



sharing A Vision, Creating A Legacy



Tennessee Education Lottery • Plaza Tower Metro Center • 200 Athens Way, Suite 200 • Nashville, TN 37228

tnlottery.com

For scholarship information, visit collegepaystn.com

2005 ANNUAL REPORT

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MESSAGE FROM THE CHAIR DENNIS BOTTORFF



Front Row (L to R): Claire Tucker, Secretary/Treasurer; Dennis Bottorff, Chair; Deborah Story. *Back Row (L to R):* Jim Hill, Vice Chair; Marvell Mitchell; Houston Gordon; Jim Ripley

has transferred \$359.6 million to the State, setting a brisk pace we hope to continue for years to come.

In addition to sales and revenue reports that continue to exceed goals, the Lottery is also recognized for its business and management expertise. In order to maximize revenues for education, the Lottery was designed to operate as a business. The public can be assured this philosophy is working.

Finally, I want to recognize and applaud the efforts of so many who made this noteworthy performance possible. From the dedicated Lottery staff and the retailers who sell Lottery products, to elected officials who support our efforts and players who have embraced the games, the TEL is very fortunate.

On behalf of the Tennessee Lottery Board of Directors, it is with pride that we present a review of fiscal year 2004–05. It is truly a pleasure to be part of this dynamic enterprise, and we look forward to continued success.

Dennis C. Bottorff

Tennesseans from Memphis to Mountain City can take pride in the Tennessee Education Lottery's performance during fiscal year 2004–05. The net proceeds of \$234.3 million were more than enough to fund the HOPE Scholarship program, in addition to millions earmarked for pre-kindergarten and after-school programs. Since ticket sales began in January 2004 until the end of the fiscal year, the Lottery

MESSAGE FROM THE CEO REBECCA PAUL



On behalf of the entire Tennessee Education Lottery Corporation, I'm honored to present our second annual report. The success of the past year not only benefits the students and families of Tennessee, but also the retailers and players who have helped us raise \$234.3 million for education during this fiscal year and \$359.6 million since we launched the games on January 20, 2004.

In addition to a solid sales performance that helped more than 40,000 students attend higher education institutions in Tennessee during the 2004–05 school year, the Lottery is succeeding in other ways. Players have enjoyed a new form of entertainment and have won \$723.4 million in prizes. Our network of more than 4,300 retailers across the state has earned \$83 million in sales commissions through a team effort that generates enthusiasm from the corner markets in the smallest town to the bustling streets of our state's urban areas. The Lottery also continues to surpass its minority business participation goals and maintains a statewide presence of five district offices and more than 170 employees—solidifying our role as a vital part of the state's business community.

I would like to express my appreciation to those who have contributed to the Lottery's achievements, both before and after we were officially in business. From elected officials, Board members, and Lottery employees to players and retailers, those efforts continue to serve as the backbone of our achievements.

The Lottery is proud of its role in creating a brighter future for education in the state of Tennessee. I'm confident in our pledge to continue maximizing dollars for this worthy cause while providing Tennesseans with exciting games that are on the leading edge of the industry.

Rebecca G. Paul

—
"WITHOUT THE HOPE SCHOLARSHIP,
I WOULD NOT HAVE BEEN ABLE
TO PURSUE A HIGHER EDUCATION."
—

LAURAN POPE-STEPHENS
HOPE SCHOLAR RECIPIENT
TENNESSEE STATE UNIVERSITY

SCHOLARS | The Power Of HOPE

The dreams of students, families, and those who played a role in helping to raise millions for education came true in the fall of 2004 when the first scholars entered school with the help of Lottery-funded awards. By the end of the 2004–05 school year, \$93.4 million had been awarded to students attending a variety of higher education institutions, from independent and community two- and four-year colleges to public colleges and technological centers across the state.

With the \$227.4 million transferred during the fiscal year, the Lottery raised more than enough to fund scholarships for every student who applied and qualified for the 2004–05 school year. According to the Tennessee Student Assistance Corporation—the organization that oversees the scholarship programs—details for the 2004–05 HOPE Scholarship award recipients include:

Independent Four-Year Programs	5,330
Independent Two-Year Programs	111
Board of Regents System	11,298
University of Tennessee System	8,057
State Technical/Community Colleges	6,614
Technology Centers	8,815

In addition to quarterly transfers to the Lottery for Education Account, the Lottery makes an annual transfer to a state account for after-school programs. With the fiscal year 2004–05 transfer of nearly \$6.9 million, the total raised since inception for these valuable programs is \$8.9 million.

Finally, due to the overwhelming success during the fiscal year, the Governor earmarked and the Legislature authorized \$25 million of Lottery funds for pre-kindergarten programs, to be distributed beginning in the fall of 2005.



*"I've always wanted to go to college,
and receiving the HOPE Scholarship
has furthered my ambitions to
pursue a higher education."*

WILLIAM T. MOORE, III
2005 HOPE SCHOLAR RECIPIENT
UT KNOXVILLE

Games | Every Day Makes A Difference

Keeping the Lottery's games fresh and exciting is one of the keys to maximizing dollars for education. During fiscal year 2004–05, the Lottery maintained the tireless pace set during its initial start-up period by introducing a variety of games designed to appeal to a broad spectrum of players.

In August 2004, the Lottery launched LOTTO 5, which joined CASH 3 and POWERBALL as the third "online," or numbers-pick, game. Prize amounts in LOTTO 5 are pari-mutuel, which means all winners share an equal portion of the winnings in each of the three prize categories. Prize amounts are based on sales, and drawings are held on Monday, Wednesday, and Friday. If there is no jackpot winner, that amount continues to grow. The top jackpot for the game reached \$1.17 million in May 2005. LOTTO 5 sales were approximately \$23.4 million during fiscal year 2004–05.

CASH 4 joined the Lottery's online game lineup in April 2005, providing players a second opportunity, along with CASH 3, to play and win daily. Sales for CASH 4, which has a top prize of \$5,000, exceeded \$6 million in fiscal year 2004–05 after just over two months of play.

Instant games continued to be popular with Tennessee players, accounting for 70.9 percent of overall gross ticket sales of \$844.3 million. The Lottery introduced several games each month, including licensed products such as Corvette® Cash and Harley-Davidson®, in addition to a variety of holiday games that proved quite successful.

Through communication channels such as the Player and Retailer Service hotlines, the Lottery uses feedback from these important audiences as a key part of developing games to ensure ongoing excitement.



