AUDIT REPORT

Tennessee Education Lottery Corporation

For the Year Ended
June 30, 2014

STATE OF TENNESSEE

COMPTROLLER OF THE TREASURY

Department of Audit

Division of State Audit

Tennessee Comptroller of the Treasury

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COMPTROLLER OF THE TREASURY
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November 19, 2014

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

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Education Lottery Corporation for the year ended June 30, 2014. You will note from the independent auditor's report that an unmodified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

Deborah V. Loveless

Deborah V. Loveless, CPA
Director

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Audit Report
Tennessee Education Lottery Corporation
For the Year Ended June 30, 2014

TABLE OF CONTENTS

State of Tennessee

Audit Highlights

Comptroller of the Treasury | Division of State Audit

Financial and Compliance Audit

Tennessee Education Lottery Corporation

For the Year Ended June 30, 2014

Opinion on the Financial Statements

The opinion on the financial statements is unmodified.

Audit Findings

The audit report contains no findings.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
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Independent Auditor's Report

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

Report on the Financial Statements

We have audited the accompanying financial statements of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of and for the years ended June 30, 2014, and June 30, 2013, and the related notes to the financial statements, which collectively comprise the Tennessee Education Lottery Corporation's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Education Lottery Corporation as of June 30, 2014, and June 30, 2013, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 13 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated November 6, 2014, 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, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Tennessee Education Lottery Corporation's internal control over financial reporting and compliance.

Deborah V. Loveless

Deborah V. Loveless, CPA
Director
November 6, 2014

TENNESSEE EDUCATION LOTTERY CORPORATION
Management's Discussion and Analysis

The Tennessee Education Lottery Corporation (TEL) offers the following discussion and analysis to the readers of the financial statements. This narrative overview provides an objective analysis of TEL's financial activity for the fiscal years ended June 30, 2014, and June 30, 2013, with comparative information presented for the fiscal year ended June 30, 2012. The overview should be considered in conjunction with the independent auditor's report, the accompanying audited financial statements, and the notes to the financial statements.

Understanding TEL's Financial Statements

TEL, a quasi-public instrumentality, is a component unit of the State of Tennessee. TEL's activities are accounted for as a business-type activity using the full accrual basis of accounting, similar to a private business entity. In accordance with accounting principles generally accepted in the United States of America, this report consists of a series of comparative financial statements, along with notes to the financial statements designed to highlight TEL's net position and changes therein resulting from business operations.

The financial statements are comprised of three components:

- **the statements of net position** – reflects TEL's financial position at June 30, 2014, and June 30, 2013;
- **the statements of revenues, expenses, and changes in net position** – reports revenues and expenses incurred in relation to the sale of lottery products, as well as other non-gaming related activity for the fiscal years ended June 30, 2014, and June 30, 2013; and
- **the statements of cash flows** – outlines the cash inflows and outflows related to the activity of selling lottery products and other business-related activities for the fiscal years ended June 30, 2014, and June 30, 2013.

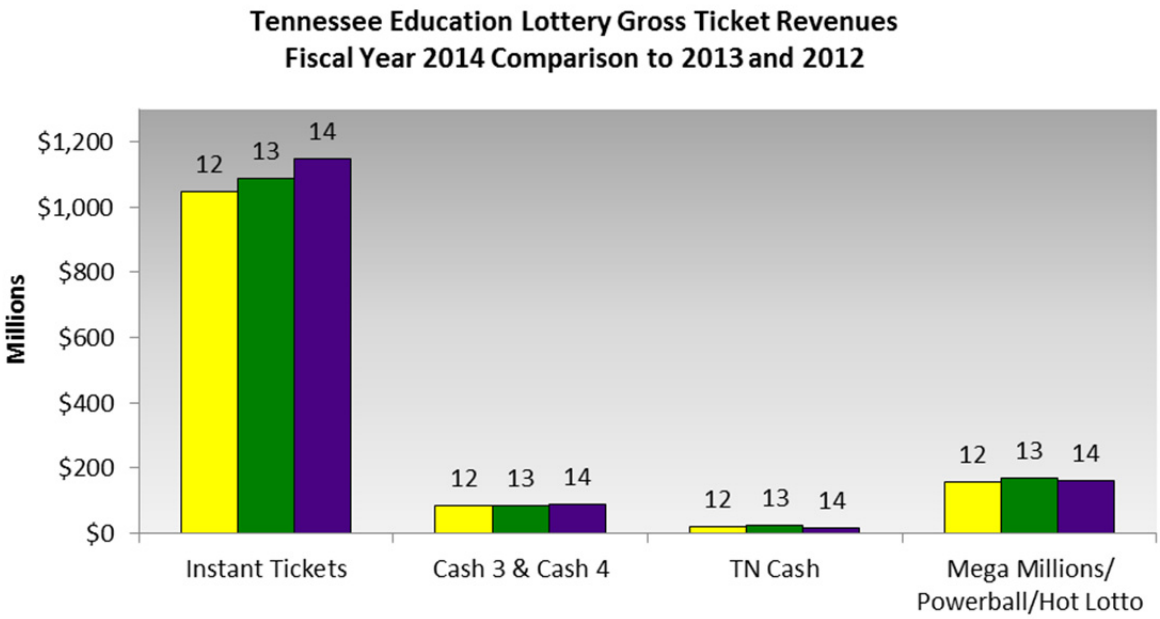
The notes to the financial statements document additional information that is essential for readers to gain a comprehensive understanding of the data provided in TEL's financial statements.

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

Fiscal Year 2014 Financial Highlights

Posting its tenth consecutive year of increased sales, the Tennessee Education Lottery Corporation reported $1.417 billion in total sales for fiscal year 2014, an increase of $49 million over last year's previous sales record of $1.368 billion. This year's sales resulted in a contribution of $337.2 million for the education programs funded by the Lottery.

Total education funding since ticket sales began in January 2004 now stands at more than $3.06 billion, with total sales surpassing $11.9 billion.



Robust growth in instant ticket sales substantially contributed to this year's sales growth. Forty-seven new instant ticket games were introduced during the year. Sales of these popular games reached an all-time high of $1.15 billion during fiscal year 2014. Management attributes the success to staying focused on the corporation's mission to serve Tennessee students and their families by responsibly maximizing proceeds for the education programs. The TEL works continually to refine our business model, introduce innovative and entertaining games for our players, promote efficiencies and best business practices across the organization, and provide top-notch support for the retailers selling the Lottery's products.

To celebrate the corporation's 10th Anniversary, TEL launched the *Tennessee Millions* ($10) instant ticket game with the chance to win up to $1,000,000. In addition, TEL launched a new $25 game, *Mega Millionaire Jumbo Bucks,* which has been very popular. The Jumbo Bucks family continues to be successful as evidenced by the popularity of the *Jumbo Bucks* ($2), and the launch of *Jumbo Bucks Season's* ($3), which features a ticket with seasonal themes planned throughout the year. In February of 2014, TEL launched the wildly popular Frenzy Family instant tickets. These games were launched at the $2, $5, and $10 price points.

Cash 3 sales in fiscal year 2014 increased by 1% over fiscal year 2013.

Cash 4 sales increased by 5.5% over fiscal year 2013.

