06 - 0622

Financial statements of

Minnesota State Lottery

Years ended
June 30, 2006 and 2005

SCHECHTER
DOKKEN
KANTER
CERTIFIED PUBLIC ACCOUNTANTS • ADVISORS

INDEPENDENT AUDITOR'S REPORT

The Director
Minnesota State Lottery
Roseville, Minnesota

We have audited the accompanying balance sheets of the Minnesota State Lottery as of June 30, 2006 and 2005, and the related statements of revenues, expenses and changes in net assets and cash flows for the years then ended. These financial statements are the responsibility of the Minnesota State Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Minnesota State Lottery as of June 30, 2006 and 2005, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 18, 2006, on our consideration of the Minnesota State Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

The Management's Discussion and Analysis on pages 2 through 6 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of supplementary information. However, we did not audit the information and express no opinion on it.

Schechter Dokken Kanter
Andrews + Selcer Ltd

August 18, 2006

Schechter Dokken Kanter
Andrews & Selcer Ltd
Suite 1600
100 Washington Avenue South
Minneapolis, MN
55401•2192
Phone 612•332•5500
Fax 612•332•1529
E-mail info@sdkcpa.com
www.sdkcpa.com

MINNESOTA STATE LOTTERY
MANAGEMENT DISCUSSION AND ANALYSIS

Overview of the Financial Statements

This discussion and analysis includes an overview of financial activities regarding the financial performance of the Minnesota State Lottery for the fiscal year ended June 30, 2006 and should be read in conjunction with the transmittal letter and supplementary information included in this report. This report consists of three parts: management's discussion and analysis, the basic financial statements, and the notes to the financial statements. Included below and on the following pages are the financial highlights, summary of contributions to the state, summary results of operations for years ended June 30, 2006, 2005 and 2004, and a condensed version of the Balance Sheets as of June 30, 2006, 2005 and 2004.

Financial Highlights

The Minnesota State Lottery had record sales in fiscal year 2006. Total sales of $450 million surpassed the previous record of $408 million set in fiscal year 2005. Record sales in conjunction with continued control of operating costs resulted in a second consecutive fiscal year of record contributions to the state.

Summary of Contributions to State

The Lottery contributed $121 million to the state in fiscal year 2006. This was an increase of 14.4 percent compared to $106 million in fiscal year 2005. Fiscal year 2005 contributions were up 5.4 percent from the $101 million contributed in fiscal year 2004. The following table provides detail on the source of the transfers provided to the state in the last three fiscal years.

Contributions to State

	2006	**2005**	**2004**
Net proceeds to the State	$81,232,065	$69,982,049	$66,703,798
In-lieu-of-sales tax	29,231,193	26,520,677	25,149,720
Compulsive gambling contribution	1,821,000	1,896,000	1,896,000
Unclaimed prizes to the State	7,008,290	7,777,552	6,960,534
Unclaimed prizes – Held in Trust	2,186,831		
Total paid to State	$121,479,379	$106,176,278	$100,710,052

Since its inception in 1990, the Lottery has contributed over $1.4 billion to the state.

Beneficiary Contributions

Total Paid to State Since Inception (1990 to 2006)	
Total to General Fund	$868,407,150
Total to Environment and Natural Resources Trust Fund	$399,013,659
Total to Game and Fish Fund	$61,453,477
Total to Natural Resources Fund	$61,453,477
Total Other	$38,418,031
Total Paid to State	$1,428,745,794

Note: Compulsive Gambling contribution is included in the General Fund.

Summary Results of Operations

Summary Results of Operation

	2006	**2005**	**2004**
Gross revenue	$ 420,529,452	$ 381,492,484	$ 361,786,100
Prizes, commissions and ticket costs	309,247,591	279,999,954	263,516,574
Gross profit	111,281,861	101,492,530	98,269,526
Operating expenses	22,782,406	22,571,484	23,170,227
Operating income	88,499,455	78,921,046	75,099,299
Non-operating revenues (expense):			
Interest earned on investments	1,366,853	734,555	461,033
Unused Compulsive Gambling Contribution	195,047		
Payments to State (not including sales tax)	(90,061,355)	(79,655,601)	(75,560,332)
Total non-operating revenue (expense)	(88,499,455)	(78,921,046)	(75,099,299)
Net Income	$0	$0	$0

Operating Income:

Operating income increased $9.6 million or 12.1 percent in fiscal year 2006 over fiscal year 2005. The increase in operating income was primarily due to a 10.2 percent increase in gross revenue combined with only a slight increase in operating expenses of .9 percent. Fiscal year 2005 operating income increased $3.8 million or 5.1 percent over fiscal year 2004. This was primarily due to a 5.5 percent increase in gross revenue coupled with a 2.6 percent decrease in operating expenses.

Operating Expenses:

Fiscal year 2006 operating expense was $22.8 million or 5.4 percent of gross revenue. Operating expense as a percent of gross revenue decreased from 5.9 percent in fiscal year 2005 to 5.4 percent in fiscal year 2006. A greater emphasis on budget control as well as improved efficiency has contributed to this decrease. Operating expense was $22.6 million or 5.9 percent of gross revenue in fiscal year 2005. Actual operating expenses decreased 2.6 percent in fiscal year 2005 over fiscal year 2004. The fiscal year 2005 reduction of operating expenses was mainly due to significant changes in Lottery operations including staff reductions.