*“With the HOPE Scholarship,
I will be able to spend more time
studying and less time working
just to pay for school.”*

CHRISTOPHER METHVIN
2005 HOPE SCHOLAR RECIPIENT
UT CHATTANOOGA

Players & Winners | The Fun Starts Here

Not only is the Tennessee Lottery a win for education in the state, but it has also meant millions in winnings for players. During fiscal year 2004–05, players won nearly \$496 million in prizes—an average of \$1.3 million a day—bringing the total since inception to more than \$723.4 million.

Every day brings new stories about winners. From the Memphis player who won \$1 million through the Tennessee Millionaire instant ticket game to the McNairy County winner of \$1,000 a week for life from the “Win for Life” instant game, fiscal year 2004–05 was full of excitement. Additional highlights from the past year include:

Tennessee’s first POWERBALL jackpot winner. Bobbi Hubbard of South Pittsburgh claimed the \$25.5 million prize on March 31, 2005. That same drawing produced another 12 players who matched five of five numbers correctly; five won \$500,000 each by using the Power Play option, while the other seven won \$100,000 each.

A \$1.17 million LOTTO 5 jackpot. Two lucky players matched all five numbers correctly from the May 9, 2005, drawing to split the jackpot. The largest single winner in this game during the fiscal year won a jackpot of \$765,923 on January 31, 2005.

An all-time high CASH 3 payout. Players in the daily pick-three game won \$624,000 on April 24, 2005, when the numbers “777” were drawn.



"The HOPE Scholarship has been a great incentive for me to study and keep up my grades."

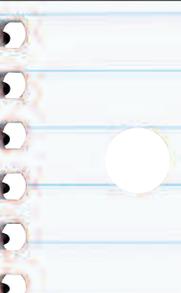
AMANDA SIMONTON
2005 HOPE SCHOLAR RECIPIENT
UT MEMPHIS

Retailers | The Places Tennessee Plays

From neighborhood markets to mega-sized grocery stores, the games of the Tennessee Lottery are available to players at over 4,300 locations throughout the state. Not only did our retail partners benefit by earning nearly \$54.9 million in sales commissions during fiscal year 2004-05, but they also took pride in being part of a team effort that resulted in raising millions of dollars for education.

The Lottery continues to recruit new retail team members and provide superior customer service to ensure a successful statewide network. A toll-free helpline, a retailer website and newsletter, hands-on training, and a network of knowledgeable sales representatives working closely with retailers are just a few of the tools the Lottery uses to help boost sales.

And finally, the TEL continues to gain valuable input from members of the Retailer Advisory Council to ensure the Lottery is meeting the needs of retailers and players.



—  —

"This internship has provided me with more than just experience. It has given me a crystal clear illustration of what I need to work for and where I need to be."

—  —

JANAH HARDWICK
2005 TEL INTERN
TENNESSEE STATE UNIVERSITY

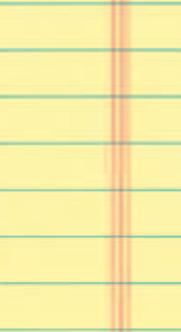
Minority Business Participation | Opportunity In Every Community

Not only does the Tennessee Education Lottery serve a vital role in raising dollars for education programs, but the Corporation is also an important part of the state's business community. With more than \$844.3 million in sales during the past fiscal year, the economic impact of the Lottery touches a variety of businesses throughout Tennessee.

One of the Lottery's goals is to maintain a minimum of 15 percent participation by minority-owned companies. During fiscal year 2004–05, 18.4 percent of the dollars spent by the Lottery on non-major procurement purchases were spent with minority businesses. The TEL's three major procurement vendors are also part of this effort and continue to exceed minority business participation goals.

In addition to contracts and purchases, the Lottery works in other ways to increase minority business participation and provide education in the minority community. The TEL's Internship Program completed a second successful summer during 2005, helping 14 college students gain substantive professional employment experience and receive an introduction to the specialized lottery industry. The program is financed by the Tennessee Lottery's three major procurement vendors, who plan to continue this program throughout the terms of their contracts with the TEL.

The TEL also continues to gain valuable input from its Advisory Council on Minority Business Participation, a group of nine citizens representing each of the state's three grand divisions.



—◆—

"The scholarship money makes a huge difference financially for us. Tabitha is working hard to continue to qualify for the scholarship."

—◆—

BRENDA NICHOLS
MOTHER OF HOPE SCHOLARSHIP RECIPIENT
TABITHA NICHOLS, AUSTIN PEAY UNIVERSITY

Organization | Getting The Job Done Right

Responsible leadership and a talented staff contribute to the success of the Tennessee Education Lottery. The dedicated professionals who make up a team of more than 170 are committed to the integrity of the games and the Lottery's overall mission of responsibly maximizing dollars for education.



In addition to the seven-member Board of Directors, which oversees the Corporation, the Lottery is managed on a daily basis by the following:

Back Row (L to R): Joe Hills, VP Sales and Distribution; David Jennings, VP Security. *Middle Row (L to R):* Lucretia Kirk, VP Information Systems; Andrew M. Morin, VP Legal Affairs; Kym Gerlock, VP Communications; Cynthia Fitzgerald, VP Legal Services; Regena Andrews, VP Human Resources; Vicki Updike, VP Finance; Khristie Stoecklein, VP Internal Controls. *Front Row (L to R):* Steve Adams, Andy Davis, Rebecca Paul, Sidney Chambers, Wanda Young Wilson.

EXECUTIVE DIVISION: Rebecca Paul,
CEO and President

In addition to overseeing the day-to-day operations of the Tennessee Lottery, the CEO leads the Executive Division, which is responsible for developing a broad vision for the organization and ensuring that strategies to achieve all objectives are implemented. This division includes a focus on marketing and communications, including all media and public relations, the Speakers Bureau, and Player Services.

LEGAL DIVISION: Wanda Young Wilson, *Executive Vice President and General Counsel*

The Legal Division is made up of the following departments:

Human Resources—Manages all personnel functions

Legal Services—Provides legal advice and assistance to management and the Board of Directors, serves as the corporate records keeper, oversees all litigation, and manages contract compliance

Security—Responsible for physical and intellectual property security, as well as the integrity of the televised drawings

ADMINISTRATION DIVISION: Steve Adams, *Chief Administrative Officer*

The Administration Division is responsible for all Lottery facilities and handles legislative affairs, prize validation, retailer contract administration, and retailer services.

SALES AND MARKETING DIVISION: Sidney Chambers, *Executive Vice President*

The Sales and Marketing Division oversees the entire sales operation, including retailer sales operations, distribution, marketing, and promotion. This division is also responsible for the Lottery's sales force and the management of the five district offices.