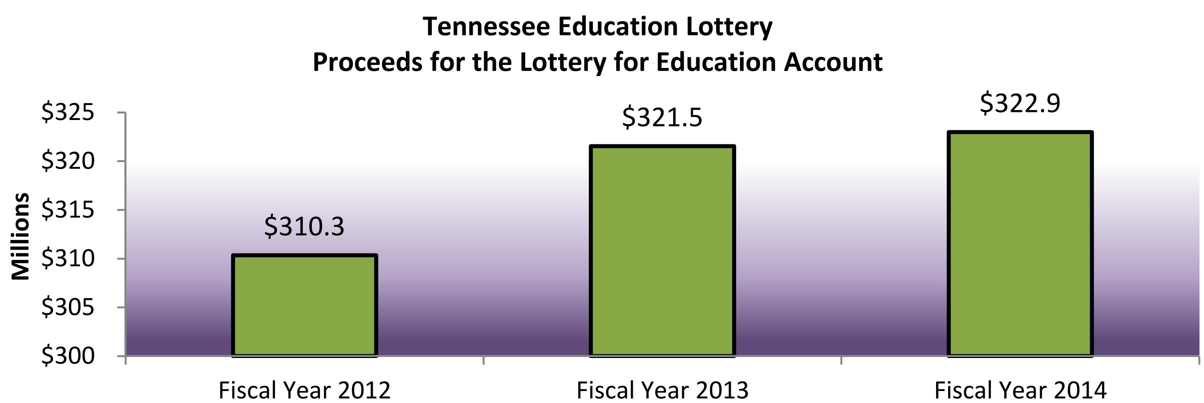
Sales for *Tennessee Cash* decreased $6.5 million during fiscal year 2014. *Tennessee Cash* is TEL's in-state, cash jackpot, drawing-style game. The sales for this game are driven by the size of the jackpot. In fiscal year 2014, *Tennessee Cash* only experienced two large jackpots, $898 thousand and $1.2 million, compared to three similar-sized jackpots in fiscal year 2013.

Powerball sales were $100.9 million in fiscal year 2014, compared to $133.2 million in fiscal year 2013. The decrease in *Powerball* sales is directly attributed to the lack of significant jackpots and the two record jackpots in fiscal year 2013 of $587.5 million and $590.5 million. One notable Powerball event did occur in fiscal year 2014, whereby TEL sold a $259.8 million jackpot ticket in June.

Sales for *Mega Millions* in fiscal year 2014 were $47.0 million compared to $31.9 million the prior year. The increase in *Mega Millions* sales is attributed to the $636 million jackpot in December 2013, a $400 million jackpot in March of 2014, and the lack of significant jackpots in the prior fiscal year. In January of 2014, TEL had its first Mega Millions jackpot winner of $61 million.

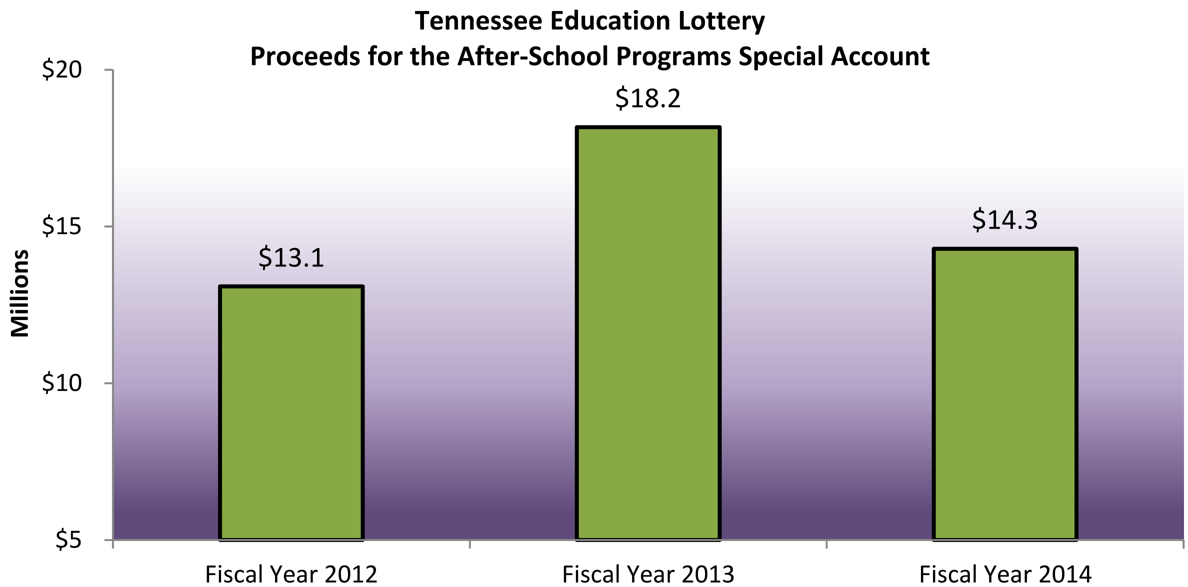
In May 2013, *Hot Lotto* was introduced as a third multijurisdictional game in TEL's portfolio. *Hot Lotto* is a drawing-style game operated in 15 states with a starting jackpot of $1 million, and its statutory taxes are paid by the lotteries in the Hot Lotto group. *Hot Lotto* sales were $13.1 million in fiscal year 2014. In October of 2013, TEL had its first Hot Lotto jackpot winner of $2.9 million.

TEL generated $322.9 million for the Lottery for Education Account in fiscal year 2014, compared to $321.5 million in fiscal year 2013 and $310.3 million in fiscal year 2012.



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

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



In fiscal year 2014, TEL recognized $14.3 million for the After-School Programs special account, as compared to $18.2 million in fiscal year 2013 and $13.1 million in fiscal year 2012. The decrease resulted primarily from the timing drawing-style game unclaimed prizes related to record jackpots of $656 million in *Mega Millions* and $587.5 million in *Powerball* in the prior year.

Condensed Statement of Net Position

	June 30, 2014	Increase/ (Decrease)	June 30, 2013	Increase/ (Decrease)	June 30, 2012
Assets:					
Current Assets					
Cash	$ 67,729,000	$(18,352,000)	$ 86,081,000	$13,854,000	$ 72,227,000
Retailer accounts receivable, net	69,296,000	4,130,000	65,166,000	5,120,000	60,046,000
Other	7,147,000	(621,000)	7,768,000	16,000	7,752,000
Total current assets	144,172,000	(14,843,000)	159,015,000	18,990,000	140,025,000
Non-current assets					
Other	6,135,000	3,339,000	2,796,000	(108,000)	2,904,000
Capital assets, net	924,000	(66,000)	990,000	(111,000)	1,101,000
Total non-current assets	7,059,000	3,273,000	3,786,000	(219,000)	4,005,000
Total assets	151,231,000	(11,570,000)	162,801,000	18,771,000	144,030,000
Liabilities:					
Current liabilities					
Due to Lottery for Education Account	80,379,000	(4,119,000)	84,498,000	8,148,000	76,350,000
Due to After-School Programs Account	14,291,000	(3,879,000)	18,170,000	5,081,000	13,089,000
Prizes payable	44,959,000	(4,569,000)	49,528,000	3,769,000	45,759,000
Accounts payable and accrued liabilities	3,627,000	(998,000)	4,625,000	(384,000)	5,009,000
Unearned revenue	901,000	43,000	858,000	199,000	659,000
Unearned rent	328,000	223,000	105,000	44,000	61,000
Total current liabilities	144,485,000	(13,299,000)	157,784,000	16,857,000	140,927,000
Non-current liabilities					

Unearned rent	590,000	590,000	-	(201,000)	201,000
Non-current portion of other liabilities	6,135,000	1,125,000	5,010,000	2,121,000	2,889,000
Total non-current liabilities	6,725,000	1,715,000	5,010,000	1,920,000	3,090,000
Total liabilities	151,210,000	(11,584,000)	162,794,000	18,777,000	144,017,000
Net Position:					
Investment in capital assets	924,000	(66,000)	990,000	(111,000)	1,101,000
Unrestricted	(924,000)	66,000	(990,000)	111,000	(1,101,000)
Restricted for uncollectible retailer receivables	21,000	14,000	7,000	(6,000)	13,000
Total net position	$ 21,000	$ 14,000	$ 7,000	$ (6,000)	$ 13,000

Overview of Financial Position

Assets

The $11.5 million decrease in total assets at June 30, 2014, and the $18.8 million increase in total assets at June 30, 2013, were primarily due to the timing of collection of the relevant Retailer Accounts Receivable balances.