Gross Revenue by Game

	2006	2005	2004
Scratch ticket sales	$267,793,640	$253,425,269	$215,696,083
Online ticket sales:			
Daily 3®	12,958,518	13,134,177	13,250,961
Gopher 5™	23,751,551	14,531,607	18,333,018
Powerball®	112,184,974	89,562,348	114,291,526
Power Play®	4,393,871	2,945,483	3,233,759
Hot Lotto®	10,823,419	16,274,511	10,421,797
Northstar Cash®	9,585,521	9,373,889	6,268,682
G 3®	8,219,169	8,763,134	5,422,945
Operating revenue	449,710,663	408,010,418	386,918,771
Other income	49,982	2,743	17,049
Total operating revenue	449,760,645	408,013,161	386,935,820
Less in-lieu-of-sales tax	29,231,193	26,520,677	25,149,720
Gross revenue	$420,529,452	$381,492,484	$361,786,100

Scratch Games:
Scratch Game sales were 59.5 percent of total sales in fiscal year 2006. Scratch sales increased $14.4 million or 5.7 percent from fiscal year 2005 to $267.8 million. The Lottery implemented two major new initiatives which contributed to the increase in scratch sales: Instant Ticket Vending Machines (ITVMs) were introduced into supermarkets and non-traditional retailers and additional 20-bin Scratch dispensers were placed in many retailer locations. ITVM sales were $3.8 million in fiscal year 2006.

Scratch Game sales were 62.1 percent of total sales in fiscal year 2005. Scratch sales increased 17.5 percent over fiscal year 2004. This was due in part to the lower than average Powerball® and Gopher 5™ jackpots which generated larger sales for other games.

Online Games:
Online Games sales were 40.5 percent of total sales in fiscal year 2006. Online sales increased $27.3 million or 17.7 percent to $181.9 million from fiscal year 2005. The increase in Online sales was mainly due to the large number of high Powerball® jackpots; including two record jackpots of $340 million in October 2005 and $365 million in February 2006. The higher jackpots were the result of the change to the game matrix for Powerball®. Powerball® and Power Play® sales increased

25.3 percent and 49.2 percent respectively in fiscal year 2006. Gopher 5™ also experienced a matrix change which improved the odds of winning a prize, while increasing average jackpots. Gopher 5™ sales increased 63.4 percent in fiscal year 2006. Northstar Cash® saw a slight increase of 2.3 percent and Daily 3®, Hot Lotto®, and G3® Games all experienced sales decreases.

Online Game sales were 37.9 percent of total sales in fiscal year 2005. Many of the historically lower volume online games, such as Hot Lotto®, Northstar Cash®, and G3®, experienced sales increases. Powerball® & Gopher 5™ recorded unusually low jackpots and decreased sales. G3® games were introduced in fiscal year 2004 and experienced the largest increase of all the online games in fiscal year 2005. G3® games sales increased 61.6 percent from fiscal year 2004; however, G3® Games were sold for only a partial year (five months) in fiscal year 2004.

Balance Sheet Summary

Condensed Balance Sheet

	2006	2005	2004
Assets:			
Cash and cash equivalents	$ 15,494,128	$ 19,081,645	$ 17,134,901
Receivables	3,151,896	2,003,947	6,222,444
Capital assets & other assets	2,343,129	2,265,693	2,144,098
Total Assets	$ 20,989,153	$ 23,351,285	$ 25,501,443
Liabilities and fund equity:			
Due to State and State Agencies	$ 10,605,584	$ 11,476,341	$ 10,642,463
Accounts payable & accrued expenses	3,972,440	5,269,379	4,372,031
Current accrued prizes & prize annuity liabilities	6,411,129	6,605,565	10,486,949
Unrestricted Net Assets	$ (1,089,022)	$ (1,095,925)	$ (933,703)
Net Assets Invested in Capital Assets	1,089,022	1,095,925	933,703
Net Assets	0	0	0
Total Liabilities	$ 20,989,153	$ 23,351,285	$ 25,501,443

The Lottery is required to advance net proceeds to the state of Minnesota and therefore, fund equity remains unchanged from year to year. In general, short term assets and liabilities will fluctuate with the activity of games being played.

Cash and cash equivalents:

The fiscal year 2006 decrease of $3.6 million was due to an increase in receivables of $1.2 million and reduction in liabilities of $2.4 million. In fiscal year 2005 there was a $1.9 million increase due to a reduction in receivables of $4.2 million and the reduction in liabilities of $2.2 million.

Receivables:
Receivables increased in fiscal year 2006 by $1.2 million this was due mainly to a timing difference between the days of the week the period ended for fiscal year 2006 versus the day of the week the period ended for fiscal year 2005. Receivables accrued for four days at the end of fiscal year 2006 versus three days at the end of fiscal year 2005. In fiscal year 2005, the decrease of $4.2 million was due mainly to a timing difference of nine days versus three days at the end of the period.

