

# AUDIT REPORT

Tennessee Education Lottery Corporation

For the Year Ended  
June 30, 2013



STATE OF TENNESSEE  
COMPTROLLER OF THE TREASURY

Department of Audit  
Division of State Audit



***Deborah V. Loveless, CPA, CGFM***  
Director

***Edward Burr, CPA, CGFM***  
Assistant Director

***Aaron Jewell, CPA, CFE***  
Audit Manager

***Randy Salt***  
In-Charge Auditor

***Amy Brown***  
Staff Auditor

***Gerry C. Boaz, CPA, CGFM***  
Technical Manager

***Amy Brack***  
Editor

***Amanda Adams***  
Assistant Editor

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

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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

February 11, 2014

The Honorable Bill Haslam, Governor  
Members of the General Assembly  
Board of Directors, Tennessee Education Lottery Corporation

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Education Lottery Corporation for the year ended June 30, 2013. You will note from the independent auditor's report that an unmodified 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,

A handwritten signature in cursive script that reads "Deborah V. Loveless".

Deborah V. Loveless, CPA  
Director

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**Audit Report**  
**Tennessee Education Lottery Corporation**  
**For the Year Ended June 30, 2013**

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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, 2013

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### **Opinion on the Financial Statements**

The opinion on the financial statements is unmodified.

### **Audit Findings**

The audit report contains no findings.



STATE OF TENNESSEE  
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SUITE 1500, JAMES K. POLK STATE OFFICE BUILDING  
NASHVILLE, TENNESSEE 37243-1402

PHONE (615) 401-7897  
FAX (615) 532-2765

## Independent Auditor's Report

The Honorable Bill Haslam, Governor  
Members of the General Assembly  
Board of Directors, Tennessee Education Lottery Corporation

### Report on the Financial Statements

We have audited the accompanying financial statements of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of and for the years ended June 30, 2013, and June 30, 2012, and the related notes to the financial statements, which collectively comprise the Tennessee Education Lottery Corporation's basic financial statements as listed in the table of contents.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

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 from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### ***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, 2013, and June 30, 2012, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

### ***Other Matters***

#### ***Required Supplementary Information***

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 14 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, which 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 our 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.

#### ***Other Reporting Required by Government Auditing Standards***

In accordance with *Government Auditing Standards*, we have also issued our report dated November 22, 2013, on our consideration of the Tennessee Education Lottery Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Tennessee Education Lottery Corporation's internal control over financial reporting and compliance.



Deborah V. Loveless, CPA  
Director  
November 22, 2013

## **TENNESSEE EDUCATION LOTTERY CORPORATION**

### **Management's Discussion and Analysis**

The Tennessee Education Lottery Corporation (TEL) offers the following discussion and analysis to the readers of the financial statements. This narrative overview provides an objective analysis of TEL's financial activity for the fiscal years ended June 30, 2013, and June 30, 2012, with comparative information presented for the fiscal year ended June 30, 2011. The overview should be considered in conjunction with the independent auditor's report, the accompanying audited financial statements, and the notes to the financial statements.

#### *Understanding TEL's Financial Statements*

TEL, a quasi-public instrumentality, is a component unit of the State of Tennessee. 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 TEL's net position and changes therein resulting from business operations.

The financial statements are comprised of three components:

- **the statements of net position** – reflects TEL's financial position at June 30, 2013, and June 30, 2012;
- **the statements of revenues, expenses, and changes in net position** – 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, 2013, and June 30, 2012; and
- **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, 2013, and June 30, 2012.

The notes to the financial statements document additional information that is essential for readers to gain a comprehensive understanding of the data provided in TEL's financial statements.

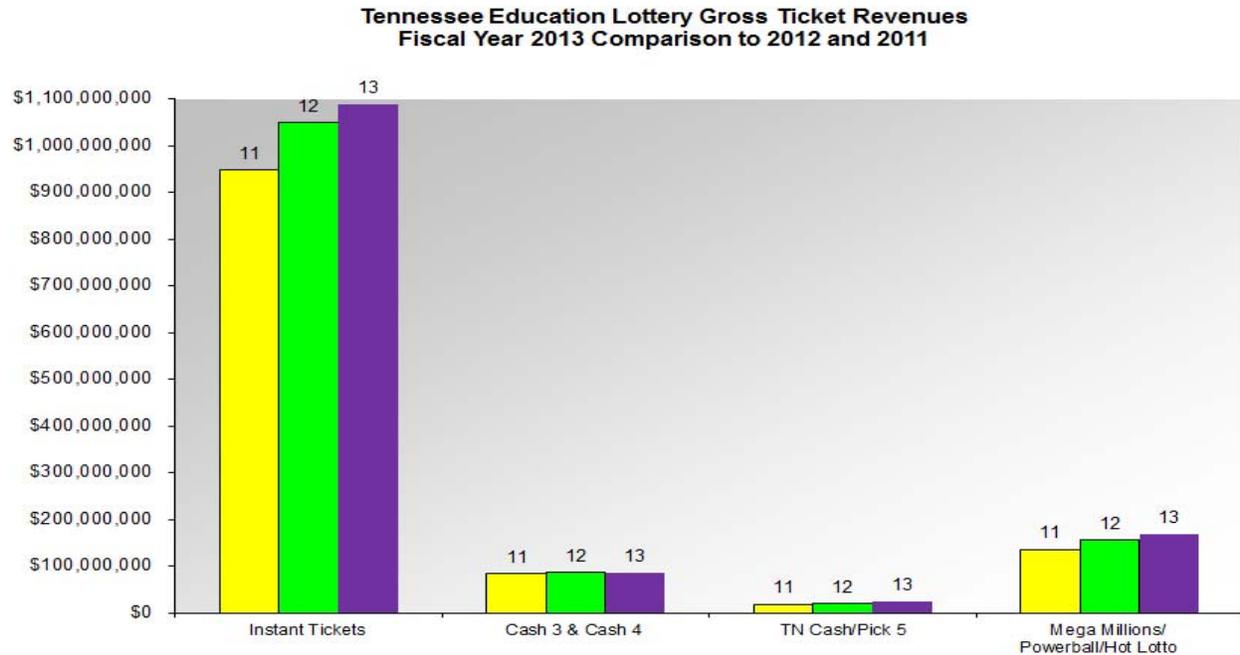
TEL's primary business purpose is to generate revenues to fund college scholarships for residential Tennessee students attending higher educational institutions within the state. Accordingly, the main focus of the financial statements is determining funds available for payment to the State of Tennessee's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

#### *Fiscal Year 2013 Financial Highlights*

TEL set a new record for proceeds raised for state education programs for fiscal year ended June 30, 2013. TEL's strong performance resulted in a record \$339.7 million for education funding in

Tennessee for fiscal year 2013. This was an increase of \$16.3 million over the prior year's return of \$323.4 million for fiscal year 2012.