Liabilities

The $11.5 million decrease in total liabilities at June 30, 2014, related to decreased Due to Lottery for Education and Due to After School Programs, which is reflective of quarterly and annual funds due, and prizes payable due to the timing of the receipt and payout of winning prize claims experienced during fiscal year 2014.

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

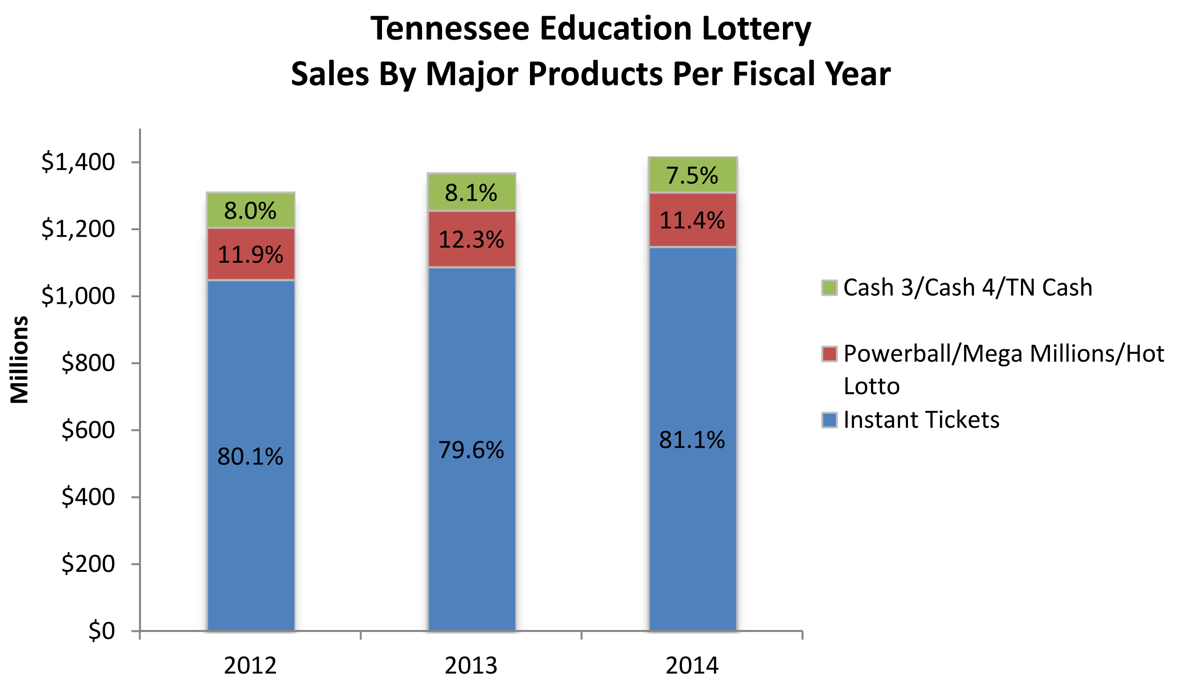
Condensed Statement of Revenues & Expenses

	June 30, 2014	Increase/ (Decrease)	June 30, 2013	Increase/ (Decrease)	June 30, 2012
Revenues:					
Instant games	$1,149,127,000	$60,387,000	$ 1,088,740,000	$ 39,136,000	$1,049,604,000
Online games	267,940,000	(10,856,000)	278,796,000	17,196,000	261,600,000
Less instant/promotional tickets provided as prizes	(97,812,000)	(5,496,000)	(92,316,000)	2,034,000	(94,350,000)
Games revenue, net	1,319,255,000	44,035,000	1,275,220,000	58,366,000	1,216,854,000
Bad debt recoveries/(expense), net	(195,000)	(245,000)	50,000	1,049,000	(999,000)
Retailer service fees	3,386,000	(307,000)	3,693,000	496,000	3,197,000
Interest income	70,000	(48,000)	118,000	50,000	68,000
Other revenue	904,000	(466,000)	1,370,000	(135,000)	1,505,000
Total revenues	1,323,420,000	42,969,000	1,280,451,000	59,826,000	1,220,625,000
Expenses					
Cost of sales	968,986,000	45,249,000	923,737,000	42,815,000	880,922,000

General, administrative, and other operating expenses	17,119,000	153,000	16,966,000	749,000	16,217,000
Other expenses	28,000	(14,000)	42,000	6,000	36,000
Proceeds to After-School Program Account	14,291,000	(3,879,000)	18,170,000	5,081,000	13,089,000
Proceeds to Lottery for Education Account	322,982,000	1,440,000	321,542,000	11,193,000	310,349,000
Total expenses	1,323,406,000	42,949,000	1,280,457,000	59,844,000	1,220,613,000
Change in net position	14,000	20,000	(6,000)	(18,000)	12,000
Total net position, beginning of year	7,000	(6,000)	13,000	12,000	1,000
Total net position, end of year	$ 21,000	$ 14,000	$ 7,000	$ (6,000)	$ 13,000

Revenues

Gross lottery ticket sales for fiscal years 2014, 2013, and 2012 were $1.417 billion, $1.368 billion, and $1.311 billion, respectively. The following chart depicts the distribution of sales by product for the three fiscal years ended June 30:



Gross instant ticket sales for fiscal year 2014 were $1.149 billion. This was a 5.5% increase from fiscal year 2013's instant ticket sales of $1.089 billion, which represented a 3.8% increase from fiscal year 2012 instant ticket sales of $1.049 million. Instant tickets represent approximately 80% of total gross sales in fiscal years 2014, 2013, and 2012. The year-over-year increase in gross instant ticket sales is attributed to the instant-ticket marketing strategy which involves the ongoing introduction of multiple games, including special theme games and higher price-point games with higher prize payouts. The games most popular with the players in 2014 were the Jumbo Bucks and Frenzy family of games, followed by the *$5,000,000 Multiplier Spectacular* game.

Powerball is a multi-jurisdictional, drawing-style lottery game operated in the following jurisdictions in addition to Tennessee: Arizona, Arkansas, Colorado, Connecticut, Delaware, the District of Columbia, Florida, Idaho, Iowa, Indiana, Kansas, Kentucky, Louisiana, Maine, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, South Dakota, U.S. Virgin Islands, Vermont, Wisconsin, and West Virginia. Starting on January 31, 2010, ten states in the Mega Millions lottery consortium group began selling *Powerball* tickets as part of a cross-selling agreement with members of the Multi-State Lottery Association (MUSL) including Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Texas, Virginia, and Washington. Ohio and California, both members of the Mega Millions consortium, started cross-selling *Powerball* on April 16, 2010, and April 8, 2013, respectively.