Capital assets and other assets:
Additions to capital assets of $362 thousand in fiscal year 2006 resulted from purchases of vehicles, computer software and office equipment. Additions to capital assets in fiscal year 2005 were $560 thousand mainly consisting of computer hardware, software and vehicles. Retirements of capital assets in fiscal year 2006 were $493 thousand consisting mainly of computer equipment and vehicles. Net of depreciation, total retirements were less than $1 thousand. Retirements of capital assets in fiscal year 2005 were $428 thousand again consisting mainly of computer equipment and vehicles. Net of depreciation, total retirements were less than $9 thousand.

Other assets increased by $84 thousand in fiscal year 2006 due to increase in ticket inventory of $492 thousand offset by reduction in pre-paid expenses of $408 thousand. Other assets decreased by $33 thousand in fiscal year 2005 due to reduction in ticket inventory of $306 thousand and increase in prepaid expenses of $273 thousand.

Due to State and State Agencies:
The fiscal year 2006 decrease of $871 thousand over fiscal year 2005 was mainly due to a decrease in unclaimed prizes money due to the state. The fiscal year 2005 increase of $834 thousand from fiscal year 2004 was due mainly to the increase of unclaimed prize money due to the state.

Accounts payable & accrued expenses and current accrued prizes and prize annuity liabilities:
A decrease of $1.5 million for fiscal year 2006 over fiscal year 2005 was mainly due to a reduction in amounts owed to vendors. The vendors include the advertising agency in the amount of $.7 million and ticket and online game vendors in the amount of $.6 million which was not owed at the end of fiscal year 2005. The fiscal year 2005 decrease of approximately $3 million over fiscal year 2004 was mainly due to the reduction in the prize liability outstanding on Scratch tickets.

MINNESOTA STATE LOTTERY
BALANCE SHEETS
JUNE 30, 2006 and 2005

ASSETS:	2006	2005
Current Assets:		
Cash and Cash Equivalents (Note 3)	$ 15,494,128	$ 19,081,645
Accounts Receivable	3,151,896	2,003,947
Scratch Ticket Inventory	874,191	381,454
Prepaid Expense	379,916	788,314
Total Current Assets	19,900,131	22,255,360
Capital Assets, Net (Note 5)	1,089,022	1,095,925
Total Assets	$ 20,989,153	$ 23,351,285
LIABILITIES AND NET ASSETS:		
Current Liabilities:		
Net Proceeds Due to State (Note 8)	$ 3,551,674	$ 3,680,395
Unclaimed Prizes Due to State (Note 6)	7,008,290	7,777,552
Due to Other State Agencies	45,620	18,394
Accounts Payable	2,150,136	3,730,960
In-Lieu-of-Sales Tax Payable	162,525	0
Prize Liability	6,411,129	6,605,565
Compensated Absences Payable, current (Note 7)	607,005	615,379
Deferred Revenue	563,319	390,485
Total Current Liabilities	20,499,698	22,818,730
Compensated absences payable, net of current portion (Note 7)	489,455	532,555
Commitments and Contingencies (Note 9 and 10)		
Net Assets:		
Unrestricted Net Assets	(1,089,022)	(1,095,925)
Net Assets Invested in Capital Assets (Note 8)	1,089,022	1,095,925
Total Net Assets	0	0
Total Liabilities and Net Assets	$ 20,989,153	$ 23,351,285

See Accompanying Notes to Financial Statements

MINNESOTA STATE LOTTERY
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEARS ENDED JUNE 30, 2006 and 2005

	2006	2005
Operating Revenues:		
Scratch Ticket Sales	$ 267,793,640	$ 253,425,269
Online Ticket Sales	181,917,023	154,585,149
Other Income	49,982	2,743
Total Operating Revenues	449,760,645	408,013,161
Less: In-Lieu-of-Sales Tax	29,231,193	26,520,677
Gross Revenue	420,529,452	381,492,484
Direct Costs:		
Scratch Ticket Prizes	177,592,560	166,740,541
Online Ticket Prizes	90,204,335	74,553,796
Online Vendor Expense	11,121,657	9,447,919
Ticket Costs	3,038,105	4,287,651
Retailer Commissions and Incentives (Note 11)	27,290,934	24,970,047
Total Direct Costs	309,247,591	279,999,954
Gross Profit	111,281,861	101,492,530
Operating Expenses: (Note 12)		
Advertising (Note 12)	6,090,612	4,701,021
Salaries and Benefits (Note 13)	9,944,117	10,080,101
Promotion	1,478,677	2,364,686
Purchased Services	1,214,638	1,027,980
Communication	407,169	441,433
Occupancy Costs (Note 9)	1,777,911	1,760,919
Supplies and Materials	788,147	1,086,508
Computer and Omnipoint Maintenance	235,839	212,122
Depreciation	367,759	388,719
Other Expense	477,537	507,995
Total Operating Expenses	22,782,406	22,571,484
Operating Income	88,499,455	78,921,046
Nonoperating Revenue (Expense)		
Interest Earned on Investments	1,366,853	734,555
Unused Compulsive Gambling Contribution	195,047	-
Payments to State:		
Compulsive Gambling Contribution from Prize Fund (Note 10)	(1,821,000)	(1,896,000)
Unclaimed Prizes to State (Note 6)	(7,008,290)	(7,777,552)
Net Proceeds to State (Note 8)	(81,232,065)	(69,982,049)
Total Nonoperating Revenue (Expense)	(88,499,455)	(78,921,046)
Net Income	0	0
Net Assets at Beginning of Year (Note 8)	0	0
Net Assets at End of Year (Note 8)	$ 0	$ 0

