at the end of each fiscal year, one hundred percent of any unclaimed prize money shall be deposited in the After-School Programs special account.

The amounts due to the After-School Programs special account are derived from unclaimed prizes for instant games that have been officially closed and online draws that have exceeded the 180-day claim period.

Unclaimed prizes for instant games are estimated based upon historical percentages of actual unclaimed dollars at the time of game close and reconciliation at the end of the 90-day redemption period.

For online games, the actual unclaimed amounts are determined after the expiration of the related claim period for the draw.

For instant games, prizes not claimed within 90 days of the announced game-end date are forfeited as unclaimed prizes. For online games, prizes not claimed within 180 days of a game draw date are forfeited as unclaimed prizes.

For fiscal year 2012, unclaimed prizes were \$13,089,000, which was current and payable to the After-School Programs special account at June 30, 2012.

For fiscal year 2011, unclaimed prizes were \$11,644,000, which was current and payable to the After-School Programs special account at June 30, 2011.

All amounts due at the end of each fiscal year were deposited to the After-School Programs special account by August 1 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, 2012 and 2011, employees contributed approximately \$444,000 and \$416,000, respectively, to the 457 Plan.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

The aggregate fair value of the plan's assets was approximately \$3,187,000 and \$2,758,000, net of administrative fees, as of June 30, 2012 and 2011, 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 5% of employee's compensation, and
2. Matching contribution of 75% of the participant's contributions to the 457 Plan up to the first 5% of the participant's compensation.

These contributions vest over a four-year period at a rate of 25% per year and are not available to participants until termination, retirement, death, or unforeseeable emergency. The TEL contributed approximately \$674,000 and \$634,000 to the 401(a) Plan on behalf of its employees in the years ended June 30, 2012 and 2011, respectively. Of these contributions, approximately \$16,000 and \$29,000 were forfeited by separated employees as of June 30, 2012, and June 30, 2011, 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, 2012 and 2011, forfeited amounts of approximately \$15,000 and \$37,000, 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 \$4,672,000 and \$4,158,000, net of forfeitures and administrative fees, as of June 30, 2012 and 2011, respectively.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

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, 2012, is estimated using historical trends. At June 30, 2012 and 2011, the estimated current portion of the compensated absences liability was \$535,000 and \$383,000, respectively.

Sick leave is earned at the end of each month at the rate of eight 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 separation pay for every year of employment with TEL. The TEL had \$347,000 and \$295,000 accrued for employment separation obligations for each of the years ending June 30, 2012 and 2011, respectively.

(10) NON-CURRENT LIABILITIES

Non-current liabilities consisted of the following as of June 30, 2012:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Prize Annuities Payable	\$ 2,414,000	\$ 775,000	\$ (156,000)	\$ 3,033,000	\$ 144,000
Compensated Absences	565,000	535,000	(565,000)	535,000	535,000
Deferred Rent	420,000	-	(158,000)	262,000	61,000
Total non-current	\$ 3,399,000	\$ 1,310,000	\$ (879,000)	\$ 3,830,000	\$ 740,000

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

Non-current liabilities consisted of the following as of June 30, 2011:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Prize Annuities Payable	\$ 2,345,000	\$ 225,000	\$ (156,000)	\$ 2,414,000	\$ 104,000
Compensated Absences	533,000	629,000	(597,000)	565,000	383,000
Deferred Rent	578,000	-	(158,000)	420,000	61,000
Total non-current	\$ 3,456,000	\$ 854,000	\$ (911,000)	\$ 3,399,000	\$ 548,000

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

(11) RISK MANAGEMENT

Effective July 31, 2005, the TEL became a member of the Risk Management Fund, an internal service fund of the State of Tennessee. The Risk Management Fund allocates the cost of providing claims servicing and claims payment by charging a premium to the TEL based on a percentage of the TEL's expected loss costs which includes both experience and exposures. This Risk Management Fund provides general and automobile liability up to \$300,000 per person and \$1,000,000 per occurrence. For property, the deductible is the first \$25,000 of losses for a member.

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. At June 30, 2012, additional insurance coverage was provided at the following maximum amounts:

<u>Coverage</u>	<u>2012</u>
Employee Fidelity	\$ 500,000
Automobile/Property	1,000,000
Workers' Compensation	1,000,000
Employment Practices	5,000,000
General Liability/Umbrella	5,000,000

Over the past three fiscal years, in the ordinary course of business, the TEL has filed insurance claims with both the risk pool and the commercial insurers. None of the related settlements exceeded the provided insurance coverage.

TENNESSEE EDUCATION LOTTERY CORPORATION
NOTES TO THE FINANCIAL STATEMENTS (CONT.)
FOR THE YEARS ENDED JUNE 30, 2012, AND JUNE 30, 2011

(12) COMMITMENTS AND CONTINGENCIES

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. Furthermore, as of the year ended June 30, 2012, management is not aware of any related liabilities.