Powerball sales for fiscal years 2014, 2013, and 2012 were $100.9 million, $133.2 million, and $102.8 million, respectively. These amounts represent approximately 7%, 10%, and 8% of gross ticket sales, respectively, for each fiscal year. The decrease in *Powerball* sales during fiscal year 2014 is a direct result of having two record jackpots of $587.5 million and $590.5 million during the prior fiscal year. Although there were 2 jackpots over $400 million, they did not drive sales in the same manner as the record setting jackpots from the prior year.

Mega Millions is a multi-jurisdictional, drawing-style lottery game administered by a lottery consortium group. The group includes the following state lotteries: California, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, and Washington. Tennessee and certain other MUSL lottery members are authorized to sell the consortium's *Mega Millions* game as part of a cross-selling agreement. Tennessee began sales for the game in January 2010. Sales for fiscal years 2014, 2013, and 2012 were $47.0 million, $31.9 million, and $53.9 million, respectively.

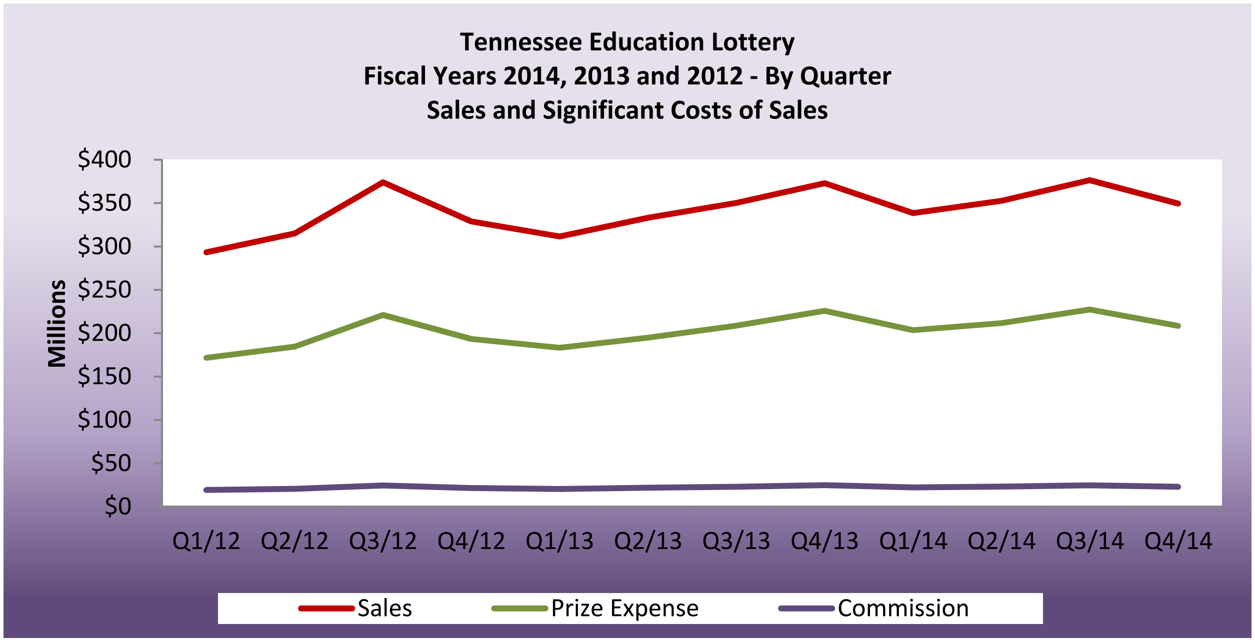
Hot Lotto is a multi-jurisdictional, drawing-style lottery game operated in the following jurisdictions in addition to Tennessee: Delaware, the District of Columbia, Idaho, Iowa, Kansas, Maine, Minnesota, Montana, New Hampshire, New Mexico, North Dakota, Oklahoma, South Dakota and West Virginia. Tennessee began sales for the game in May 2013. Sales were $2.4 million in 2013 and $13.1 million in fiscal year 2014.

Cash 3 sales for fiscal years 2014, 2013, and 2012 were $57.6 million, $57.1 million, and $57.9 million, respectively.

Cash 4 sales were $30.8 million, $29.2 million, and $27.7 million in the years 2014, 2013, and 2012, respectively.

Tennessee Cash, a drawing-style, jackpot driven game, was introduced on October 3, 2010. Ticket sales for fiscal years 2014, 2013, and 2012 were $18.3 million, $24.8 million, and $19.2 million, respectively.

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



Gross prize expense was $850.7 million, $812.5 million, and $770.6 million in the years 2014, 2013, and 2012, respectively. Increases of $38.2 million in 2014 and $41.9 million in 2013 reflect the increases in overall ticket sales realized in the related period.

Instant games prize expense is managed through the number of tickets printed for each game and the value of prizes as determined prior to ticket production. Prize expense is recorded based on an established prize structure and a related percentage of sales for each game introduced and is recognized when products are made available for sale to the public. The aggregated prize payout for all instant games was 68.28%, 67.6%, and 67.0% of instant game sales, net of free tickets, for 2014, 2013, and 2012, respectively.

Gross prize expense for drawing-style games generally increases or decreases in direct proportion to ticket sales of the related game and is recorded at the time of the related draw. The aggregated prize payout for all drawing-style games were 49.5%, 50.0%, and 50.3% for 2014, 2013, and 2012, respectively.

Retailer commissions were $92.4 million, $89.2 million, and $85.5 million for fiscal years 2014, 2013, and 2012, respectively. Consistent with the cost driver relationship of ticket sales to retailer commissions, the increases of $3.2 million in 2014 and $3.7 million in 2013 reflect the increases in overall ticket sales realized in the related period.

Retailers are compensated a set commission percentage of 6.5% on all instant tickets settled and drawing-style tickets sold. They also receive an additional 1% bonus for cashing *Cash 3* and *Cash 4* ticket prizes. Additionally, TEL will pay a bonus of $25,000 to a retailer who sells a single jackpot-winning ticket for *Powerball* or *Mega Millions*; however, if there are multiple winning *Powerball* or *Mega Millions* jackpot winning tickets sold in Tennessee in a single drawing, the $25,000 selling bonus will be proportionately divided among the respective retailers based on the number of winning tickets sold by the retailer. TEL will also pay a $5,000 bonus to retailers selling any drawing-style game ticket where the prize won is equal to or greater than $1 million. Two *Powerball* or *Mega Millions* jackpot ticket selling bonuses were paid during the last three fiscal years. Drawing-style game ticket selling bonuses equaling $85,000, $80,000, and $15,000 were awarded for fiscal years 2014, 2013, and 2012, respectively.

Gaming Contractor fees for fiscal years 2014, 2013, and 2012 were $28.6 million, $27.4 million, and $26.3 million, respectively. TEL has retained two major gaming contractors, one for the operation of its gaming systems and network and one for the manufacturing, warehousing, and distribution of its instant ticket games. As compensation, the instant ticket vendor receives 1.07% of the selling price of all instant ticket activations, whereas the gaming systems and network vendor receives 1.24% of the selling price of drawing-style tickets sold and of the selling price of instant ticket activations net of free instant tickets available as prizes.