See Accompanying Notes to Financial Statements

MINNESOTA STATE LOTTERY
STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2006 and 2005

	2006	2005
Cash Flows from Operating Activities:		
Cash Received from Customers	$ 448,785,530	$ 412,415,625
Cash Received from Other Income	88,801	99,936
Payments to State (In-Lieu-of-Sales Tax)	(29,068,668)	(26,536,677)
Payments to Employees	(9,995,591)	(9,840,379)
Payments to Suppliers	(28,294,074)	(25,299,744)
Payments to Retailers	(27,379,734)	(25,067,240)
Payments to Prize Winners	(267,991,330)	(245,175,720)
Net Cash Provided by Operating Activities	86,144,934	80,595,801
Cash Flows from Non-Capital Financing Activities:		
Net Proceeds Paid to State	(81,360,786)	(69,967,475)
Compulsive Gambling Contribution Transfer	(1,821,000)	(1,896,000)
Compulsive Gambling Contribution Returned	195,047	0
Unclaimed Prizes Transfer	(7,777,552)	(6,960,534)
Net Cash Used by Non-Capital Financing Activities	(90,764,291)	(78,824,009)
Cash Flows from Capital and Related Financing Activities:		
Purchases of Capital Assets	(361,629)	(559,603)
Proceeds from sale of Capital Assets	26,617	0
Net Cash Used by Capital Financing Activities	(335,012)	(559,603)
Cash Flows from Investing Activities:		
Investment Income	1,366,852	734,555
Net Cash Provided by Investing Activities	1,366,852	734,555
Net (Decrease) Increase in Cash and Cash Equivalents	(3,587,517)	1,946,744
Beginning of Year Cash and Cash Equivalents	19,081,645	17,134,901
End of Year Cash and Cash Equivalents	$ 15,494,128	$ 19,081,645
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating Income	$ 88,499,455	$ 78,921,046
Adjustments to Reconcile Operating Income to Net Cash provided by Operating Activities:		
Depreciation	367,759	388,719
(Gain) loss on the disposal of capital assets	(25,843)	8,662
Net Change in Assets and Liabilities:		
Inventory	(492,737)	313,619
Other Assets	(739,551)	3,945,505
Current Liabilities	(1,269,713)	899,633
Prize Awards Payable	(194,436)	(3,881,383)
Net Cash Provided by Operating Activities	$ 86,144,934	$ 80,595,801

See Accompanying Notes to Financial Statements

1. ORGANIZATION OF THE MINNESOTA STATE LOTTERY

In 1988, Minnesotans voted to amend their Constitution to authorize a state-run lottery. In 1989, the Legislature approved and the Governor signed Minnesota Statutes Chapter 349A into law, officially creating the Minnesota State Lottery, the 33rd lottery in the country.

The Minnesota State Lottery (the Lottery), an enterprise fund of the State of Minnesota, is under the supervision and control of the Director of the Lottery, who is appointed by the Governor with the advice and consent of the Senate. The Lottery net proceeds and proceeds from the in-lieu-of-sales tax on tickets sales are dedicated to the General Fund, the Environment and Natural Resources Trust Fund, the Game and Fish Fund, and the Natural Resources Fund. The funds are used to enhance the state's natural resources as well as public education, local government assistance, and public safety.

Lottery revenue is generated by sales of Scratch Games and Online Games that include: Daily 3®, Northstar Cash®, G3®, Gopher 5™, Powerball®, Power Play®, and Hot Lotto®.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Lottery is an agency of the State of Minnesota using proprietary type enterprise accounting. The financial statements are prepared in accordance with generally accepted accounting principles as applicable to governmental units. Following are the more significant accounting policies:

(a) Basis of Accounting

The financial statements of the Lottery have been prepared on the accrual basis of accounting. Revenues are recorded when they are earned and expenses are recognized as incurred.

Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting,* provides that proprietary and similar trust funds should apply all GASB pronouncements, as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB Pronouncements: Statements and Interpretations of the Financial Accounting Standards Board (FASB), Accounting Principles Board Opinions (APB), and Accounting Research Bulletins (ARB). As permitted by GASB Statement No. 20, the Lottery has elected not to apply FASB statements or interpretations issued on or after November 30, 1989, unless the GASB specifically adopts such statements or interpretations.

(b) Accounting Standard: GASB No. 34

In June 1999, the Governmental Accounting Standards Board (GASB) issued Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments.* This Statement established updated financial reporting requirements for state and local governments. This statement also requires budgetary comparison schedules to be presented as supplementary information. The Lottery is not legally required to adopt a budget and therefore budgetary comparison schedules are not included as supplementary information.

(c) Measurement Focus

A proprietary fund is accounted for using the "economic resources" measurement focus. This means that all assets and liabilities associated with its activity are included on its balance sheet. The proprietary fund type operating statement presents increases (revenues) and decreases (expenses) in net total assets.