FINANCE AND INFORMATION SYSTEMS: Andy Davis, *Chief Financial and Information Systems Officer*

Finance and Information Systems is responsible for financial and retail accounting and reporting, cash management, budgeting, collections, procurement, computer systems, technology infrastructure, and telecommunications systems.

Financials | Crunching The Numbers

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Auditor's Opinion Letter



STATE OF TENNESSEE
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Independent Auditor's Report

December 9, 2005

The Honorable John G. Morgan
Comptroller of the Treasury
State Capitol
Nashville, Tennessee 37243

Dear Mr. Morgan:

We have audited the accompanying statement of net assets of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of June 30, 2005, and the related statements of revenues, expenses, and changes in net assets and cash flows for the year then ended. These financial statements are the responsibility of the Tennessee Education Lottery Corporation's management. Our responsibility is to express an opinion on these financial statements, based on our audit.

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. 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 audit provides a reasonable basis for our opinion.

The Honorable John G. Morgan
December 9, 2005
Page Two

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, 2005, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 9, 2005, 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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Sincerely,

Arthur A. Hayes, Jr., CPA,
Director

AAH/ras

Management Discussion and Analysis

The management team of the Tennessee Education Lottery Corporation ("TEL") offers readers of the TEL's financial statements this narrative overview and analysis of the financial activities for the year ended June 30, 2005. We encourage readers to consider the information presented here in conjunction with the financial statements that begin on page 26 of this annual report. The financial statements, notes, and this discussion are the responsibility of management.

Upon reviewing this narrative and the corresponding financial statements, readers should note that the TEL's year ended June 30, 2005, is comprised of twelve months of operational activity whereas the previous year ended June 30, 2004, is comprised of approximately six months of operational activity. Therefore, no financial comparisons between the years ended June 30, 2005, and June 30, 2004, will be made in this discussion, as it would be misleading to our financial statement users.

Financial Highlights

As of the year ended June 30, 2005, the TEL retailer base was composed of approximately 4,350 retailers. Our game roster was composed of sixty-five (65) instant games and four (4) online games noted as follows:

CASH 3, introduced on March 1, 2004, is a computerized game consisting of a daily drawing of one three-digit number between 000 and 999. Televised drawings are conducted every evening Monday through Sunday.

POWERBALL, introduced on April 19, 2004, is a nationally recognized multi-jurisdictional game. The game consists of a drawing whereby 5 numbers are chosen from a field of 53 and one number from a field of 42. The game gives players a chance to win prizes from \$3 to a multimillion-dollar jackpot. Televised drawings are conducted on Wednesday and Saturday evenings.

LOTTO 5, introduced on August 29, 2004, is a computerized game consisting of a drawing whereby 5 numbers are chosen from a field of 39. Prize amounts are pari-mutuel based upon sales. Televised drawings are conducted on Monday, Wednesday, and Friday evenings.

CASH 4, introduced on April 17, 2005, consists of a daily drawing of one four-digit number between 0000 and 9999. Televised drawings are conducted every evening, Monday through Sunday.

The significant financial highlights include the following:

- Gross ticket sales were \$844.32 million. Ticket sales, net of free instant tickets issued as prizes, were \$783.70 million.
- Gross prize expense was \$457.99 million. This expense increases or decreases in direct proportion to ticket sales and represented approximately 58.4% of net ticket sales in 2005.
- Direct gaming expenses (not including prize expense) totaled \$71.39 million. These expenses increase or decrease in proportion to ticket sales. Direct gaming expenses consisted of retailer commissions of \$54.88 million and vendor fee payments of \$16.51 million. Direct gaming expenses represented approximately 8.46% of gross ticket sales.
- Operating and other administrative expenses were \$19.41 million. These expenses represented 2.3% of gross ticket sales.
- Advertising expenses were \$13.83 million. These expenses represented 1.6% of gross ticket sales.
- Other operating and non-operating revenues were \$4.30 million. These revenues primarily consisted of retailer service fees and interest income.

Overview of the Financial Statements

The TEL is accounted for similar to a business activity and as a discretely presented component unit of the State of Tennessee, reporting transactions using the full accrual basis of accounting. This discussion and analysis is intended to serve as an introduction to the TEL's basic financial statements, along with the notes to the financial statements. The basic financial statements include three components that report the TEL's net assets and changes therein: The Statement of Net Assets on page 26; the Statement of Revenues, Expenses, and Changes in Net Assets on page 27; and the Statement of Cash Flows on pages 28 and 29.

The Statement of Net Assets reflects the TEL's financial position as of June 30, 2005.

The Statement of Revenues, Expenses and Changes in Net Assets reports the activity of selling lottery products and expenses related to such activity for the year ended June 30, 2005.

The Statement of Cash Flows outlines the cash inflows and outflows related to the activity of selling lottery products for the year ended June 30, 2005.

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the financial statements. The notes to the financial statements begin on page 30 of this annual report.

Each quarter, the TEL transfers its net proceeds, as defined by the Tennessee Education Lottery Implementation Law, to the general fund of the state treasury for credit to the Lottery for Education Account. As a result, the TEL's net assets consist of capital assets and funds restricted for other statutorily defined purposes. The reader of these financial statements should review the assets and liabilities in the Statement of Net Assets and the operating revenues and expenses in the Statement of Revenues, Expenses, and Changes in Net Assets to assess the TEL's financial position as of June 30, 2005.

Financial Analysis

Current Assets

As of June 30, 2005, current assets of \$93.7 million were primarily composed of cash and retailer accounts receivables. Cash totaling \$54.38 million represented operating funds and funds on deposit with the State of Tennessee's Local Government Investment Pool. Retailer receivables of \$35.28 million represented funds due from retailers that are generally collected within three weeks of the reporting period.

Capital Assets

Total capital assets, presented net of depreciation and amortization, were approximately \$2.98 million as of the year ended June 30, 2005. These consisted of fixed assets and leasehold improvements common to a business entity.

Current Liabilities

Total current liabilities were \$88.32 million at June 30, 2005. Current liabilities included \$59.09 million to be transferred to the Lottery for Education Account; \$6.87 million to be transferred to the After School Special Account; \$16.88 million of prizes payable to prize winners; \$4.69 million primarily due to vendors for goods and services performed; and \$786,000 of deferred revenues received from retailers.

Long-Term Liabilities

Total long-term liabilities at June 30, 2005, were \$1.17 million. This amount represents deferred rent incurred in relation to operating leases for the TEL's office spaces and the long-term portion of compensated absences.