TEL reported total gross sales of \$1.36 billion, a \$56.3 million (4.3%) increase over the previous fiscal year revenues of \$1.31 billion, not to mention the seventh straight year that TEL has reached gross sales of over \$1 billion. Total education funding since ticket sales began in January 2004 now stands at more than \$2.73 billion, with total sales surpassing \$10.4 billion.



TEL's sales growth is primarily due to the continued upward movement in instant ticket sales. 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, TEL launched 47 new instant ticket games at varying price points, that were met with great favor by the players during fiscal year 2013. To celebrate the corporation's ninth anniversary, TEL launched the *Win For Life* (\$20) instant ticket game with the chance to win \$3,000 a week for life. In addition, TEL launched the popular *\$5,000,000 Multiplier Spectacular* (\$25) game, featuring the largest top prize of any instant game in Tennessee Lottery history. The Jumbo Bucks family continues to be successful as evidenced by the popularity of the *Jumbo Bucks* (\$10) and the launch of *Jumbo Bucks Seasons* (\$3), which features a ticket with seasonal themes planned throughout the year.

*Cash 3* sales in fiscal year 2013 remained relatively consistent with those of fiscal year 2012.

*Cash 4* sales increased by 5.5% over fiscal year 2012.

Sales for *Tennessee Cash* increased \$5.6 million during fiscal year 2013. *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 2013, *Tennessee Cash* experienced three large jackpots, \$935 thousand, \$1.5 million, and \$2.2 million, which contributed to increased sales.

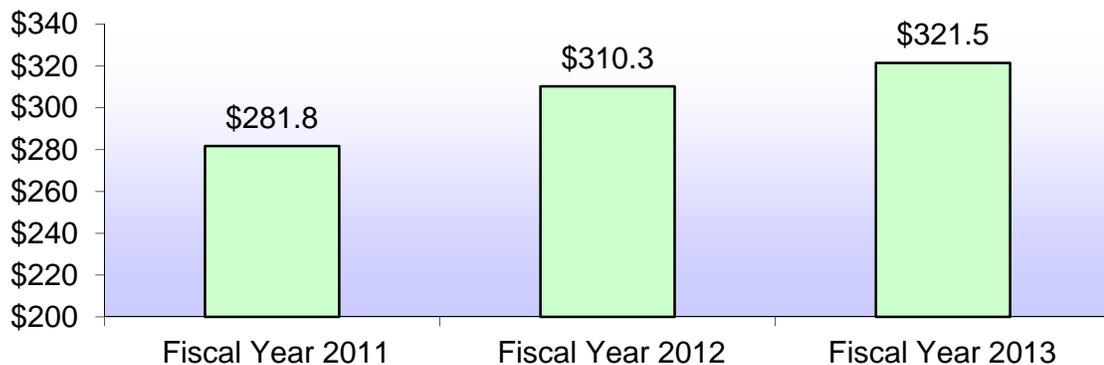
*Powerball* sales were \$133.2 million in fiscal year 2013, compared to \$102.8 million in fiscal year 2012. The 30% increase in *Powerball* sales resulted from two record jackpots in fiscal year 2013 of \$587.5 million and \$590.5 million, in addition to a full year of sales at the \$2 price point.

Sales for *Mega Millions* in fiscal year 2013 were \$31.9 million, compared to \$53.9 million the prior year. The decline in *Mega Millions* sales is directly attributed to the lack of significant jackpots and the fiscal year 2012 world-record jackpot of \$656 million.

In May 2013, *Hot Lotto* was introduced as a third multi-jurisdictional game in TEL’s portfolio. *Hot Lotto* is a drawing-style game operated in 16 states with a starting jackpot of \$1 million, and its statutory taxes are paid by the lotteries in the Hot Lotto group.

TEL generated \$321.5 million for the Lottery for Education Account in fiscal year 2013, compared to \$310.3 million in fiscal year 2012 and \$281.8 million in fiscal year 2011.

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

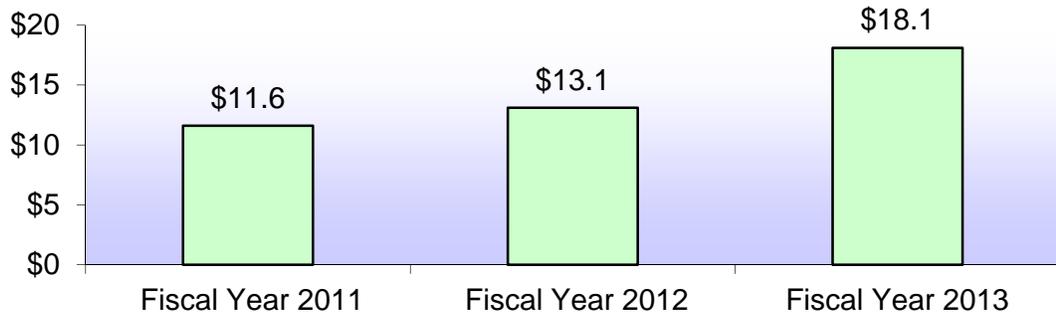


The amounts deposited to the After-School Programs special account are derived from unclaimed instant and drawing-style game prizes at fiscal year-end. Prizes not claimed within 90 days of the announced game-end date for instant games, and within 180 days for all drawing-style games, are forfeited as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

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, TEL records the actual unclaimed amounts determined after the expiration of the related claim period for the draw.

In fiscal year 2013, TEL recognized \$18.1 million for the After-School Programs special account, as compared to \$13.1 million in fiscal year 2012 and \$11.6 million in fiscal year 2011. The increase resulted primarily from the timing of instant ticket game closings and drawing-style game unclaimed prizes related to record jackpots of \$656 million in *Mega Millions* and \$587.5 million in *Powerball*.