(d) Operating Revenue and Expenses

Operating revenue and expenses for proprietary fund such as the Lottery are revenues and expenses that result from providing services and producing and delivering goods and/or services. Operating revenues are derived from providing various types of games. Operating expenses include commissions, prize costs, other direct costs of providing lottery games, and administrative expenses.

Packs of Scratch tickets are distributed to retail sales outlets. Scratch ticket sales are recognized as operating revenue upon settlement of ticket packs by retailers and are recorded at the sale price to the consumer. Sales of Online tickets are recognized as operating revenue on the date of the draw for which the tickets were purchased. Revenues from future Online ticket draw sales are deferred until the date of the draw for which the tickets were purchased.

(e) Cash and Cash Equivalents

Cash and cash equivalents include an amount in demand deposits as well as funds held in the State Treasury and invested by the State Board of Investment.

(f) Prizes and Reserves

Scratch ticket prize expense is recognized in accordance with the predetermined prize structure for each game and is accrued when revenue is recognized. High tier prizes for certain Scratch ticket games may also be structured and paid as an annuity.

Prize expense for Daily 3® is recorded based upon the actual winners on the date of the draw. Prize expense for G3® games are based on actual winners and are recorded at the time of sale. The prize expense for Northstar Cash® is recorded at 50 percent of draw sales. The prize expense for Gopher 5™ is recorded at 54 percent of draw sales, prior to September 23, 2005 it was recorded at 57 percent of draw sales. An additional 2 percent of Gopher 5™ sales, up to $1 million, is expensed to provide a reserve for guaranteed grand prize amounts.

Included in the Lottery Prize Liability for fiscal year 2006 is a $156,118 prize reserve which reflects funds due to the State Treasury that have been set aside in the Lottery prize fund by the Director in accordance with Minnesota Statutes, Section 349A.10, subdivision 2(b) to assure proper funding for future lottery prizes. The prize reserve for fiscal year 2005 was zero.

Prize expenses for Powerball®, Power Play®, and Hot Lotto® are recorded at 50 percent of draw sales in accordance with the Multi-State Lottery Association (MUSL) prize structure. The Powerball®, Power Play®, and Hot Lotto® prizes are paid with funds held by MUSL. MUSL has established separate prize pool reserves for Powerball®, Power Play®, and Hot Lotto® to support payment of prizes in light of the remote possibility of claims greatly exceeding the expected amounts. In the event that the Lottery ceases to participate in one of these games, the Lottery may make claim to assets, if any, in the related prize pool reserve. The Lottery's share of these prize reserves as of June 30, 2006 was as follows:

Powerball®	$ 5,038,000
Hot Lotto®	538,725
	$ 5,576,725

These reserves held by MUSL are not included in these financial statements.

(g) Scratch Ticket Inventory

Scratch ticket inventories are carried at cost using the specific identification method. Tickets are charged to operating expense over the estimated life of each Scratch game.

(h) Capital Assets

Assets costing five thousand dollars or more are capitalized and are carried at cost less accumulated depreciation. Depreciation is computed on the straight-line method using estimated useful lives from three to seven years. Computer equipment, PCs and printers, and software costs are depreciated over three years. Vehicles, other than the warehouse truck, are depreciated over four years. Office equipment, Online draw equipment and signs are depreciated over five years. Office furniture and the warehouse truck and equipment are depreciated over seven years. Leasehold improvements are depreciated on a straight-line basis over the shorter of the useful life or length of the lease. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is recognized.

(i) In-Lieu-of-Sales Tax

From every dollar in Lottery sales, the Lottery sets aside six and one-half cents as in-lieu-of-sales tax and remits that amount monthly to the Commissioner of Revenue as required by Minnesota Statutes, Section 297A.259. Minnesota Laws 2003, Chapter 128, Article 1, Section 154, provides that for FY04 and thereafter, 27.57% of the in-lieu-of-sales-tax is credited to the General Fund and the remaining 72.43% is credited equally between the Game and Fish Fund and the Natural Resources Fund to be used for natural resources projects as specified by law.

(j) Income Taxes

The Lottery, as an agency of the State of Minnesota, is exempt from federal and state income taxes. Accordingly, the Lottery makes no provision for income taxes.

(k) Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure 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.

(l) Reclassifications

Certain reclassifications have been made to the 2005 financial statements to conform to the 2006 presentation.

3. CASH AND CASH EQUIVALENTS

Minnesota Statutes, Section 349A.10, subdivision 7(a), requires the Lottery transfer all funds to a Lottery cash flow account in the State Treasury. Funds necessary to cover cash needs are transferred as needed from State Treasury to the Lottery fund. Funds in this account earn interest, which is credited monthly to the Lottery's account. Cash on deposits in the State Treasury and with financial institutions are insured. Cash on deposit is covered up to $100,000 per institution by the federal depository insurance corporation. At times, cash balances may be in excess of the FDIC insurance limit. As a result, the financial institutions are required to pledge collateral to the Lottery in an amount equal to the funds in excess of the FDIC insurance limit. At June 30, 2006, the market value of the pledged collateral was $10,894,000.