Net Assets

Generally, the TEL's net assets are comprised of three components: assets invested in capital assets, unrestricted assets, and restricted assets.

Investments in capital assets were approximately \$2.98 million as of the year ended June 30, 2005. Amounts represent capital assets acquired since inception, net of accumulated depreciation.

Unrestricted assets were a negative \$2.98 million as of the year ended June 30, 2005, representing capital assets not restricted for use by the business entity.

Restricted assets were \$716 million and are comprised of \$288,000 restricted for certain uncollected retailer accounts receivable as defined by statute, and \$6.87 million in unclaimed prizes restricted for future prizes as mandated by statute.

Sales

Total lottery ticket sales for the fiscal year ended June 30, 2005, were \$844.32 million.

Gross instant ticket sales for 2005 were \$598.97 million. This represented approximately 70.9% of the total gross sales for the year 2005. The instant ticket marketing strategy included multiple game introductions, along with \$1, \$2, \$5, and \$10 price points. The games most popular with the players were Jumbo Bucks, Lucky 7's, and \$100,000 Jackpot.

CASH 3 sales for 2005 were \$691.8 million and 8.2% of gross sales. Average weekly sales for CASH 3 were approximately \$1.3 million.

POWERBALL sales for 2005 were \$146.67 million and 17.4% of gross sales. POWERBALL is a multi-jurisdictional lottery game operated in the following jurisdictions: Arizona, Colorado, Connecticut, Delaware, Idaho, Iowa, Indiana, Kansas,

Kentucky, Louisiana, Maine, Minnesota, Missouri, Montana, North Dakota, Nebraska, New Hampshire, New Mexico, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, Vermont, Wisconsin, West Virginia, District of Columbia and US Virgin Islands. The TEL's average weekly sales for POWERBALL were approximately \$2.8 million.

LOTTO 5 sales for 2005 were \$23.4 million. This represented 2.8% of total gross sales. This game was on sale for 10 months during the fiscal year. Average weekly sales for LOTTO 5 were approximately \$530,000.

CASH 4 sales for 2005 were \$6.09 million and approximately 0.7% of gross sales. This game was on sale for 2 1/2 months during the fiscal year. Average weekly sales for CASH 4 were approximately \$570,000.

Prize Expense

Total prize expense for all games was approximately \$457.99 million.

Gross prize expense for instant games in 2005 was \$334.07 million, representing 73% of total prize expense. Instant games prize expense is managed through the number of tickets printed for each game and value of prizes as determined prior to ticket production. Prize expense is recognized based on an established prize structure and related percentage of sales for each game introduced, and is recognized when products are made available for sale to the public. The aggregated prize payout for all instant games was 62% of instant game sales, net of free tickets.

The TEL utilized \$2.049 million of unclaimed prizes from fiscal year 2004 to reduce the instant prize expense in fiscal year 2005 to \$332.03 million.

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

Gross prize expense for CASH 3 was approximately \$35.8 million. This represents 7% of total prize expense. Historically, the industry average prize payout is approximately 50% of the sales for this game. TEL has experienced a rate of 51.9% since inception of this game.

Gross prize expense for CASH 4 was approximately \$3.04 million. This represents 0.6% of total prize expense. Historically, the industry average prize payout is approximately 50% of the sales for this game. The TEL is recording prize expense at the industry average for this game until we obtain historical experience.

Gross prize expense for LOTTO 5 was approximately \$11.7 million. This represents 2.5% of total prize expense. Prizes for this game are paid on a pari-mutuel basis with 50% of sales available for prizes.

Gross prize expense for POWERBALL was approximately \$73.3 million. This represented 16% of total prize expense. Gross prize expense for POWERBALL is recognized at 50% of sales in accordance with the game rules established by the Multi-State Lottery Association. The jackpot prize is paid on a pari-mutuel basis. All other prizes are set prize amounts in accordance with the game prize structure.

Unclaimed Prizes

TEL recognizes a percentage of all prize expenses will remain unclaimed. For fiscal year 2005, we estimated 2% as the percentage we expect to remain unclaimed relating to all prizes for instant games. For online games, unclaimed prizes were recognized based on the actual unclaimed experience for each game, with the exception of CASH 4, which was recognized at the industry average of 2% of prize liability.

The estimated unclaimed prize percentage for CASH 3, LOTTO 5, and POWERBALL were 1%, 3% and 10%, respectively, of prize liability for these games, not including LOTTO 5 and POWERBALL jackpot prizes.

Direct Gaming and Operating Expenses

Direct gaming expenses represent retailer commissions and vendor fees, which change in proportion with changes in ticket sales. The TEL compensates its retailers through a set commission percentage of 6.5% on all instant tickets settled and online tickets sold. In addition, retailers will receive a \$25,000 bonus for selling a winning POWERBALL jackpot ticket. Retailer commissions for 2005 were \$54.88 million, including one \$25,000 POWERBALL jackpot bonus.

Vendor fees were \$16.51 million in 2005. Vendor fees represent payments and commitments to our two major gaming related suppliers, G-Tech Corporation and Scientific Games Inc., for the online and instant gaming products, systems, and services. The amount paid to each vendor is determined by a percentage of sales formula in accordance with their respective contractual payment terms.

Advertising expenses were \$13.83 million in 2005. The majority of these costs represent payments to Gish, Sherwood and Friends, our major advertising partner, for media buys and production costs associated with our advertising campaigns.

Operating and other gaming expenses for 2005 were \$19.41 million. The majority of these expenses were retailer merchandising costs of \$1.04 million, new game development and marketing costs of \$2.59 million, property expense of \$1.38 million, and personnel expense of \$11.85 million.

Other Revenue

Other revenues totaling \$4.30 million consisted primarily of retailer service fees of \$3.28 million and interest income of \$714,000.

Significant Factors Impacting Next Year

While the Tennessee General Assembly approved several legislative changes relating to the lottery program in its most recent session, the operational impact to TEL from those changes was very minimal, with no fiscal impact as of the date of this report.

The state of North Carolina recently passed legislation to establish a lottery in that state. TEL management does not expect this action to negatively impact next year's financial results due to the limited number of retailers operating near the North Carolina border.

The TEL will continue to introduce new product offerings for instant games, including licensed property games, which are gaining nationwide popularity.

The TEL will also research new online terminal-based games, as well as evaluate possible enhancements to our existing games. One such enhancement was introduced in August 2005 to the POWERBALL game. This enhancement should help increase sales for this game in the next fiscal year.