Advertising costs incurred by TEL were $8.1 million, $9.4 million, and $8.3 million for the fiscal years 2014, 2013, and 2012, respectively. These costs are significantly influenced by budget directives and constraints. Management continually strives to achieve an optimal balance between advertising costs and obtained benefits, while keeping the costs relatively consistent with prior year amounts. The decrease in fiscal year 2014 is directly attributable to the timing of contract executions during the latter part of the fiscal year.

General, administrative, and other operating expenses were $17.3 million, $16.9 million, and $16.2 million for the fiscal years 2014, 2013, and 2012, respectively. For each of these years, the five major expense components were depreciation, personnel, professional fees, property, and telecommunications expenses. These expenses do not change in direct proportion with revenues but are instead significantly influenced by budget directives and constraints, as well as current business and economic conditions. In view of these factors, moderate variances in these expenses are expected to occur over fiscal periods. Nevertheless, to the most reasonable extent possible, TEL's management team works diligently to make these expenses relatively consistent year-over-year.

<u>Potential Factors Impacting Future Results</u>

TEL's mission is to maximize revenues for the purpose of maximizing payments to the Lottery for Education Account. A continuous assessment of Tennessee's economic environment and TEL's own product lines and operations is essential to accomplish this mission. The following considerations have been presented to inform those interested in TEL's operations about factors that could potentially affect future results:

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

- TEL will continually review the prize payout percentages for its instant-game products to ensure we are receiving the highest actual net proceeds for each game and/or price point category.
- TEL will continue to enhance its promotional offerings and player affinity programs to improve brand awareness and increase player participation in our games.

Contacting TEL's Financial Management

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

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

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Net Position
As of June 30, 2014, and June 30, 2013

	June 30, 2014	June 30, 2013
ASSETS		
Current assets:		
Cash (Note 2)	$ 67,708,000	$ 86,074,000
Restricted fidelity fund cash	21,000	7,000
Retailer accounts receivable, net	69,296,000	65,166,000
Prepaid expenses and other assets	6,795,000	7,572,000
Prize annuity investments (Note 3)	352,000	196,000
Total current assets	144,172,000	159,015,000
Noncurrent assets:		
Prize annuity investments (Note 3)	6,135,000	2,796,000
Capital assets, net of depreciation of $4,284,000 and $4,405,000 (Note 4)	924,000	990,000
Total noncurrent assets	7,059,000	3,786,000
Total assets	151,231,000	162,801,000
LIABILITIES		
Current liabilities:		
Due to Lottery for Education Account (Note 7)	80,379,000	84,498,000
Due to After-School Programs Account (Note 8)	14,291,000	18,170,000
Prizes payable	44,607,000	49,176,000
Accounts payable	62,000	90,000
Prize annuities payable (Notes 3 and 10)	352,000	352,000
Accrued liabilities	3,565,000	4,535,000
Unearned revenues	901,000	858,000
Unearned rent (Note 6)	328,000	105,000
Total current liabilities	144,485,000	157,784,000
Noncurrent liabilities:		
Prize annuities payable (Notes 3 and 10)	6,135,000	5,010,000
Unearned rent (Note 6)	590,000	-
Total noncurrent liabilities	6,725,000	5,010,000
Total liabilities	151,210,000	162,794,000
NET POSITION		
Investment in capital assets	924,000	990,000
Restricted:		
Restricted for uncollectible retailer receivables	21,000	7,000
Unrestricted	(924,000)	(990,000)
Total net position	$ 21,000	$ 7,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Revenues, Expenses, and Changes in Net Position
For the Years Ended June 30, 2014, and June 30, 2013

	Year Ended June 30, 2014	Year Ended June 30, 2013
OPERATING REVENUES		
Ticket sales, net	$ 1,416,872,000	$ 1,367,587,000
Less instant/promotional tickets provided as prizes	(97,812,000)	(92,316,000)
Net ticket sales	1,319,060,000	1,275,271,000
Retailer service fees	3,386,000	3,693,000
Other	861,000	1,335,000
Net operating revenues	1,323,307,000	1,280,299,000
OPERATING EXPENSES		
Available prizes	850,791,000	812,547,000
Current year actual unclaimed prizes (Note 8)	(14,291,000)	(18,170,000)
Net prizes	836,500,000	794,377,000
Retailer commissions and bonuses	92,492,000	89,259,000
Contractor fees	28,614,000	27,430,000
Advertising	8,173,000	9,403,000
Salaries and benefits	13,195,000	12,879,000
Retailer merchandising and marketing	3,207,000	3,268,000
Rent, utilities, and maintenance	1,950,000	1,783,000
Depreciation	468,000	475,000
Professional fees	487,000	823,000
General administrative and other operating	1,019,000	1,007,000
Total operating expenses	986,105,000	940,704,000
Operating income	337,202,000	339,595,000
NONOPERATING REVENUES (EXPENSES)		
Interest revenue	70,000	118,000
Retailer fees for future uncollectible retailer receivables	43,000	35,000
Fidelity fund retailer non-feasance recoupments (Note 1)	(28,000)	(42,000)
Proceeds to After-School Programs Account (Note 8)	(14,291,000)	(18,170,000)
Proceeds to Lottery for Education Account (Note 7)	(322,982,000)	(321,542,000)
Total nonoperating revenues (expenses)	(337,188,000)	(339,601,000)
Change in net position	14,000	(6,000)
NET POSITION		
Net position, beginning of year	7,000	13,000
Net position, end of year	$ 21,000	$ 7,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Cash Flows
For the Years Ended June 30, 2014, and June 30, 2013

	Year Ended June 30, 2014	Year Ended June 30, 2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 1,315,036,000	$ 1,270,399,000
Cash received from MUSL for grand prize winner	32,700,000	-
Other operating cash received	4,161,000	4,966,000
Cash paid for prizes	(839,643,000)	(788,406,000)
Cash paid to grand prize winner	(32,700,000)	-
Cash paid to/on behalf of gaming vendors	(28,296,000)	(27,380,000)
Cash paid to retailers	(92,500,000)	(89,272,000)
Cash paid for advertising	(9,112,000)	(9,118,000)
Cash paid to/on behalf of employees	(13,326,000)	(12,779,000)
Other operating payments	(5,683,000)	(7,456,000)
Net cash provided by operating activities	330,637,000	340,954,000
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Payments to Lottery for Education Account	(327,100,000)	(313,394,000)
Payments to After-School Programs Account	(18,170,000)	(13,089,000)
Fidelity fund cash received from retailers	49,000	45,000
Fidelity fund cash refunded to retailers	(7,000)	(9,000)
Fidelity fund cash non-feasance recoupments	(28,000)	(42,000)
Net cash used in noncapital financing activities	(345,256,000)	(326,489,000)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of property and equipment	(453,000)	(763,000)
Proceeds from disposal of capital assets	37,000	34,000
Net cash used in capital and related financing activities	(416,000)	(729,000)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of prize annuity	(3,387,000)	-
Interest income	70,000	118,000
Net cash provided/(used) by investing activities	(3,317,000)	118,000
Net cash provided by all activities	(18,352,000)	13,854,000
Cash - beginning of year	86,081,000	72,227,000
Cash - end of year	$ 67,729,000	$ 86,081,000
Reconciliation of cash on the statement of net position		
Cash	$ 67,708,000	$ 86,074,000
Restricted fidelity fund cash	21,000	7,000
Cash at end of year	$ 67,729,000	$ 86,081,000