The following table summarizes the Lottery's cash and cash equivalents at June 30, 2006 and 2005:

	2006	2005
Cash (checks issued but not yet presented for payment)	$ (1,283,422)	$ (450,518)
Cash on Deposit	16,777,550	19,532,163
Total Cash and Cash Equivalents	$15,494,128	$19,081,645

Available cash in the State Treasury is invested by the State Board of Investment. In accordance with Minnesota Statutes, Section 11A.24, the State Board of Investment must invest in obligations and stocks of U.S. and Canadian governments, their agencies and their registered corporations, short-term obligations of specified high quality, restricted participation as a limited partner in venture capital, real estate, or resource equity investments, and restricted participation in registered mutual funds. Lottery funds on deposit in the State Treasury cannot be tied to specific investment securities.

4. PRIZE ANNUITY INVESTMENTS AND PAYABLES

The prize structure of certain Scratch Games, operated solely by the Lottery, included prizes in the form of lifetime annuities. Since 1991, the Lottery has awarded sixteen Scratch Game annuity prizes.

In fiscal year 2004, the Lottery sold the investments used to fund these prizes, and it purchased lifetime annuities in each winner's name from Principal Financial Group to satisfy its obligation related to the lifetime annuity prizes. Although Principal is responsible for paying the annuities, the Lottery could ultimately be responsible in the event of default by Principal (see Note 9).

5. CAPITAL ASSETS

Summary of changes in capital assets for the years ended June 30, 2006 and 2005 are as follows:

2006

	01-Jul-05	Additions	Deletions	30-Jun-06
Depreciable Capital Assets:				
Office Equipment & Furniture	$ 2,312,094	$ 73,557	$ (1,135)	$ 2,384,516
PC & Printer Equipment	1,184,547		(268,258)	916,289
Software Costs	-	59,965		59,965
Leasehold Improvements	1,634,348		(5,089)	1,629,259
Vehicles	1,028,726	218,282	(205,697)	1,041,311
Computer Equipment	1,455,535	9,825	(12,634)	1,452,726
Online Drawing Equipment	694,498			694,498
Signs	196,691			196,691
Warehouse Equipment	201,775			201,775
Total	8,708,214	361,629	(492,813)	8,577,030
Less - accumulated depreciation:				
Office Equipment & Furniture	(2,150,691)	(66,165)	1,135	(2,215,721)
PC & Printer Equipment	(1,176,505)	(8,042)	268,258	(916,289)
Software Costs	-	(3,331)		(3,331)
Leasehold Improvements	(1,536,426)	(29,187)	4,316	(1,561,297)
Vehicles	(860,582)	(55,703)	205,697	(710,588)
Computer Equipment	(1,107,356)	(98,883)	12,634	(1,193,605)
Online Drawing Equipment	(426,893)	(98,195)		(525,088)
Signs	(196,691)			(196,691)
Warehouse Equipment	(157,145)	(8,253)		(165,398)
Total accumulated depreciation	(7,612,289)	(367,759)	492,040	(7,488,008)
Net Capital Assets	$ 1,095,925	$ (6,130)	$ (773)	$ 1,089,022

2005	1-Jul-04	Additions	Deletions	30-Jun-05
Depreciable Capital Assets:				
Office Equipment & Furniture	$2,236,137	$92,085	(16,128)	$2,312,094
PC & Printer Equipment	1,398,388		(213,841)	1,184,547
Leasehold Improvements	1,670,407		(36,059)	1,634,348
Vehicles	979,579	170,081	(120,934)	1,028,726
Computer Equipment	1,184,463	312,278	(41,206)	1,455,535
Online Drawing Equipment	694,498			694,498
Signs	196,691			196,691
Warehouse Equipment	201,775			201,775
To Be Placed in Service	14,841	(14,841)		-
Total	$8,576,779	$559,603	(428,168)	$8,708,214
Less - accumulated depreciation:				
Office Equipment & Furniture	(2,080,822)	(85,997)	16,128	(2,150,691)
PC & Printer Equipment	(1,350,582)	(39,486)	213,563	(1,176,505)
Leasehold Improvements	(1,529,689)	(34,412)	27,675	(1,536,426)
Vehicles	(935,777)	(45,739)	120,934	(860,582)
Computer Equipment	(1,072,046)	(76,516)	41,206	(1,107,356)
Online Drawing Equipment	(328,698)	(98,195)		(426,893)
Signs	(196,570)	(121)		(196,691)
Warehouse Equipment	(148,892)	(8,253)		(157,145)
Total accumulated depreciation	(7,643,076)	(388,719)	419,506	(7,612,289)
Net Capital Assets	$ 933,703	$ 170,884	$ (8,662)	$ 1,095,925

6. UNCLAIMED PRIZES

Effective July 1, 2003 pursuant to Minnesota Laws 2003, 1st Special Session, Chapter 1, Article 2, Section 101, all unclaimed prizes will be transferred to the General Fund at the end of the fiscal year. The unclaimed prizes due to the State are $7,008,290 and $7,777,552 on June 30, 2006 and 2005, respectively.