Contacting the TEL's Finance Department

This financial report is designed to provide the State of Tennessee, the public, and other interested parties with an overview of the financial results of the TEL's activities and to show the TEL's accountability for conducting business in a fiscally responsible manner. If you have questions about this report or require additional financial information, contact the TEL's Finance Department at the following address:

Tennessee Education Lottery Corporation
Plaza Tower MetroCenter
200 Athens Way, Suite 200
Nashville, Tennessee 37228

STATEMENT OF NET ASSETS

AS OF JUNE 30, 2005

ASSETS

CURRENT ASSETS:

Cash (Note 2)	\$ 54,381,000
Restricted fidelity fund cash	288,000
Retailer accounts receivable, net of commissions due to retailers	35,284,000
Prepaid expenses and other assets	3,603,000
Prepaid rent	113,000
Total current assets	\$ 93,669,000

NON-CURRENT ASSETS:

Capital Assets, net of depreciation of \$928,000	2,981,000
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TOTAL ASSETS

\$ 96,650,000

LIABILITIES

CURRENT LIABILITIES:

Due to Lottery for Education Account (Note 6)	\$ 59,089,000
Due to After School Program Account	6,873,000
Prizes payable	16,884,000
Accounts payable	183,000
Accrued liabilities	4,437,000
Deferred rent	68,000
Deferred revenue	786,000
Total current liabilities	\$ 88,320,000

NON-CURRENT LIABILITIES

Non-current portion of accrued liabilities	226,000
Non-current portion of deferred rent	943,000
Total non-current liabilities	\$ 1,169,000

TOTAL LIABILITIES

\$ 89,489,000

NET ASSETS:

Investment in capital assets	2,981,000
Unrestricted assets	(2,981,000)
Restricted Assets:	
Restricted for uncollectible retailer receivables	288,000
Restricted for future prizes	6,873,000

TOTAL NET ASSETS

\$ 7,161,000

See notes to financial statements.

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

FOR THE YEAR ENDED JUNE 30, 2005

OPERATING REVENUES:

Ticket sales	\$ 844,319,000
Less instant tickets provided as prizes	(60,620,000)
Net ticket sales	783,699,000
Retailer service fees	3,288,000
Other	322,000
Net operating revenues	787,309,000

OPERATING EXPENSES:

Available prizes	457,989,000
Prizes recognized as unclaimed	(13,746,000)
Net prizes	444,243,000
Retailer commissions and bonuses	54,878,000
Contractor fees	16,511,000
Advertising	13,829,000
Salaries and benefits	11,854,000
Retailer merchandising and marketing	3,808,000
Rent, utilities, and maintenance	1,376,000
Depreciation	769,000
Professional fees	467,000
Other	1,168,000
Total operating expenses	548,903,000

OPERATING INCOME

238,406,000

NONOPERATING REVENUES (EXPENSES):

Interest revenue	714,000
Retailer fees for future uncollectible retailer receivables	23,000
Proceeds to After School Program Account	(6,873,000)
Proceeds to Lottery for Education Account	(227,423,000)
Total nonoperating revenues (expenses)	(233,559,000)

NET ASSETS, beginning of year

2,314,000

NET ASSETS, end of year

\$ 7,161,000

See notes to financial statements.

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED JUNE 30, 2005

OPERATING ACTIVITIES:

Cash received from customers	\$ 759,691,000
Other operating cash received	3,486,000
Cash paid for prizes	(444,019,000)
Cash paid to/on behalf of gaming vendors	(16,387,000)
Cash paid to retailers	(54,895,000)
Cash paid for advertising	(13,416,000)
Cash paid to/on behalf of contractors and employees	(10,150,000)
Other operating payments	(6,731,000)
Net cash provided by operating activities	<u>217,579,000</u>

NONCAPITAL FINANCING ACTIVITIES:

Payments to Lottery for Education Account	(227,832,000)
Payments to After School Program Account	(2,049,000)
Fidelity fund cash received from retailers	37,000
Fidelity fund cash refunded to retailers	(14,000)
Net cash used in noncapital financing activities	<u>(229,858,000)</u>

CAPITAL AND RELATED FINANCING ACTIVITIES:

Purchase of property and equipment	(1,832,000)
Proceeds from disposal of capital assets	13,000
Net cash used in capital and related financing activities	<u>(1,819,000)</u>

INVESTING ACTIVITIES:

Interest income	773,000
Net cash provided by investing activities	<u>773,000</u>

NET CASH USED IN ALL ACTIVITIES

(13,325,000)

CASH at beginning of year

67,994,000

CASH at end of year

\$ 54,669,000

RECONCILIATION OF CASH ON THE STATEMENT OF NET ASSETS

Cash	\$ 54,381,000
Restricted fidelity fund cash	288,000
Cash at end of year	<u>\$ 54,669,000</u>

See notes to financial statements.

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED JUNE 30, 2005

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

Operating income	\$ 238,406,000
Adjustments to reconcile operating income to net cash	
Depreciation	769,000
Gain on disposal of vehicle	(4,000)
Changes in assets and liabilities:	
Retailer accounts receivable	(24,240,000)
Prepays and other assets	(2,290,000)
Accounts payable and accrued liabilities	2,323,000
Prizes payable	2,355,000
Deferred rent	28,000
Deferred revenue	232,000
Net cash provided by operating activities	<u>\$ 217,579,000</u>

See notes to financial statements.

Tennessee Education Lottery Corporation

NOTES TO THE FINANCIAL STATEMENTS AS OF AND FOR THE YEAR ENDED JUNE 30, 2005

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Description of Reporting Entity – Effective June 11, 2003, the Tennessee Education Lottery Implementation Law (the “Act”), Tennessee Code Annotated §§ 4-51-101, et. seq., was signed into law, creating the Tennessee Education Lottery Corporation (the “TEL”). Pursuant with the Act, the TEL was incorporated in the State of Tennessee as a body, politic and corporate, and a quasi-public instrumentality.

The TEL is considered a component unit of the State of Tennessee as the state has financial accountability for fiscal matters as follows:

1. The board of directors is appointed by the governor;
2. Upon dissolution of the TEL, title to all TEL property shall vest in the State of Tennessee; and
3. The TEL provides financial benefits to the state in the form of transfer payments to the state treasury.

The accompanying financial statements present information only as to the transactions of the programs of the TEL. The TEL is reported as a discretely presented component unit within the State of Tennessee’s *Comprehensive Annual Financial Report*.

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

On January 20, 2004, the TEL began lottery ticket sales. As of June 30, 2005, the TEL’s lottery sales include a variety of instant ticket games and four terminal-based online ticket games: CASH 3, CASH 4, LOTTO 5, and POWERBALL.