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



## Condensed Statement of Net Position

	June 30, 2013	Increase/ (Decrease)	June 30, 2012	Increase/ (Decrease)	June 30, 2011
<b>Assets:</b>					
<i>Current Assets</i>					
Cash	\$ 86,081,000	\$13,854,000	\$ 72,227,000	\$ 5,813,000	\$ 66,414,000
Retailer accounts receivable, net	65,166,000	5,120,000	60,046,000	6,536,000	53,510,000
Other	7,768,000	16,000	7,752,000	744,000	7,008,000
<b>Total current assets</b>	<b>159,015,000</b>	<b>18,990,000</b>	<b>140,025,000</b>	<b>13,093,000</b>	<b>126,932,000</b>
<i>Non-current assets</i>					
Other	2,796,000	(108,000)	2,904,000	559,000	2,345,000
Capital assets, net	990,000	(111,000)	1,101,000	81,000	1,020,000
<b>Total non-current assets</b>	<b>3,786,000</b>	<b>(219,000)</b>	<b>4,005,000</b>	<b>640,000</b>	<b>3,365,000</b>
<b>Total assets</b>	<b>162,801,000</b>	<b>18,771,000</b>	<b>144,030,000</b>	<b>13,733,000</b>	<b>130,297,000</b>
<b>Liabilities:</b>					
<i>Current liabilities</i>					
Due to Lottery for Education Account	84,498,000	8,148,000	76,350,000	6,069,000	70,281,000
Due to After-School Programs Account	18,170,000	5,081,000	13,089,000	1,445,000	11,644,000
Prizes payable	49,528,000	3,769,000	45,759,000	4,862,000	40,897,000
Accounts payable and accrued liabilities	4,625,000	(384,000)	5,009,000	1,377,000	3,632,000
Unearned rent	105,000	44,000	61,000	-	61,000
Unearned revenue	858,000	199,000	659,000	(272,000)	931,000
<b>Total current liabilities</b>	<b>157,784,000</b>	<b>16,857,000</b>	<b>140,927,000</b>	<b>13,481,000</b>	<b>127,446,000</b>
<i>Non-current liabilities</i>					
Non-current portion of other liabilities	5,010,000	1,920,000	3,090,000	240,000	2,850,000
<b>Total non-current liabilities</b>	<b>5,010,000</b>	<b>1,920,000</b>	<b>3,090,000</b>	<b>240,000</b>	<b>2,850,000</b>
<b>Total liabilities</b>	<b>162,794,000</b>	<b>18,777,000</b>	<b>144,017,000</b>	<b>13,721,000</b>	<b>130,296,000</b>
<b>Net Position:</b>					
Net Investment in capital assets	990,000	(111,000)	1,101,000	81,000	1,020,000
Unrestricted	(990,000)	111,000	(1,101,000)	(81,000)	(1,020,000)
Restricted for uncollectible retailer receivables	7,000	(6,000)	13,000	12,000	1,000
<b>Total net position</b>	<b>\$ 7,000</b>	<b>\$ (6,000)</b>	<b>\$ 13,000</b>	<b>\$ 12,000</b>	<b>\$ 1,000</b>

## Overview of Financial Position

### Assets

The \$18.8 million increase in total assets at June 30, 2013, and the \$13.7 million increase in total assets at June 30, 2012, 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 \$18.8 million increase in total liabilities at June 30, 2013, relates primarily to increased fiscal year 2013 ticket sales, resulting in higher net proceeds payable to the Lottery for Education Account and more prizes payable to players.

The \$13.7 million increase in total liabilities at June 30, 2012, related primarily to increased fiscal year 2012 ticket sales and more prizes payable to players.

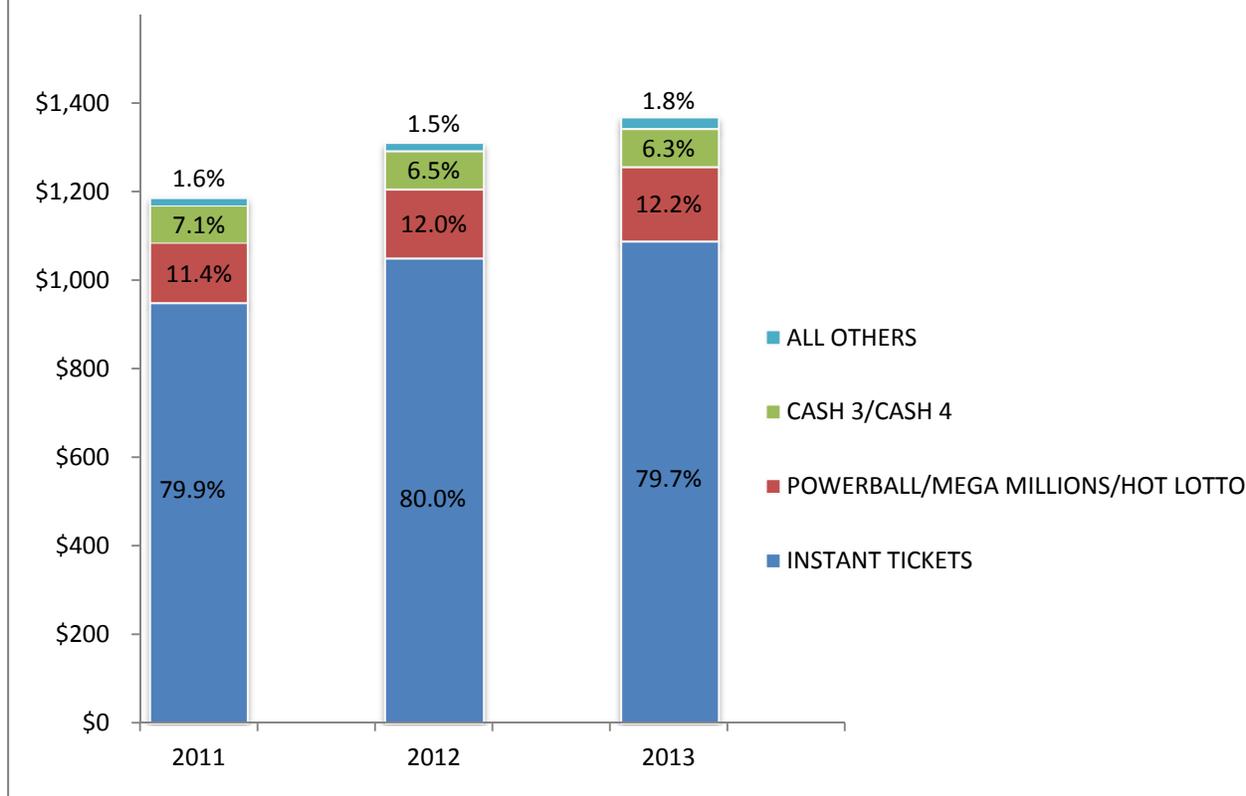
### **Condensed Statement of Revenues & Expenses**