7. COMPENSATED ABSENCES

A liability is recognized for unpaid vacation, compensatory hours, vested severance and anticipated severance pay when earned. Non-vested severance pay is estimated based upon historical trends and current demographics.

	Beginning	Additions	Retirements	Ending
Compensated absences:				
2006	$ 1,147,934	$ 912,270	$ (963,744)	$ 1,096,460
2005	908,212	1,169,021	(929,299)	1,147,934

The current portions of compensated absences are $607,005 and $615,379, respectively, for fiscal years 2006 and 2005.

8. NET ASSETS

Within 30 days after the end of each month the Lottery is required by Minnesota Statutes, Section 349A.10, subdivision 5 to deposit the net proceeds in the State Treasury. The monthly transfer of net proceeds leaves a zero balance in Net Assets. The amount to be paid for the month ended June 30, 2006 and 2005 were $3,551,674 and $3,680,395, respectively, shown as Net Proceeds Due to State on the accompanying balance sheets. Net assets invested in capital assets consist of capital assets, net of accumulated depreciation.

9. COMMITMENTS AND CONTINGENCIES

(a) Risk Management

The Lottery is exposed to various risks of loss related to torts, theft, damage to and destruction of assets, errors and omissions, injuries to employees, and natural disasters.

The Lottery participates in the State's Risk Management Fund for property, liability, crime and automobile insurance coverage. The Lottery pays annual premiums for this coverage. The State's Risk Management Fund covers all claims above the deductible. The Lottery has not experienced any settlements in excess of coverage in the past three years.

The areas of insurance coverage, limits and deductibles as of June 30, 2006 are as follows:

Coverage	Limits	Deductible
Property	$ 3,973,994	$ 1,000
Auto		
Bodily Injury & Property Damage	$300,000/$1,000,000	$ 500
Primary Crime		
Employee Dishonesty, Money & Securities	$ 25,000	$ 1,000
General Liability	$300,000/$1,000,000	None
Excess Crime		
Employee Dishonesty	$ 1,000,000	$ 25,000
Forgery or Alteration	$ 1,000,000	$ 500
Computer Fraud	$ 1,000,000	$ 5,000
Wire Transfer	$ 1,000,000	$ 5,000
Robbery and Safe Burglary	$ 50,000	$ 100

The Lottery also participates in the State's workers' compensation coverage.
The State is a member of the Workers' Compensation Reinsurance Association that pays for workers' compensation claims in excess of $450,000. The Lottery is responsible for all workers' compensation claims below $450,000. The Lottery accrues for workers' compensation claims when it is probable that a loss has occurred and the amount can be reasonably estimated. The Lottery does not have a workers' compensation accrual as of June 30, 2006 or 2005.

The Lottery purchased sixteen lifetime annuities from Principal Financial Group. If Principal Financial Group were to default on those obligations these policies would be covered under a "Guaranty Fund Law" which is administered by the State of Minnesota. The amount guaranteed per annuity is $300,000. The Lottery may be ultimately responsible for the lifetime annuities, however management feels that the possibility of Principal Financial Group defaulting on its obligations in a material sum in excess of the $300,000 guaranteed by the State is remote.

(b) Operating Leases

The Lottery is committed under various leases for building and office space. The leases are classified as operating leases for accounting purposes. For the years ended June 30, 2006 and 2005, the lease expense was $1,223,648 and $1,333,693, respectively. This is net of sublease rental income of $109,024 in fiscal year 2006. Sublease rental income is included within occupancy costs on the financial statements. Future minimum lease payments for existing lease agreements are:

Year Ending June 30	Amount	Sub-lease Amount	Net
2007	$1,357,571	$ 346,555	$1,011,016
2008	1,302,883	349,553	953,330
2009	1,338,563	352,667	985,896
2010	1,358,895	350,216	1,008,679
2011	1,347,975	218,780	1,129,195
2012	1,144,214		1,144,214
2013	1,070,950		1,070,950
Total	$8,921,051	$1,617,771	$7,303,280

(c) Sales Tax Contingency

The Lottery was subject to a sales and use tax audit in fiscal year 2006 for the period July 1, 2002 to June 30, 2005. The Lottery is currently appealing an assessed tax liability of $734,879 with the Department of Revenue and management believes it is likely that the assessment will be overturned. Accordingly, the financial statements do not reflect this amount as an amount due for sales tax assessment. If the assessment is not overturned, the effect on the financial statements would be to increase Scratch Ticket Expense by $734,879 and decrease Net Proceeds to State by the same amount. Because the sales tax is also payable to the State there is no change in the total amount the Lottery submits to the State. However, it would result in a reallocation of Lottery proceeds between State funds, most likely increasing the amount going to the General fund. There is approximately $198,000 of sales tax related to the period from July 1, 2005 to August 30, 2006 that may also be payable to the State if the Lottery does not win its appeal.

10. COMPULSIVE GAMBLING TREATMENT CONTRIBUTION PROVIDED FROM PRIZE FUND

Minnesota Laws 1998, Chapter 407, Article 8, Section 11 directed the Lottery to pay $340,000 annually from the prize fund to a special Indian Gaming account in the State Treasury. Funds in this account are transferred to the Department of Human Services for compulsive gambling treatment programs.