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Cash Flows (Continued)
For the Years Ended June 30, 2014, and June 30, 2013

	Year Ended June 30, 2014	Year Ended June 30, 2013
Reconciliation of net operating income to net cash provided by investing activities:		
Operating income	$ 337,202,000	$ 339,595,000
Adjustments to reconcile operating income to net cash provided by operating activities		
Bad debt expense	195,000	(50,000)
Depreciation	468,000	475,000
Gain on disposal of capital assets	(4,000)	(32,000)
Changes in assets and liabilities:		
Retailer accounts receivable	(4,325,000)	(5,070,000)
Prepaids and other assets	777,000	50,000
Accounts payable and accrued liabilities	(984,000)	14,000
Prize annuity investments	(108,000)	41,000
Prize annuities payable	1,125,000	2,329,000
Prizes payable	(4,565,000)	3,561,000
Unearned revenues	43,000	199,000
Unearned rent	813,000	(158,000)
Net cash provided by operating activities	$ 330,637,000	$ 340,954,000
Noncash investing activities:		
Increase in fair value of prize annuity investments	$ 304,000	$ 103,000

See notes to financial statements.

Note 1. Summary of Significant Accounting Policies

Organization and Description of Reporting Entity

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

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

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

The accompanying financial statements present information only as to the transactions of the programs of the TEL. The TEL is reported as a discretely presented component unit within the State of Tennessee's *Comprehensive Annual Financial Report,* which may be viewed at http://tn.gov/finance/act/cafr.shtml.

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

On January 20, 2004, the TEL began lottery ticket sales. During the years ended June 30, 2014 and 2013, the TEL's lottery sales included a variety of instant ticket games and drawing-style ticket games: Cash 3, Cash 4, Tennessee Cash, Hot Lotto, Powerball, and Mega Millions.

Basis of Presentation

The accompanying financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board.

Basis of Accounting and Measurement Focus

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

Revenue Recognition

Lottery games are sold to the public by contracted retailers. Revenue is recognized for instant games when retailers make them available for sale to the public, as indicated by the retailers' activation of tickets.

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

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

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

Revenues are presented net of bad debt expense.

Net Position

Net position represents cumulative revenues less expenses and required beneficiary program payments in accordance with the Act (see Notes 7 and 8). Net position includes funds invested in capital assets, restricted net position and unrestricted net position.

Cash

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

Retailer Accounts Receivable

Retailer accounts receivable represents lottery proceeds due from retailers for ticket sales net of commissions due to and prizes paid by the retailers, and allowance for bad debt.

Lottery proceeds are collected weekly from retailer bank accounts established in trust for the TEL. Amounts not collected upon the established collection date are deemed delinquent. Delinquent accounts are reviewed periodically by TEL management. Accounts outstanding more than 180 days from the most recent date of delinquency or date of last payment are considered doubtful. At June 30, 2014 and 2013, the Allowance for Doubtful Accounts was $293 thousand and $184 thousand, respectively.

Capital Assets

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

Unearned Revenue

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

Fidelity Fund

In accordance with the *Tennessee Code Annotated,* Sections 4-51-118 (a), TEL retailers are assessed a one-time fidelity fund fee of $50. Fidelity fund proceeds are held in a demand deposit account at Citizens Bank and are classified as restricted fidelity fund cash on the Statement of Net Position. These funds may be used to cover losses incurred as a result of the nonfeasance, malfeasance, or misfeasance of TEL retailers. During the years ended June 30, 2014 and June 30, 2013, $28 thousand and $42 thousand were, respectively, used to cover losses incurred as a result of uncollected accounts of TEL retailers.

At the end of each fiscal year, fidelity funds exceeding $500,000 may be treated as net proceeds from the TEL subject to deposit to the Lottery for Education Account. As of the years ended June 30, 2014 and 2013, there were no fidelity funds available for deposit as net proceeds.

Retailer Commissions and Bonuses

Retailers receive a commission of 6.5% on all instant tickets settled and drawing-style tickets sold. In addition, retailers cashing Cash 3 and Cash 4 tickets receive an additional 1% for amounts cashed. Where commission has been paid to retailers for unearned revenue ticket sales, this fee is recorded as a prepaid expense until the related revenue is recognized.

The TEL will pay a bonus of $25,000 to a retailer who sells a single jackpot winning ticket for Powerball or Mega Millions; however, if there are multiple winning Powerball or Mega Millions jackpot winning tickets sold in Tennessee in a single drawing, the $25,000 selling bonus will be divided proportionately (based on the number of winning tickets sold by each retailer) between or among the respective retailers.

The TEL will pay a selling bonus of $5,000 to a retailer who sells a winning non-jackpot Powerball or Mega Millions prize, or a ticket for any other drawing-style game, if the prize is equal to or greater than one million dollars ($1,000,000).

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

Drawing-Style Game	2014	2013
Powerball	$50,000	$55,000
Mega Millions	25,000	10,000
Hot Lotto	5,000	-
Tennessee Cash	5,000	15,000
Total Retailer Bonuses	**$85,000**	**$80,000**

Contractor Fees

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

GTECH operates the gaming network that consists of approximately 5,000 instant and drawing-style retailer ticket terminals and associated software. Effective March 3, 2009, the TEL renegotiated its contract with GTECH to extend through April 9, 2015. Terms of this contract include the continuation of the contractor service fee rate of 1.24%, on the selling price of drawing-style tickets sold and on instant ticket activations net of free tickets available as prizes. Additionally, contractual terms include GTECH’s agreement to provide, install and maintain up to eight hundred (800) instant ticket vending machines (ITVMs) for the TEL. Accordingly, during fiscal years 2014 and 2013, GTECH was compensated at the rate of 1.24% for all drawing-style and instant ticket game sales.

SGI prints, warehouses, and distributes the instant ticket games to retailers. Effective April 1, 2009, the TEL renegotiated its contract with SGI to extend through April 9, 2015. In accordance with this contract, SGI receives the negotiated fee of 1.07% on the selling price of all instant ticket activations. During the years ended June 30, 2014 and 2013, SGI was compensated at this rate for all instant ticket activations.

Prizes

In accordance with the Act, as nearly as practical, at least 50% of ticket proceeds must be made available as prize money. Gross prize expense for instant ticket sales is recognized based on a predetermined prize structure for each game in accordance with the approved game working papers when tickets are activated for sale. Gross prize expense for Cash 3, Cash 4, and Tennessee Cash is recognized based on historical payout experience when the related drawings occur.

Powerball and Mega Millions prizes are shared based on contributions made to the prize pool by all member lotteries of the Powerball Group and the Mega Millions Group of the Multi-State Lottery Association ("MUSL"). All Powerball and Mega Millions grand prizes won by players who purchase tickets in Tennessee are funded from pooled contributions by all participating lottery states. For Powerball and Mega Millions, the contributions are held by MUSL in trust for the TEL and are paid, at the option of the prize winner, in either a lump-sum, or thirty (30) annual installments for Powerball or twenty-six (26) annual payments for Mega Millions. Lump-sum payments are discounted to present value, as calculated by MUSL for the Powerball game, and the Mega Millions Consortium Group for the Mega Millions game.