	<b>June 30, 2013</b>	<b>Increase/ (Decrease)</b>	<b>June 30, 2012</b>	<b>Increase/ (Decrease)</b>	<b>June 30, 2011</b>
<i>Revenues:</i>					
Instant games	\$1,088,740,000	\$39,136,000	\$ 1,049,604,000	\$ 100,894,000	\$ 948,710,000
Online games	278,796,000	17,196,000	261,600,000	23,753,000	237,847,000
Less instant/promotional tickets provided as prizes	(92,316,000)	2,034,000	(94,350,000)	(10,372,000)	(83,978,000)
<b>Games revenue, net</b>	<b>1,275,220,000</b>	<b>58,366,000</b>	<b>1,216,854,000</b>	<b>114,275,000</b>	<b>1,102,579,000</b>
Bad debt recoveries/(expense), net	50,000	1,049,000	(999,000)	(760,000)	(239,000)
Retailer service fees	3,693,000	496,000	3,197,000	(199,000)	3,396,000
Interest income	118,000	50,000	68,000	(42,000)	110,000
Other revenue	1,370,000	(135,000)	1,505,000	866,000	639,000
<b>Total revenues</b>	<b>1,280,451,000</b>	<b>59,826,000</b>	<b>1,220,625,000</b>	<b>114,140,000</b>	<b>1,106,485,000</b>
<i>Expenses</i>					
Cost of sales	923,737,000	42,815,000	880,922,000	83,432,000	797,490,000
General, administrative, and other operating expenses	16,966,000	749,000	16,217,000	756,000	15,461,000
Other expenses	42,000	6,000	36,000	(14,000)	50,000
Proceeds to After-School Program Account	18,170,000	5,081,000	13,089,000	1,445,000	11,644,000
Proceeds to Lottery for Education Account	321,542,000	11,193,000	310,349,000	28,503,000	281,846,000
<b>Total expenses</b>	<b>1,280,457,000</b>	<b>59,844,000</b>	<b>1,220,613,000</b>	<b>114,122,000</b>	<b>1,106,491,000</b>
Change in net position	(6,000)	(18,000)	12,000	18,000	(6,000)
Total net position, beginning of year	13,000	12,000	1,000	(6,000)	7,000
<b>Total net position, end of year</b>	<b>\$ 7,000</b>	<b>\$ (6,000)</b>	<b>\$ 13,000</b>	<b>\$ 12,000</b>	<b>\$ 1,000</b>

## **Revenues**

Gross lottery ticket sales for fiscal years 2013, 2012, and 2011 were \$1.368 billion, \$1.311 billion, and \$1.187 billion, respectively. The following chart depicts the distribution of sales by product for the three fiscal years ended June 30:

## Tennessee Education Lottery Sales By Major Products Per Fiscal Year (in millions)



**Gross instant ticket** sales for fiscal year 2013 were \$1.089 billion. This was a 3.8% increase from fiscal year 2012's instant ticket sales of \$1.049 billion, which represented a 10.6% increase from fiscal year 2011 instant ticket sales of \$948.7 million. Instant tickets represent approximately 80% of total gross sales in fiscal years 2013, 2012, and 2011. The year-over-year increase in gross instant ticket sales is attributed to the instant ticket marketing strategy, which involves the ongoing introduction of multiple games, including special theme games and higher price-point games with higher prize payouts. The games most popular with the players in 2013 were the Jumbo Bucks family of games, followed by the *\$5,000,000 Multiplier Spectacular* and the *Win for Life* games.

**Powerball** sales for fiscal years 2013, 2012, and 2011 were \$133.2 million, \$102.8 million, and \$90.4 million, respectively. These amounts represent approximately 10%, 8%, and 8% of gross ticket sales, respectively, for each fiscal year. The increase in *Powerball* sales during fiscal year 2013 resulted from two record jackpots of \$587.5 million and \$590.5 million.

*Powerball* is a multi-jurisdictional, drawing-style lottery game operated in the following jurisdictions in addition to Tennessee: Arizona, Arkansas, Colorado, Connecticut, Delaware, the

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, U.S. 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-selling agreement with members of the Multi-State Lottery Association (MUSL), including Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Texas, Virginia, and Washington. Ohio and California, both members of the Mega Millions consortium, started cross-selling *Powerball* on April 16, 2010, and April 8, 2013, respectively.

**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 consortium's *Mega Millions* game as part of a cross-selling agreement. Tennessee began sales for the game in January 2010. Sales for fiscal years 2013, 2012, and 2011 were \$31.9 million, \$53.9 million, and \$45.3 million, respectively.

**Hot Lotto** is a multi-jurisdictional, drawing-style lottery game operated in the following jurisdictions in addition to Tennessee: Delaware, the District of Columbia, Idaho, Iowa, Kansas, Maine, Minnesota, Montana, New Hampshire, New Mexico, North Dakota, Oklahoma, South Dakota, Vermont, and West Virginia. Tennessee began sales for the game in May 2013. Sales were \$2.4 million in 2013.

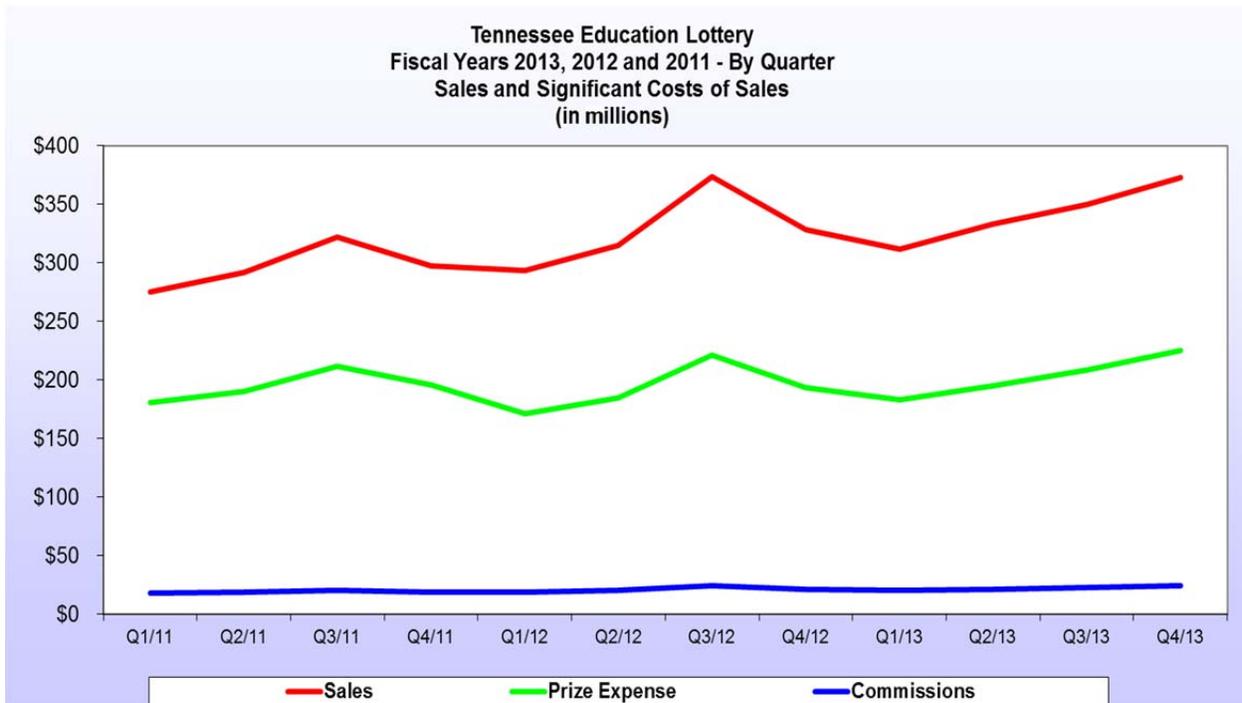
**Cash 3** sales for fiscal years 2013, 2012, and 2011 were \$57.1 million, \$57.9 million, and \$58.1 million, respectively. These amounts represent approximately 5% of gross ticket sales, respectively, for each of the noted fiscal years.