Minnesota Laws 2003, 1st Special Session, Chapter 14 Article 9, Section 2, subdivisions 8(e) and 9 appropriated $1,556,000 in fiscal year 2004 and 2005 from the prize fund to the Department of Human Services for statewide compulsive gambling treatment programs.

Minnesota Laws 2005, 1st Special Session, Chapter 4, Article 9, section 2, subdivisions 8(e) and 9 appropriated $1,456,000 in fiscal year 2006 and 2007 from the prize fund to the Department of Human Services for statewide compulsive gambling treatment programs.

Minnesota Laws 2006, Chapter 225, section 1 appropriated $25,000 for fiscal year 2006 and $150,000 for fiscal year 2007 to the Department of Human Services to be used for a grant to the state affiliate recognized by the National Council of Problem Gambling. Of the appropriation for fiscal year 2007, $75,000 is contingent on the contribution of nonstate matching funds.

Non-operating revenue of $195,047 represents funds transferred from the Lottery to the Compulsive Gambling Fund, which were unused by the Agency. Therefore, the funds were returned to the Lottery.

11. RETAILER COMMISSIONS

Retailer commission is set by Minnesota Rule 7856.4030 as 5.5% of the price of each lottery ticket sold by a retailer and 1% of the amount of each winning lottery ticket cashed by a retailer.

12. STATUTORY LIMITATION ON OPERATING AND ADVERTISING EXPENSES

Gross revenue is defined in law as ticket sales and all other income less in-lieu-of-sales tax. Direct costs are expenses that are a direct function of lottery sales, which include all prize payouts, retailer commissions and incentives, amounts paid to produce and deliver scratch lottery tickets, and amounts paid to an outside vendor to operate and maintain an on-line gaming system. Operating costs include all other expenses of the Lottery.

For fiscal year 2005, Minnesota Statutes, Section 349A.10, subdivision 3, limits the Lottery's advertising costs to 2.75 percent and operating costs to 15 percent of gross revenue. For fiscal year 2006 and thereafter, Minnesota Statutes, Section 349A.10, subdivision 3 (as amended by Minnesota Laws 2005, Chapter 156, Article 2, section 36), limits the Lottery's advertising costs to 2.75 percent and operating costs to 9 percent of gross revenue. Minnesota Laws 2003, 1st Special Session, Chapter 1, Article 1, Section 23, as amended by Minnesota Laws 2004, Chapter 233, Section 6, provides that notwithstanding Minnesota Statutes, section 349A.10, the operating costs of the Lottery may not exceed $27,419,000 in fiscal year 2005. Minnesota Laws 2005, Chapter 156, Article 1, section 20, provides that notwithstanding Minnesota Statutes, section 349A.10, the operating costs of the Lottery may not exceed $26,700,000 in fiscal year 2006 and $27,350,000 in fiscal year 2007. The Lottery is in compliance with the statutory limits on advertising and operating costs. Advertising costs as a percentage of gross revenue were 1.23 percent and 1.44 percent for the years ended June 30, 2005 and 2006, respectively. Operating costs as a percentage of gross revenue were 5.90 percent and 5.40 percent for the years ended June 30, 2005 and 2006, respectively.

13. RETIREMENT PLANS

The Lottery is involved in two pension programs as follows:

(a) General Plan - Defined Benefit Pension Plan - Statewide:

Plan Description

The Lottery contributes to the Minnesota State Retirement System (MSRS), which is a cost-sharing multiple-employer defined benefit pension plan administered by the MSRS. The plan provides retirement and disability benefits, annual cost of living adjustments, and death benefits to qualifying plan members and beneficiaries. Benefit provisions are established and may be amended by state statute and vest after three years of credited service. MSRS issues a publicly available financial report that includes financial statements and required supplementary information for MSRS. That report may be obtained by contacting MSRS.

Funding Policy

Plan members are required to contribute 4.0% of their annual covered salary and the Lottery is required to contribute at an actuarially-determined rate. The Lottery's current rate is 4.0% of annual covered payroll. The contribution requirements of plan members and the Lottery are established and may be amended by state statute.

The Lottery's contributions to MSRS for the years ending June 30, 2006, 2005, and 2004 were equal to the required contribution for each year, as follows:

	June 30		
	2006	2005	2004
MSRS	$293,890	$278,704	$317,619

(b) Unclassified Plan - Defined Contribution Plan - Statewide:

Plan Description

The Lottery contributes to the MSRS, which is a multiple-employer defined contribution plan administered by the MSRS. The plan provides retirement and disability benefits, and death benefits to qualifying plan members and beneficiaries. Benefit provisions are established and may be amended by state statute and vest immediately. MSRS issues a publicly available financial report that includes financial statements and required supplementary information for MSRS. That report may be obtained by contacting MSRS.

Funding Policy

Plan members are required to contribute 4.0% of their annual covered salary and the Lottery is required to contribute 6.0% of the annual covered payroll. The contribution requirements of plan members and the Lottery are established and may be amended by state statute.

The Lottery's contributions to MSRS for the years ending June 30, 2006, 2005 and 2004 were equal to the required contributions for each year, as follows:

	June 30		
	2006	2005	2004
MSRS	$34,924	$41,018	$47,363