As of the year ended June 30, 2014, there were two grand prize winners in Tennessee, one for Powerball and Mega Millions. The Mega Millions grand prize winner claimed in January 2014. The Powerball grand prize winner had not claimed as of June 30, 2014. Per the MUSL Powerball Group rules, grand prize amounts are held by MUSL and shall be transferred to the selling lottery immediately after the selling lottery validates the prize claim and after MUSL has collected the prize pool shares from all selling lotteries. Therefore, the related assets and liabilities for the Powerball winner transfer are not reflected on TEL's financial statements since the ticket was not validated at June 30, 2014.

Hot Lotto prizes are shared based on contributions made to the prize pool by all member lotteries of the Hot Lotto Group of MUSL. Grand prizes won by Tennessee players are funded from pooled contributions by all participating lottery states. The contributions are held by MUSL in trust for the TEL and are paid in cash as a lump sum with taxes withholding paid by the party lottery. As of June 30, 2014, there were no grand prize winners in Tennessee.

Unclaimed Prizes

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

Budget

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

Contingencies

The TEL is subject to various claims and contingencies related to litigation; fines and penalties; assessments; and other matters arising out of the normal course of business. Liabilities related to contingencies are recognized when a loss is probable and can be reasonably estimated. As of the years ended June 30, 2014 and 2013, the TEL has not incurred, nor was it aware of any related liabilities.

Use of Estimates

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

Advertising

Advertising costs are expensed when the related advertising takes place.

Non-Operating Revenues and Expenses

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

Compensated Absences

Effective November 29, 2004, the TEL implemented an attendance and leave policy allowing employees to earn vacation and sick leave during their employment. The corporation recognizes expense for accrued but unused vacation leave for all employees who have completed one year of service. No such expense exists for accrued but unused sick leave (Note 9).

Employment Separation

Corporate officers earn separation pay for each year of employment with the TEL. Such expense is accrued in the period it is earned (Note 9).

Note 2. Cash

A significant portion of TEL's deposits are in a financial institution that participates in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. At June 30, 2014 and 2013, bank balances of approximately $1.258 million and $4.104 million, respectively, were insured by the bank collateral pool.

Additionally, for both the years ended June 30, 2014 and 2013, the bank balances for the fidelity fund account were $22,000 and maintained in a demand deposit account that was insured by the Federal Deposit Insurance Corporation for up to a maximum of $250,000.

The TEL also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. The TEL's deposits with the LGIP were approximately $66.8 million and $83.0 million at June 30, 2014 and 2013, respectively. The LGIP is part of the State Pooled Investment Fund. The fund is not rated by a nationally recognized statistical rating organization.

The fund's investment policy and required risk disclosures are presented in the *State of Tennessee Treasurer's Report*. That report is available on the state's website at http://www.treasury.tn.gov or by calling (615) 741-2956.

Note 3. Prize Annuity Investments

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

In February 2013, the TEL relaunched the Win for Life instant ticket game; however, this time the grand prizes guaranteed the winners would receive $156,000 a year. As of June 30, 2013, one top prize winner elected the annuity option. In April 2014, the TEL went under contract for that annuity for approximately $3,387,000 with Nationwide with payments to be made directly to the prize winner.

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

In August 2004, the Win for Life instant ticket game was launched and included three grand prizes in the form of lifetime annuities. These grand prizes guaranteed the winner would receive $52,000 a year for the remainder of his/her life, with a minimum of 20 annual payments totaling $1,040,000. As of June 30, 2006, all of the grand prizes have been claimed by and awarded to winners.

In fiscal year 2007, the TEL purchased one (1) single premium, sum certain lifetime annuity contract for approximately $739,000, in its name from Aviva Life, and appointed the respective Win for Life prize winner as the beneficiary.

In fiscal year 2006, the TEL purchased two (2) single premium, sum certain lifetime annuity contracts for approximately $904,000 and $848,000, in its name from Metropolitan Life (Met Life), and appointed the respective Win for Life prize winners as the beneficiaries.

In accordance with its investment policy, the TEL may enter into insurance annuity contracts in order to fund annuity prizes. All life insurance annuity contracts must be issued by companies which are financially rated "A" or better by a nationally recognized rating agency duly licensed, admitted and authorized to transact business in the State of Tennessee.

Credit risk. This is the risk that a counterparty will fail to fulfill its obligation. The TEL mitigates this risk through its investment policy, which limits purchase of investments to those financially rated "A" or better by a nationally recognized rating agency. Consistent with this policy, the annuities purchased from Met Life were rated A+ (Superior) by A.M. Best as of June 30, 2014 and June 30, 2013. The annuity purchased from Aviva was rated A (Excellent) by A.M. Best as of June 30, 2014 and June 30, 2013. The annuity purchased from Nationwide was rated A+ (Superior) by A.M. Best as of June 30, 2014.

Concentration of credit risk. This risk relates to an investor's failure to adequately diversify its investments and is specifically defined as investments of 5 percent or more in the securities of a single issuer. Though the TEL does not have a policy specific to this risk, as a condition of the purchase, and for the duration of the contract, Met Life, Aviva, and Nationwide are required to maintain insurance sufficient to reimburse the TEL for any losses resulting from its failure or inability to meet related obligations.

Custodial credit risk. For an investment, this is the risk that in the event of the failure of the counterparty to a transaction, the investor will not be able to recover the value of its investments that are in the possession of an outside party. Investments are subject to custodial credit risk only if they are evidenced by securities that exist in physical or book entry form. Given that annuity contracts do not meet this condition, no related custodial credit risk exists as of the years ended June 30, 2014 and June 30, 2013.

The TEL records all investments purchased to fund annuity prizes at fair value. Liabilities for annuity prizes are recorded at their discounted present value as prize annuities payable.

In relation to both the prize annuity investments and prize annuities payables, payments due from insurance companies and due to prize winners within the next fiscal year are classified as current, whereas the remaining portion is classified as noncurrent on the Statement of Net Position.

Changes in the fair value of the prize annuity investments are presented as noncurrent prize annuities payable. As of the years ended June 30, 2014 and 2013, the fair value of the prize annuity investments increased by $304 thousand and $103 thousand, respectively.

Note 4. Capital Assets

Capital assets consisted of the following as of June 30, 2014:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	$ 883,000	$ 2,000	$ (52,000)	$ 833,000
Computer equipment	463,000	217,000	(60,000)	620,000
Vehicles	212,000	19,000	(13,000)	218,000
High mileage vehicles - Vans	1,387,000	-	(128,000)	1,259,000
Leasehold improvements	402,000	164,000	(302,000)	264,000
Communication equipment	695,000	19,000	(2,000)	712,000
Software	747,000	31,000	(11,000)	767,000
Gaming equipment	606,000	1,000	(72,000)	535,000
Total capital assets	5,395,000	453,000	(640,000)	5,208,000
Less accumulated depreciation	(4,405,000)	(481,000)	602,000	(4,284,000)
Total capital assets, net	**$ 990,000**	**$ (28,000)**	**$ (38,000)**	**$ 924,000**

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

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

Gaming equipment	604,000	2,000	-	606,000
Total capital assets	5,457,000	367,000	(429,000)	5,395,000
Less accumulated depreciation	(4,356,000)	(475,000)	426,000	(4,405,000)
Total capital assets, net	**$1,101,000**	**$(108,000)**	**$ (3,000)**	**$ 990,000**

Note 5. Leasing Arrangements

The TEL's leasing arrangements consist of non-cancelable operating leases for office space, outdoor advertising billboards, and related equipment that expire at various dates through 2019. Certain of these leases contain provisions for scheduled rental increases and are renewable at the option of the TEL. During the year ended June 30, 2014, the TEL renewed the Knoxville District Office lease in April 2014 for term of 10 years. No options were exercised during the year ended June 30, 2013.