Basis of Presentation – The accompanying financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board. Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in the financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. The TEL has elected to follow subsequent private-sector guidance subject to this same limitation.

Basis of Accounting and Measurement Focus – Basis of accounting refers to the timing of recognition of revenues and expenses in the accounts and reporting in the financial statements, and the measurement focus refers to what transactions and events should be recorded. The financial statements are reported using the accrual basis of accounting and the economic resources measurement focus in accordance with accounting principles generally accepted in the United States of America. Under this method, revenues are recognized when they are earned and expenses are recognized when a liability is incurred, regardless of the timing of related cash flows.

Revenue Recognition – Lottery games are sold to the public by contracted retailers. Revenue is recognized for instant games when retailers make them available for sale to the public, as indicated by the retailers’ activation of tickets. Revenue is recognized for online games when tickets are sold to players and the related draw occurs. Certain instant games include free tickets, which entitle the holder to exchange one instant ticket for another of equal value. The selling price of free tickets reduces instant ticket revenue when the ticket is claimed by a player.

Net Assets – Net assets represent cumulative revenues less expenses in excess of net proceeds transferred to the Lottery for Education Account, as defined under the Act (see Note 6). Net assets include funds invested in capital assets, restricted assets, and unrestricted net assets.

Cash – Cash includes cash in banks, petty cash, and deposits on account in the State of Tennessee Local Government Investment Pool (LGIP) (see Note 2).

Retailer Accounts Receivable – Retailer accounts receivable represents lottery proceeds due from retailers for ticket sales net of commissions due to and prizes paid by the retailers. Lottery proceeds are collected weekly from retailer bank accounts established in trust for the TEL.

Capital Assets – Capital assets are stated at cost less accumulated depreciation. Depreciation on capital assets is computed using the straight line method over the estimated useful lives of the assets, which is 3 to 7 years for most assets. Leasehold improvements are amortized over their expected useful lives or the lease term, whichever is shorter. When assets are retired or otherwise disposed of, the costs and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in the results from operations in the period of disposal. The TEL’s general threshold for capitalization is assets valued at \$500 or greater.

Deferred Revenue – Funds collected from retailers for online game tickets sold in advance of the game drawings are recorded as deferred revenue and recognized as revenue once the related drawing occurs.

Fidelity Fund – In accordance with the Act, upon acceptance as a TEL retailer, retailers contribute a fee to a fidelity fund. Funds may be used to cover losses incurred as a result of nonfeasance, malfeasance, or misfeasance of TEL retailers. Fidelity fund proceeds are held in a demand deposit account at Citizens Bank and are classified as restricted fidelity fund cash on the Statement of Net Assets. At the end of each fiscal year, the net assets exceeding \$500,000 may be treated as net proceeds from the TEL subject to transfer to the Lottery for Education Account. As of the year ended June 30, 2005, there were no fidelity funds available for transfer as net proceeds.

Retailer Commissions and Bonuses – Retailers receive a commission of 6.5% on all instant tickets settled and online tickets sold. Where commission has been paid to retailers for deferred revenue ticket sales, this fee is recorded as a prepaid expense until the related revenue is recognized. A \$25,000 bonus is paid to any retailer who sells a winning POWERBALL jackpot ticket. During the year ended June 30, 2005, one \$25,000 bonus was earned by and paid to a retailer.

Contractor Fees – The TEL has contracted with two vendors, GTECH Corporation (“GTECH”) and Scientific Games, Inc. (“SGI”), for the majority of the gaming systems and supplies.

GTECH operates the gaming network that consists of over 4,350 instant and online retailer ticket terminals and associated software. GTECH receives a fee of 1.24% of the selling price of online tickets sold and of instant ticket activations, net of free tickets available as prizes.

SGI prints, warehouses, and distributes the instant game tickets to retailers. SGI receives a fee of 1.139% of the selling price of instant ticket activations by retailers.

Prizes – In accordance with the Act, as nearly as practical, at least 50% of ticket proceeds must be made available as prize money. Gross prize expense for instant ticket sales is recognized based on a predetermined prize structure for each game in accordance with the approved game working papers when tickets are activated for sale. Gross prize expense for online games—CASH 3, CASH 4 and LOTTO 5—is recognized based on industry average or historical payout experience when tickets are actually sold.

POWERBALL prizes are shared based on contributions made to the prize pool by all member lotteries of the POWERBALL Group of the Multi-State Lottery Association (“MUSL”). All POWERBALL grand prizes won by players who purchase tickets in Tennessee are funded from pooled contributions by MUSL. The contributions are held by MUSL in trust for the TEL and are paid, at the option of the prize winner, in either a lump-sum or 29 annual installments. Lump-sum payments are discounted to present value, as calculated by MUSL. As of the year ended June 30, 2005, one grand prize of \$25 million, discounted to a lump-sum payment of \$13,851,000, was awarded to a winning player in Tennessee.

Unclaimed Prizes – Prizes not claimed within 90 days of the game-end date for instant games, and within 180 days of a game draw date for online games, are forfeited as unclaimed prizes. Prior to August 17, 2004, the claim period for online prizes was 365 days from the game draw date.

For instant games, unclaimed prizes are recognized based on the actual unclaimed aggregate experience for all instant games officially ended by the TEL. For 2005, the instant unclaimed prize was 2%.

For online games, unclaimed prizes are recognized based on the actual unclaimed experience for each game, with the exception of CASH 4, which is recognized at the industry average of 2% of prize liability. For 2005, the online unclaimed prizes as a percentage of prize liability (excluding POWERBALL grand and LOTTO 5 jackpot prizes) were 1% for CASH 3, 3% for LOTTO 5, and 10% for POWERBALL.

In accordance with the Act, fifty percent (50%) of unclaimed prizes recognized at the fiscal year end must be transferred to the State of Tennessee After School Program Special Account. The remaining 50% of unclaimed prizes is used to fund future prizes or special prize promotions, as defined by the statute.

The TEL transferred \$6.873 million for the year ended June 30, 2005, to the After School Program Special Account. Additionally, the TEL utilized \$2.049 million of prior year unclaimed prizes to fund fiscal year 2005 higher instant prize payouts.

Budget – Pursuant with the Act, annually by June 30, the TEL is required to submit a proposed operating budget for the next fiscal year to the Tennessee Department of Finance and Administration, Office of Legislative Budget Analysis, and Comptroller of the Treasury. Additionally, the TEL is required to submit, for informative purposes, a proposed operating budget for the succeeding fiscal year by September 1, to the Tennessee Department of Finance and Administration.