**Cash 4** sales were \$29.2 million, \$27.7 million, and \$25.5 million in the years 2013, 2012, and 2011, 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 fiscal years 2013, 2012, and 2011 were \$24.8 million, \$19.2 million, and \$16.0 million, respectively.

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

**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 relate to and change in direct proportion with changes in ticket sales:



**Gross prize expense** was \$812.5 million, \$770.6 million, and \$695.1 million in the years 2013, 2012, and 2011, respectively. Increases of \$41.9 million in 2013 and \$75.5 million in 2012 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 the value of prizes as determined prior to ticket production. Prize expense is recorded based on an established prize structure and a 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 67.6%, 67.0%, and 66.6% of instant game sales, net of free tickets, for 2013, 2012, and 2011, 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 were 50.0%, 50.3%, and 50.2% for 2013, 2012, and 2011, respectively.

**Retailer commissions** were \$89.2 million, \$85.5 million, and \$77.5 million for fiscal years 2013, 2012, and 2011, respectively. Consistent with the cost driver relationship of ticket sales to retailer commissions, the increases of \$3.7 million in 2013 and \$8.0 million in 2012 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, 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. 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 \$80,000; \$15,000; and \$50,000 were awarded for fiscal years 2013, 2012, and 2011, respectively.

**Contractor fees** for fiscal years 2013, 2012, and 2011 were \$27.4 million, \$26.3 million, and \$23.8 million, respectively. 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 tickets sold, and on instant ticket activations, net of free instant tickets available as prizes.

**Advertising costs** incurred by TEL were \$9.4 million, \$8.3 million, and \$9.4 million for fiscal years 2013, 2012, and 2011, respectively. These costs are significantly influenced by budget directives and constraints. Management continually strives to achieve an optimal balance between advertising 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.

**General, administrative and other operating expenses** were \$16.9 million, \$16.2 million, and \$15.5 million for fiscal years 2013, 2012, and 2011, 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, as well as 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 make these expenses relatively consistent year-over-year.

#### *Potential Factors Impacting Future Results*

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 TEL's own product lines and operations is essential to accomplish this mission. The following considerations have been presented to inform those interested in TEL's operations about factors that could potentially affect future results:

- TEL will continue to introduce new and/or enhanced instant and drawing-style game product offerings.

- 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.
- TEL will continue to enhance its promotional offerings and player affinity programs to improve brand awareness and increase player participation in our games.

*Contacting 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 TEL's activities and to show TEL's accountability for conducting business in a fiscally responsible manner. If you have questions about this report or require additional financial information, contact TEL's Finance Department at the following address:

Tennessee Education Lottery Corporation  
One Century Place  
26 Century Boulevard  
Suite 200  
Nashville, Tennessee 37214

**TENNESSEE EDUCATION LOTTERY CORPORATION**  
**Statements of Net Position**  
**As of June 30, 2013, and June 30, 2012**

	<b>June 30, 2013</b>	<b>June 30, 2012</b>
<b>ASSETS</b>		
Current assets:		
Cash (Note 2)	\$ 86,074,000	\$ 72,214,000
Restricted fidelity fund cash	7,000	13,000
Retailer accounts receivable, net	65,166,000	60,046,000
Prepaid expenses and other assets	7,572,000	7,608,000
Prize annuity investments (Note 3)	196,000	144,000
Total current assets	159,015,000	140,025,000
Noncurrent assets:		
Prepaid expenses and other assets	-	15,000
Prize annuity investments (Note 3)	2,796,000	2,889,000
Capital assets, net of depreciation of \$4,405,000 and \$4,356,000 (Note 4)	990,000	1,101,000
Total noncurrent assets	3,786,000	4,005,000
Total assets	162,801,000	144,030,000
<b>LIABILITIES</b>		
Current liabilities:		
Due to Lottery for Education Account (Note 6)	84,498,000	76,350,000
Due to After-School Programs Account (Note 7)	18,170,000	13,089,000
Prizes payable	49,176,000	45,615,000
Accounts payable	90,000	480,000
Prize annuities payable (Notes 3 and 9)	352,000	144,000
Accrued liabilities	4,535,000	4,529,000
Unearned revenues	858,000	659,000
Unearned rent (Note 9)	105,000	61,000
Total current liabilities	157,784,000	140,927,000
Noncurrent liabilities:		
Prize annuities payable (Notes 3 and 9)	5,010,000	2,889,000
Unearned rent (Note 9)	-	201,000
Total noncurrent liabilities	5,010,000	3,090,000
Total liabilities	162,794,000	144,017,000
<b>NET POSITION</b>		
Net investment in capital assets	990,000	1,101,000
Restricted:		
Restricted for uncollectible retailer receivables	7,000	13,000
Unrestricted	(990,000)	(1,101,000)
Total net position	\$ 7,000	\$ 13,000

See notes to financial statements.

**TENNESSEE EDUCATION LOTTERY CORPORATION**  
**Statements of Revenues, Expenses, and Changes in Net Position**  
**For the Years Ended June 30, 2013, and June 30, 2012**

	<b>Year Ended June 30, 2013</b>	<b>Year Ended June 30, 2012</b>
<b>OPERATING REVENUES</b>		
Ticket sales, net	\$1,367,587,000	\$1,310,205,000
Less instant/promotional tickets provided as prizes	(92,316,000)	(94,350,000)
Net ticket sales	1,275,271,000	1,215,855,000
Retailer service fees	3,693,000	3,197,000
Other	1,335,000	1,457,000
Net operating revenues	1,280,299,000	1,220,509,000
<b>OPERATING EXPENSES</b>		
Available prizes	812,547,000	770,568,000
Current year actual unclaimed prizes (Note 7)	(18,170,000)	(13,089,000)
Net prizes	794,377,000	757,479,000
Retailer commissions and bonuses	89,259,000	85,526,000
Contractor fees	27,430,000	26,280,000
Advertising	9,403,000	8,289,000
Salaries and benefits	12,879,000	12,682,000
Retailer merchandising and marketing	3,268,000	3,348,000
Rent, utilities, and maintenance	1,783,000	1,712,000
Depreciation	475,000	495,000
Professional fees	823,000	286,000
General administrative and other operating	1,007,000	1,042,000
Total operating expenses	940,704,000	897,139,000
Operating income	339,595,000	323,370,000
<b>NONOPERATING REVENUES (EXPENSES)</b>		
Interest revenue	118,000	68,000
Retailer fees for future uncollectible retailer receivables	35,000	48,000
Fidelity fund retailer non-feasance recoupments (Note 1)	(42,000)	(36,000)
Proceeds to After-School Programs Account (Note 7)	(18,170,000)	(13,089,000)
Proceeds to Lottery for Education Account (Note 6)	(321,542,000)	(310,349,000)
Total nonoperating revenues (expenses)	(339,601,000)	(323,358,000)
Change in net position	(6,000)	12,000
<b>NET POSITION</b>		
Net position, beginning of year	13,000	1,000
Net position, end of year	\$ 7,000	\$ 13,000

See notes to financial statements.