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:

Year Ending June 30:	2014
2015	$ 1,925,000
2016	1,947,000
2017	1,737,000
2018	1,650,000
2019	1,510,000
2020 – 2024	7,878,000
2025	1,335,000
Total minimum rental payments	**$17,982,000**

The TEL also subleases office space under operating leases expiring through 2015 to its major vendors. Minimum rental payments at June 30, 2014, have not been reduced by minimum sublease rentals of $6 thousand.

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

Year Ending June 30:	2014
2015	$6,000
Total minimum sublease payments	**$6,000**

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

	2014	2013
Minimum rentals:		
Property	$1,969,000	$1,491,000
Billboards	1,232,000	1,220,000
Less: Sublease rentals	(136,000)	(203,000)
Total minimum rentals	**$3,065,000**	**$2,508,000**

Note 6. Unearned Rent

As an incentive for entering into certain lease agreements, the TEL received rent abatements approximating $2,223,000 from landlords. In accordance with 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, 2014, total unearned rent of $918,000 consisted of rent abatements of $264,000 and $1,182,000 to the straight-lining of rental expense over the life of the related lease terms.

At June 30, 2013, total unearned rent of $105,000 consisted of $41,000 related to rent abatements and $64,000 to the straight-lining of rental expense over the life of the related lease terms.

Note 7. Due to Lottery for Education Account

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

Net proceeds and operating expenses for the years ended June 30, 2014, and June 30, 2013, are summarized as follows:

	2014	2013
Operating revenues:		
Ticket sales (net)	$1,416,872,000	$1,367,587,000
Less tickets provided as prizes	(97,812,000)	(92,316,000)
Net ticket sales	1,319,060,000	1,275,271,000
Fees and other revenue	4,247,000	5,028,000
Total lottery proceeds	1,323,307,000	1,280,299,000
Operating expenses, as defined:		
Gaming	983,277,000	941,907,000
Operating	17,118,000	16,967,000
Total operating expenses, as defined	1,000,395,000	958,874,000
Net proceeds before distribution of unrestricted net position	322,912,000	321,425,000
Nonoperating revenue and expenses		
Interest income	70,000	118,000
Total nonoperating revenue and expenses	70,000	118,000
Net proceeds	$ 322,982,000	$ 321,543,000
Amount due to Lottery for Education Account for year	$ 322,982,000	$ 321,543,000
Amount paid during year	(242,603,000)	(237,045,000)
Amount due to Lottery for Education Account, end of year	$ 80,379,000	$ 84,498,000

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

Note 8. Due to After-School Programs Special Account

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

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

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

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

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

For fiscal year 2014, unclaimed prizes were $14,291,000, which was current and payable to the After-School Programs special account at June 30, 2014.

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

All amounts due at the end of each fiscal year were deposited to the After-School Programs special account by August 1 of the subsequent fiscal year.

Note 9. Employee Benefits

A. Deferred Compensation

Effective September 22, 2003, the TEL provided its employees with a deferred compensation plan created in accordance with Internal Revenue Code Section 457 (the "457 Plan"). The 457 Plan is available to all eligible employees at their option and permits participants to defer a portion of their salary until future years. The deferred compensation is not available to participants until termination, retirement, death, or unforeseeable emergency. During the years ended June 30, 2014 and 2013, employees contributed approximately $451,000 and $461,000, respectively to the 457 Plan.

The aggregate fair value of the plan's assets was approximately $4,199,000 and $3,701,000, net of administrative fees, as of June 30, 2014 and 2013, respectively.

B. Defined Contribution Plan

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

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

These contributions vest over a 4-year period at a rate of twenty-five percent (25%) per year and are not available to participants until termination, retirement, death, or unforeseeable emergency. The TEL contributed approximately $682,000 and $674,000, to the 401(a) Plan on behalf of its employees for the years ended June 30, 2014 and 2013, respectively. Of these contributions, approximately $26,000 and $15,000 were forfeited by separated employees as of June 30, 2014 and June 30, 2013, respectively.

In accordance with the 401(a) Plan, forfeitures of employer contributions may be used to offset plan administrative expenses and/or reduce future contribution costs. As of the years ended June 30, 2014 and 2013, forfeited amounts of approximately $29,000 and $26,000, respectively, were used to offset employer contributions and plan administrative expenses.

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

The aggregate fair value of the plan's assets was approximately $6,328,000 and $5,364,000, net of forfeitures and administrative fees, as of June 30, 2014 and 2013, respectively.

C. Compensated Absences

Vacation leave can be earned at various rates depending on the employee's position and years of service. Carryover of vacation leave is limited to the number of hours earned in the prior year. Employees must complete twelve months of service from the date of hire before they receive termination payment for any unused vacation hours. The current portion of the compensated absence liability, expected to be due within one year of the statement date, June 30, 2014, is estimated using historical trends. At June 30, 2014 and 2013, the estimated current portion of the compensated absences liability was $584 thousand and $530 thousand, respectively.

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

D. Employment Separation

Corporate officers accrue forty hours of separation pay for every year of employment with TEL. The TEL had $365 thousand and $344 thousand accrued for employment separation obligations for each of the years ending June 30, 2014 and 2013, respectively.

Note 10. Non-current Liabilities

Non-current liabilities consisted of the following as of June 30, 2014:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Prize annuities payable	$5,362,000	$1,321,000	$(196,000)	$6,487,000	$352,000
Unearned rent	105,000	1,156,000	(343,000)	918,000	328,000
Total non-current	$5,467,000	$2,477,000	$(539,000)	$7,405,000	$680,000

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

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

Note 11. Risk Management

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

Additionally, in order to minimize financial losses resulting from the occurrence of theft; employee dishonesty; legal judgments; work-related employee injury and accidents; and catastrophic events, the TEL maintains insurance from various other providers. At June 30, 2014, additional insurance coverage was provided at the following maximum amounts:

Coverage	2014
Employee Fidelity	$ 500,000
Automobile/Property	1,000,000
Workers' Compensation	1,000,000
Employment Practices	5,000,000
General Liability/Umbrella	5,000,000

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

Note 12. Commitments and Contingencies

Legal. The TEL is subject to litigation in the ordinary course of its business. In the opinion of management and legal counsel, the outcome of such litigation will not have a material impact on the financial position or cash flows of the TEL. Furthermore, as of the year ended June 30, 2014, management is not aware of any related liabilities.

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Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With *Government Auditing Standards*

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

We have audited the financial statements of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of and for the year ended June 30, 2014, and the related notes to the financial statements, which collectively comprise the Tennessee Education Lottery Corporation's basic financial statements, and have issued our report thereon dated November 6, 2014. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered the Tennessee Education Lottery Corporation's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Tennessee Education Lottery Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Tennessee Education Lottery Corporation's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Tennessee Education Lottery Corporation's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards.*

Purpose of this Report

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

Deborah V. Loveless

Deborah V. Loveless, CPA
Director
November 6, 2014