Contingencies – The TEL is subject to various claims and contingencies related to litigation, fines and penalties, assessments, and other matters arising out of the normal course of business. Liabilities related to contingencies are recognized when a loss is probable and reasonably estimable. As of the year ended June 30, 2005, the TEL has not incurred any related liabilities.

Use of Estimates – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the financial statements in the period they are determined.

Advertising – In accordance with AICPA Statement of Position 93-7, *Reporting on Advertising Costs*, advertising costs are expensed the first time the related advertising takes place.

Insurance – In order to minimize financial losses resulting from the occurrence of theft; employee dishonesty; legal judgments; work-related employee injury and accidents; and catastrophic events, the TEL has obtained insurance from various providers. For the year ended June 30, 2005, in the event of loss, coverage was provided as follows:

- Employee dishonesty – aggregate of \$500,000 total
- Business personal property – limit of \$1,827,000 per occurrence
- Automobile – limit of \$1,000,000 combined single limit (bodily injury/property damage)
- General liability – aggregate of \$2,000,000
- Worker’s compensation – up to statutory limits
- Director’s and officer’s liability – aggregate of \$5,000,000
- Umbrella coverage – aggregate of \$5,000,000

Non-Operating Revenues and Expenses – Represents revenues and expenses resulting from activities not directly associated with the sale of lottery tickets.

Compensated Absences – Effective November 29, 2004, the TEL implemented an attendance and leave policy allowing employees to earn vacation and sick leave during their employment. The corporation recognizes expense for accrued but unused vacation leave for all employees who have completed one year of service. No such expense exists for accrued but unused sick leave. (see Note 7)

Employment Separation – Corporate officers earn separation pay for each year of employment with the TEL. Such expense is accrued in the period it is earned. (see Note 7)

(2) CASH

The TEL has implemented Governmental Accounting Standards Board No. 40, *Deposits and Investment Risk Disclosure*, which established and modified the disclosure requirements for deposits and investments.

The TEL’s deposits are in financial institutions that participate in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. At June 30, 2005, bank balances of approximately \$820,000 were insured by the bank collateral pool.

The TEL also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. The TEL’s deposits with the LGIP were approximately \$54.3 million at June 30, 2005. The LGIP is part of the Pooled Investment Fund. The Pooled Investment Fund is authorized by statute to invest funds in accordance with policy guidelines approved by the State Funding Board. The State Treasurer’s Pooled Investment Fund is not rated by a nationally recognized statistical rating organization. The Pooled Investment Fund’s investment policy and required risk disclosures are presented in the *Tennessee Comprehensive Annual Financial Report*. That report may be obtained by contacting the Tennessee Department of Finance and Administration, Division of Accounts, 14th Floor William R. Snodgrass Tennessee Tower, 312 Eighth Avenue North, Nashville, Tennessee 37243-0298 or by calling (615) 741-2140.

(3) CAPITAL ASSETS

Capital assets consisted of the following as of June 30, 2005:

	Beginning Balance	Increases	Decreases	Ending Balance
Capital asset being depreciated:				
Furniture and fixtures	\$ 85,000	\$ 797,000	\$ (16,000)	\$ 866,000
Computer equipment	273,000	96,000	(3,000)	366,000
Vehicles	200,000	–	–	200,000
High mileage vehicles (vans)	684,000	198,000	(17,000)	865,000
Leasehold improvements	260,000	47,000	–	307,000
Communication equipment	677,000	182,000	–	859,000
Software	243,000	15,000	–	258,000
Gaming equipment	58,000	130,000	–	188,000
Total capital assets	2,480,000	1,465,000	(36,000)	3,909,000
Less accumulated depreciation	(166,000)	(769,000)	7,000	(928,000)
Total capital assets, net	\$ 2,314,000	\$ 696,000	\$ (29,000)	\$ 2,981,000

(4) LEASING ARRANGEMENTS

The TEL’s leasing arrangements consist of non-cancelable operating leases for office space and outdoor advertising billboards and related equipment which expire at various dates through 2014. Certain of these leases contain provisions for scheduled rental increases and are renewable at the option of the TEL. No lease renewal options were exercised during the year ended June 30, 2005.

In addition, the TEL subleases office space to certain parties under operating leases expiring through 2014. These subleases contain provisions for scheduled rental increases and are subordinate to the related lease agreement held by TEL.

The following is a schedule by years of future minimum rental payments required of TEL under all non-cancelable operating leases with original terms of one year or more as of June 30, 2005:

Year Ending June 30:	
2006	\$ 2,225,000
2007	1,762,000
2008	1,746,000
2009	1,653,000
2010	1,228,000
2011-2014	4,318,000
Total minimum lease payments	<u>\$ 12,932,000</u>

Minimum rental payments have not been reduced by minimum sublease rentals of \$1.72 million due in future years under non-cancelable subleases.

The following is a schedule by years of future minimum sublease rental payments due to TEL under all non-cancelable operating leases with original terms of one year or more as of June 30, 2005:

Year Ending June 30:	
2006	\$ 188,000
2007	188,000
2008	188,000
2009	194,000
2010	206,000
2011-2014	756,000
Total minimum lease payments	<u>\$ 1,720,000</u>

The following schedule shows the composition of total rental expense, net of deferred rent expense and income, for all operating leases for the year ended June 30, 2005:

Year Ending June 30:	
Minimum rentals	\$ 997,852
Less: Sublease rentals	125,200
Total minimum rentals	<u>\$ 872,652</u>

(5) DEFERRED RENT

As an incentive for entering into certain lease agreements, the TEL received rent abatements approximating \$667,000 from landlords. In accordance with Financial Accounting Standards 13 (FAS 13), *Accounting for Leases*, and Governmental Accounting Standards Board Statement No. 13, *Accounting for Operating Leases with Scheduled Rent Increases*, the TEL defers rent incentives over the entire lease term on a straight line basis. Additionally, where lease agreements stipulate escalation of rental payments over the term of the lease, the TEL recognizes related rental expense on a straight line basis over the entire term of the lease.

At June 30, 2005, total deferred rent of \$1,011,000 consisted of \$554,441 related to rent abatements and \$456,766 to the straight lining of rental expense over the life of the related lease terms.