**TENNESSEE EDUCATION LOTTERY CORPORATION**  
**Statements of Cash Flows**  
**For the Years Ended June 30, 2013, and June 30, 2012**

	<b>Year Ended June 30, 2013</b>	<b>Year Ended June 30, 2012</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Cash received from customers	\$1,270,399,000	\$1,209,093,000
Other operating cash received	4,966,000	4,578,000
Cash paid for prizes	(788,406,000)	(752,440,000)
Cash paid to/on behalf of gaming vendors	(27,380,000)	(26,213,000)
Cash paid to retailers	(89,272,000)	(85,513,000)
Cash paid for advertising	(9,118,000)	(8,164,000)
Cash paid to/on behalf of employees	(12,779,000)	(12,481,000)
Other operating payments	(7,456,000)	(6,325,000)
Net cash provided by operating activities	340,954,000	322,535,000
<b>CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES</b>		
Payments to Lottery for Education Account	(313,394,000)	(304,280,000)
Payments to After-School Programs Account	(13,089,000)	(11,644,000)
Fidelity fund cash received from retailers	45,000	57,000
Fidelity fund cash refunded to retailers	(9,000)	(9,000)
Fidelity fund cash non-feasance recoupments	(42,000)	(36,000)
Net cash used in noncapital financing activities	(326,489,000)	(315,912,000)
<b>CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES</b>		
Purchase of property and equipment	(763,000)	(295,000)
Proceeds from disposal of capital assets	34,000	51,000
Net cash used in capital and related financing activities	(729,000)	(244,000)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of prize annuity	-	(634,000)
Interest income	118,000	68,000
Net cash provided/(used) by investing activities	118,000	(566,000)
Net cash provided by all activities	13,854,000	5,813,000
Cash - beginning of year	72,227,000	66,414,000
Cash - end of year	\$ 86,081,000	\$ 72,227,000
<b>Reconciliation of cash on the statement of net position</b>		
Cash	\$ 86,074,000	\$ 72,214,000
Restricted fidelity fund cash	7,000	13,000
Cash at end of year	\$ 86,081,000	\$ 72,227,000

See notes to financial statements.

**TENNESSEE EDUCATION LOTTERY CORPORATION**  
**Statements of Cash Flows (Continued)**  
**For the Years Ended June 30, 2013, and June 30, 2012**

	<b>Year Ended June 30, 2013</b>	<b>Year Ended June 30, 2012</b>
<b>Reconciliation of net operating income to net cash provided by investing activities:</b>		
Operating income	\$ 339,595,000	\$ 323,370,000
Adjustments to reconcile operating income to net cash provided by operating activities		
Bad debt expense	(50,000)	998,000
Depreciation	475,000	495,000
Gain on disposal of capital assets	(32,000)	(50,000)
Changes in assets and liabilities:		
Retailer accounts receivable	(5,070,000)	(7,536,000)
Prepays and other assets	50,000	(684,000)
Accounts payable and accrued liabilities	14,000	914,000
Prize annuity investments	41,000	634,000
Prize annuities payable	2,329,000	-
Prizes payable	3,561,000	4,823,000
Unearned revenues	199,000	(272,000)
Unearned rent	(158,000)	(157,000)
<b>Net cash provided by operating activities</b>	<b>\$ 340,954,000</b>	<b>\$ 322,535,000</b>
<b>Noncash investing activities:</b>		
Increase in fair value of prize annuity investments	\$ 103,000	\$ 141,000

See notes to financial statements.

**TENNESSEE EDUCATION LOTTERY CORPORATION**  
**Notes to the Financial Statements**  
**June 30, 2013, and June 30, 2012**

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**Note 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 (TEL). Pursuant to the Act, TEL was incorporated in the State of Tennessee as a body, politic and corporate, and a quasi-public instrumentality.

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 TEL, title to all TEL property shall vest in the State of Tennessee; and
3. TEL provides financial benefits to the state in the form of deposit payments to the state treasury.

The accompanying financial statements present information only attributable to the transactions of the programs of TEL. 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>.

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

On January 20, 2004, TEL began lottery ticket sales. During the years ended June 30, 2013, and June 30, 2012, TEL's lottery sales included a variety of instant ticket games and drawing-style ticket games: *Cash 3*, *Cash 4*, *Tennessee Cash*, *Powerball*, and *Mega Millions*. On May 12, 2013, *Hot Lotto* was implemented with the multi-state jackpot games.

**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.

**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

## Notes to the Financial Statements (Continued)

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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 drawing-style games is recognized based on the game characteristics. For drawing-style 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 unearned revenue and recognized once the drawing occurs.

Revenues for drawing-style 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 drawing-style 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 Position

Net position represents cumulative revenues, less expenses and required beneficiary program payments, in accordance with the Act (see Notes 6 and 7). Net position includes funds invested in capital assets, restricted net position, and unrestricted net position.

### 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 represent 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 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 or date of last payment are considered doubtful.

## Notes to the Financial Statements (Continued)

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At June 30, 2013, and June 30, 2012, the Allowance for Doubtful Accounts was \$184 thousand and \$236 thousand, respectively.

### Capital Assets

Capital and intangible assets are stated at cost, less accumulated depreciation/amortization. Depreciation/amortization on capital/intangible 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. TEL's general threshold for capitalization is assets valued at \$500 or greater.

### Unearned Revenue

Funds collected from retailers for drawing-style game tickets sold in advance of the drawings are recorded as unearned revenue and recognized as revenue once the related drawing occurs.

### Fidelity Fund

In accordance with Section 4-51-118 (a), *Tennessee Code Annotated*, 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 position. 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, 2013, and June 30, 2012, \$42 thousand and \$36 thousand, respectively, were 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 TEL, subject to deposit to the Lottery for Education Account. As of the years ended June 30, 2013, and June 30, 2012, 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 drawing-style 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 unearned revenue ticket sales, this fee is recorded as a prepaid expense until the related revenue is recognized.

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

## Notes to the Financial Statements (Continued)

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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 \$1,000,000.

TEL will pay a selling bonus of \$5,000 to a retailer who sells a drawing-style winning ticket other than *Powerball* and *Mega Millions* if the prize is equal to or greater than \$1,000,000.