(6) DUE TO LOTTERY FOR EDUCATION ACCOUNT

In accordance with the Act, all net proceeds of the TEL are due to the Lottery for Education Account. "Net proceeds" is defined under the Act as "all revenue derived from the sale of lottery tickets or shares and all other monies derived from lottery games less operating expenses." "Operating expenses" are defined under the Act as "all costs of doing business, including, but not limited to, prizes, commissions, and other compensation paid to lottery retailers, advertising and marketing costs, rental fees, personnel costs, capital costs, depreciation of property and equipment, amounts held in or paid from a fidelity fund, and all other operating costs." All other expenses are considered non-operating.

Net proceeds and operating expenses for the year ended June 30, 2005, is summarized as follows:

Operating revenues:	
Ticket sales	\$ 844,319,000
Less instant tickets provided as prizes	(60,620,000)
Net ticket sales	783,699,000
Service fees and other revenue	3,610,000
Net operating revenues	<u>787,309,000</u>
Operating expenses, as defined:	
Gaming	544,966,000
Operating	15,634,000
Total operating expenses, as defined	<u>560,600,000</u>
Net proceeds before distribution of unrestricted net assets	<u>226,709,000</u>
Non-operating revenue and expenses	
Interest income	714,000
Total non-operating revenue and expenses	714,000
Net proceeds subject to transfer	<u>\$ 227,423,000</u>
Amount due to Lottery for Education Account for year	\$ 227,423,000
Amount paid during year	(168,334,000)
Amount due to Lottery for Education Account, end of year	<u>\$ 59,089,000</u>

All amounts due at June 30, 2005, were transferred to the Lottery for Education Account in July 2005.

(7) EMPLOYEE BENEFITS

Deferred Compensation – Effective September 22, 2003, the TEL provided its employees with a deferred compensation plan created in accordance with Internal Revenue Code Section 457 (the "457 Plan"). The 457 Plan is available to all eligible employees at their option and permits participants to defer a portion of their salary until future years. The deferred compensation is not available to participants until termination, retirement, death, or unforeseeable emergency. During the year ended June 30, 2005, employees contributed approximately \$344,000 to the 457 Plan.

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

Defined Contribution Plan – Effective September 22, 2003, the TEL established a defined contribution plan in accordance with Internal Revenue Code Section 401(a) (the "401(a) Plan"). Under the 401(a) Plan, all eligible employees receive compensation from the TEL in the form of non-voluntary deferrals to their individual 401(a) accounts as follows:

1. Contribution of five percent (5%) of employee's compensation, and
2. Matching contribution of seventy-five percent (75%) of the participant's contributions to the 457 Plan up to the first five percent (5%) of the participant's compensation.

These contributions vest over a 4-year period at a rate of twenty-five percent (25%) per year and are not available to participants until termination, retirement, death, or unforeseeable emergency. During the year ended June 30, 2005, the TEL contributed approximately \$571,000 to the 401(a) Plan on behalf of its employees. Of these contributions, approximately \$40,000 was forfeited by separated employees as of June 30, 2005.

In accordance with the 401(a) Plan, forfeitures of employer contributions may be used to offset plan administrative expenses and/or reduce future contribution costs. As of the year ended June 30, 2005, forfeited amounts of approximately \$36,000 were used to offset employer contributions and plan administrative expenses.

Section 1448 of the Small Business Job Protection Act of 1996 added Subsection (g) to Section 457 of the Internal Revenue Code to provide that all assets and income under a Section 457(b) plan that are maintained by a state or local government employer must be held in trust for the exclusive benefit of plan participants and their beneficiaries. The 457 Plan and 401(a) Plan assets are held in aggregate by John Hancock Financial, the plans' custodian.

The aggregate fair value of the plan's assets was approximately \$825,000, net of forfeitures and administrative fees, as of June 30, 2005.

Compensated Absences – Vacation leave can be earned at various rates depending on the employee's position and years of service. Carryover of vacation leave is limited to the number of hours earned in the prior year. Employees must complete twelve (12) months of service from the date of hire before they receive termination payment for any unused vacation hours. The current portion of the compensated absence liability, expected to be due within one year of the statement date, June 30, 2005, is estimated using historical trends. At June 30, 2005, the estimated current portion of the compensated absences liability was \$188,000.

Sick leave is earned at the end of each month at the rate of four hours per month for all employees. Sick leave may be carried over from year to year, but all such accrued sick leave is forfeited upon separation of employment.

Employment Separation – Corporate officers accrue forty hours of severance pay for every year of employment with TEL. As of June 30, 2005, \$36,000 was accrued for employment separation obligations.

(8) COMMITMENTS AND CONTINGENCIES

Win for Life Winner – On December 22, 2004, a prize of \$1,000 a week for life, to be paid in installments of \$52,000 per year, was awarded to a prize winner. The winner will receive the annual payment for the remainder of their life, with a guarantee of a minimum of twenty annual payments totaling \$1,040,000. As of June 30, 2005, the TEL was obligated to pay a minimum of 19 remaining installment payments to this winner. The TEL will purchase a single premium annuity in fiscal year 2006 to fund all future payments required after December 2005.

Corvette Grand Prize Drawing – The TEL has committed to conducting a drawing whereby \$100,000 or a Corvette automobile will be awarded to one individual. The TEL anticipates completion of this drawing to occur during the fiscal year ending June 30, 2006.

Harley Davidson Prize Drawing – The TEL has committed to conducting a drawing whereby \$25,000 or a Harley Davidson motorcycle will be awarded to one individual. The TEL anticipates completion of this drawing to occur during the fiscal year ending June 30, 2006.

Legal – The TEL is subject to litigation in the ordinary course of its business. In the opinion of management and legal counsel, the outcome of such litigation will not have a material impact on the financial position or cash flows of the TEL.

(9) SUBSEQUENT EVENTS

Advertising Billboards – In July 2005, the TEL entered into operating lease agreements for outdoor billboard advertising space. In relation to these billboards, the TEL will incur expense of approximately \$48,000 during the fiscal year ending June 30, 2006.

Insurance – Effective July 31, 2005, the TEL became a member of the State of Tennessee liability insurance coverage pool. This pool provides coverage that replaces current coverage for business/personal property liability, general liability, directors and officers' liability, and umbrella coverage.

Millionaire Live Drawing – On October 22, 2005, the TEL conducted this special lottery drawing whereby prizes totaling \$1,035,000 were awarded to three individuals.

Win for Life Winner – In July 2005, a prize of \$1,000 a week for life was awarded to a prize winner. The winner will receive \$52,000 a year for the remainder of their life, with a minimum guarantee of 20 annual payments totaling \$1,040,000. The TEL made the first payment related to this prize in August 2005. The TEL will purchase a single premium annuity in fiscal year 2006 to fund all future payments.