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

<b><u>Drawing-Style Game</u></b>	<b><u>2013</u></b>	<b><u>2012</u></b>
Powerball	\$55,000	\$15,000
Mega Millions	10,000	-
Tennessee Cash	15,000	-
<b><u>Total Retailer Bonuses</u></b>	<b><u>\$80,000</u></b>	<b><u>\$15,000</u></b>

### Contractor Fees

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 drawing-style retailer ticket terminals and associated software. Effective March 3, 2009, 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%, both on the selling price of drawing-style tickets sold and on the instant ticket activations, net of free tickets available as prizes. Additionally, contractual terms include GTECH's agreement to provide, install, and maintain up to 800 instant ticket vending machines for TEL. Accordingly, during fiscal years 2013 and 2012, GTECH was compensated at the rate of 1.24% for all drawing-style and instant ticket game sales.

SGI prints, warehouses, and distributes the instant ticket games to retailers. Effective April 1, 2009, 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, 2013, and June 30, 2012, SGI was compensated at this rate for all instant ticket activations.

### 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*, 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

## Notes to the Financial Statements (Continued)

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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. For *Powerball* and *Mega Millions*, the contributions are held by MUSL in trust for TEL and are paid, at the option of the prize winner, in either a lump sum or 30 annual installments for *Powerball* or 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.

*Hot Lotto* prizes are shared based on contributions made to the prize pool by all member lotteries of the Hot Lotto Group of MUSL. Grand prizes won by Tennessee players are funded from pooled contributions by all participating lottery states. The contributions are held by MUSL in trust for TEL and are paid in cash as a lump sum, with the withholding taxes paid by TEL.

### 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 drawing-style games, are forfeited as unclaimed prizes.

### Budget

Pursuant to the Act, TEL is required to submit an annual proposed operating budget for the next fiscal year to the Tennessee Department of Finance and Administration, the Office of Legislative Budget Analysis, and the Comptroller of the Treasury by June 30. Additionally, by September 1, 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

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, 2013, and June 30, 2012, 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, as well as 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

Advertising costs are expensed when the related advertising takes place.

## **Notes to the Financial Statements (Continued)**

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### **Nonoperating Revenues and Expenses**

Revenues and expenses resulting from activities not directly associated with the sale of lottery tickets are reflected as nonoperating revenues and expenses.

### **Compensated Absences**

Effective November 29, 2004, 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 (see Note 8).

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.

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.

### **Employment Separation**

Corporate officers earn separation pay for each year of employment with TEL. Such expense is accrued in the period it is earned (see Note 8).

### **Note 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, 2013, and June 30, 2012, bank balances of approximately \$4.104 million and \$1.829 million, respectively, were insured by the bank collateral pool.

Additionally, for both fiscal year 2013 and 2012, 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.

TEL also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. TEL's deposits with the LGIP were approximately \$83.0 million and \$70.7 million at June 30, 2013, and June 30, 2012, respectively. The LGIP is part of the State Pooled Investment Fund. The fund is not rated by a nationally recognized statistical rating organization.

## Notes to the Financial Statements (Continued)

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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.

### Note 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.

In accordance with its investment policy, TEL may enter into insurance annuity contracts in order to fund annuity prizes. All life insurance annuity contracts must be issued by companies that 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. 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, 2013, and June 30, 2012. The annuity purchased from Aviva was rated A (Excellent) by A.M. Best as of June 30, 2013, and June 30, 2012.

*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% or more in the securities of a single issuer. Though 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 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, 2013, and June 30, 2012.

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 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 position.

## Notes to the Financial Statements (Continued)

Changes in the fair value of the prize annuity investments are presented as noncurrent prize annuities payable. As of the years ended June 30, 2013, and June 30, 2012, the fair value of the prize annuity investments increased by \$103 thousand and \$141 thousand, respectively.

In August 2004, the *Win for Life* instant ticket game was launched and included three grand prizes in the form of lifetime annuities. These grand prizes guaranteed the winner would 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, TEL purchased one single premium, sum certain lifetime annuity contract for approximately \$739,000, in its name from Aviva, and appointed the respective *Win for Life* prize winner as the beneficiary.

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

The prize structure of the *Millionaire Jumbo Bucks* instant ticket game includes 11 top prizes of \$1 million. Winners can choose the annuity or take a 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. TEL purchased one single premium, sum certain annuity contract for approximately \$634,000 in its name from Met Life, and appointed the respective winner as the beneficiary.

In February 2013, TEL launched the *Win for Life* instant ticket game and included three grand prizes. The grand prizes guaranteed the winners would receive \$156,000 a year for life. As of June 30, 2013, one top prize had been claimed and the winner elected the annuity option. As of June 30, 2013, the annuity is not under contract.

### Note 4. Capital Assets

Capital assets consisted of the following as of June 30, 2013:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	\$ 895,000	\$ -	\$ (12,000)	\$ 883,000
Computer equipment	474,000	20,000	(31,000)	463,000
Vehicles	260,000	2,000	(50,000)	212,000
High mileage vehicles - Vans	1,175,000	323,000	(111,000)	1,387,000
Leasehold improvements	402,000	-	-	402,000
Communication equipment	919,000	1,000	(225,000)	695,000
Software	728,000	19,000	-	747,000
Gaming equipment	604,000	2,000	-	606,000
Total capital assets	5,457,000	367,000	(429,000)	5,395,000

## Notes to the Financial Statements (Continued)

Less accumulated depreciation	(4,356,000)	(475,000)	426,000	(4,405,000)
<b>Total capital assets, net</b>	<b>\$ 1,101,000</b>	<b>\$(108,000)</b>	<b>\$ (3,000)</b>	<b>\$ 990,000</b>

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)
<b>Total capital assets, net</b>	<b>\$ 1,020,000</b>	<b>\$ 91,000</b>	<b>\$ (10,000)</b>	<b>\$ 1,101,000</b>

### Note 5. Operating Leases

TEL's leasing arrangements consist of non-cancelable operating leases for TEL's headquarter and district office space, outdoor advertising billboards, and related equipment. For certain leases, TEL has the option to renew the lease. No options were exercised during the years ended June 30, 2013, and June 30, 2012.

On February 18, 2013, TEL entered into a new non-cancelable operating lease for its headquarters office space. The new lease's term is for 134 months, commencing on March 1, 2014.

The following is a schedule by years of future minimum rental payments under all non-cancelable operating leases with original terms of one year or more:

<u>Year Ending June 30:</u>	<u>2013</u>
2014	\$ 2,042,000
2015	1,315,000
2016	1,634,000
2017	1,451,000
2018	1,433,000
2019 through 2023	7,456,000
2024 through 2025	2,902,000
<b>Total minimum rental payments</b>	<b>\$18,233,000</b>

## Notes to the Financial Statements (Continued)

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TEL subleases office space under non-cancelable operating leases to its major vendors. These subleases expire in 2014.

Future minimum rental payments at June 30, 2013, as presented above, have not been reduced by the minimum sublease rental income of \$135 thousand.

The following is a schedule of future minimum sublease rental income 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>2013</u>
2014	\$135,000
<b>Total minimum sublease payments</b>	<b>\$135,000</b>

Certain operating lease agreements for office space include scheduled increases in rent payments over the term of the lease and inducements to enter into the lease. In accordance with GASB 13, the scheduled increases in rental payments are recognized as rent expense on a straight-line basis over the terms of the leases. In accordance with GASB 62, lessor inducements are recognized as rental expense on a straight-line basis over the term of the lease.

The following schedule presents the composition of total rental expense for all non-cancelable operating leases for the year ended June 30:

	<u>2013</u>	<u>2012</u>
Minimum rentals:		
Office space	\$1,491,000	\$1,480,000
Billboards	1,220,000	1,274,000
Less: Sublease rentals	(203,000)	(203,000)
<b>Total minimum rentals</b>	<b>\$2,508,000</b>	<b>\$2,551,000</b>

### Note 6. Due to Lottery for Education Account

In accordance with the Act, all TEL's net proceeds are due to the Lottery for Education Account. "Net proceeds" are 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 nonoperating.

Net proceeds and operating expenses for the years ended June 30, 2013, and June 30, 2012, are summarized as follows:

## Notes to the Financial Statements (Continued)

	2013	2012
Operating revenues:		
Ticket sales (net)	\$1,367,587,000	\$1,310,205,000
Less tickets provided as prizes	(92,316,000)	(94,350,000)
Net ticket sales	1,275,271,000	1,215,855,000
Fees and other revenue	5,028,000	4,654,000
Total lottery proceeds	1,280,299,000	1,220,509,000
Operating expenses, as defined:		
Gaming	941,907,000	894,011,000
Operating	16,967,000	16,217,000
Total operating expenses, as defined	958,874,000	910,228,000
Net proceeds before distribution of unrestricted net position	321,425,000	310,281,000
Nonoperating revenue and expenses		
Interest income	118,000	68,000
Total nonoperating revenue and expenses	118,000	68,000
Net proceeds	\$ 321,543,000	\$ 310,349,000
Amount due to Lottery for Education Account for year	\$ 321,543,000	\$ 310,349,000
Amount paid during year	(237,045,000)	(233,999,000)
Amount due to Lottery for Education Account, end of year	\$ 84,498,000	\$ 76,350,000

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.

### Note 7. Due to After-School Programs Special Account

In accordance with the Act, at the end of each fiscal year, 100% 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 from drawing-style games 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 are reconciled at the end of the 90-day redemption period.

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

## Notes to the Financial Statements (Continued)

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

For fiscal year 2013, unclaimed prizes were \$18,170,000, which was current and payable to the After-School Programs special account at June 30, 2013.

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.

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.

### **Note 8. Employee Benefits**

#### *A. Deferred Compensation*

Effective September 22, 2003, 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, 2013, and June 30, 2012, employees contributed approximately \$461,000 and \$444,000, respectively, to the 457 Plan.

The aggregate fair value of the plan's assets was approximately \$3,701,000 and \$3,187,000, net of administrative fees, as of June 30, 2013, and June 30, 2012, 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 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. TEL contributed approximately \$674,000 to the 401(a) Plan on behalf of its employees for both the years ended June 30, 2013, and June 30, 2012. Of these contributions, approximately \$15,000 and \$16,000 were forfeited by separated employees, as of June 30, 2013, and June 30, 2012, respectively.

## Notes to the Financial Statements (Continued)

In accordance with the 401(a) Plan, forfeitures of employer contributions may be used to offset plan administrative expenses and/or to reduce future contribution costs. As of the years ended June 30, 2013, and June 30, 2012, forfeited amounts of approximately \$26,000 and \$15,000, 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 457 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 the 401(a) Plan assets are held in aggregate by John Hancock Financial, the plans' custodian.

The aggregate fair value of the plans' assets was approximately \$5,364,000 and \$4,672,000, net of forfeitures and administrative fees, as of June 30, 2013, and June 30, 2012, respectively.

### *C. Compensated Absences*

The current portion of the compensated absence liability, expected to be due within one year of the statement date, June 30, 2013, is estimated using historical trends. At June 30, 2013, and June 30, 2012, the estimated current portion of the compensated absences liability was \$530 thousand and \$535 thousand, respectively.

### *D. Employment Separation*

TEL had \$344 thousand and \$347 thousand accrued for employment separation obligations for each of the years ending June 30, 2013, and June 30, 2012, respectively.

## **Note 9. Non-current Liabilities**

Non-current liabilities consisted of the following as of June 30, 2013:

	<b>Beginning Balance</b>	<b>Increases</b>	<b>Decreases</b>	<b>Ending Balance</b>	<b>Due Within One Year</b>
Prize annuities payable	\$3,033,000	\$2,473,000	\$(144,000)	\$5,362,000	\$352,000
Unearned rent	262,000	58,000	(215,000)	105,000	105,000
<b>Total non-current</b>	<b>\$3,295,000</b>	<b>\$2,531,000</b>	<b>\$(359,000)</b>	<b>\$5,467,000</b>	<b>\$457,000</b>

## Notes to the Financial Statements (Continued)

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
Unearned rent	420,000	-	(158,000)	262,000	61,000
<b>Total non-current</b>	<b>\$2,834,000</b>	<b>\$775,000</b>	<b>\$(314,000)</b>	<b>\$3,295,000</b>	<b>\$205,000</b>

### Note 10. Risk Management

Effective July 31, 2005, 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 TEL based on a percentage of 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, TEL maintains insurance from various other providers. At June 30, 2013, additional insurance coverage was provided at the following maximum amounts:

<u>Coverage</u>	<u>2013</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, TEL has filed insurance claims with both the risk pool and the commercial insurers. None of the related settlements exceeded the provided insurance coverage.

### Note 11. Commitments and Contingencies

*Legal.* 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 TEL's financial position or cash flows. Furthermore, as of the year ended June 30, 2013, management is not aware of any related liabilities.

## Notes to the Financial Statements (Continued)

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### **Note 12. Accounting Change**

TEL implemented the Governmental Accounting Standards Board's Statement 63, *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*, during the year ended June 30, 2013. The effect on the financials was related to renaming the deferral line items and referring to net position, rather than net assets, within the 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

**Independent Auditor's 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***

The Honorable Bill Haslam, Governor  
Members of the General Assembly  
Board of Directors, Tennessee Education Lottery Corporation

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, 2013, and the related notes to the financial statements, which collectively comprise the Tennessee Education Lottery's basic financial statements, and have issued our report thereon dated November 22, 2013. 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 of the financial statements, we considered the Tennessee Education Lottery Corporation's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances 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 Tennessee Education Lottery Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Tennessee Education Lottery Corporation's internal control.

*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 entity's financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did

not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

### **Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Tennessee Education Lottery Corporation's financial statements are free from 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 *Government Auditing Standards*.

### **Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.



Deborah V. Loveless, CPA  
Director  
November 22, 2013