

Colorado Lottery

Financial and Compliance Audit

June 30, 2006 and 2005

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Contract Auditors

August 17, 2006

Members of the Legislative Audit Committee

We have completed the financial statement audits of the Colorado Lottery as of and for the years ended June 30, 2006 and 2005. Our audits were conducted in accordance with auditing standards generally accepted in the United States of America.

We were engaged to conduct our audit pursuant to Section 24-35-211, C.R.S., which authorizes the State Auditor to audit the Lottery Fund. The reports we have issued as a result of this engagement are set forth in the table of contents which follows.

 **BKD, LLP**

Colorado Lottery
June 30, 2006 and 2005

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Colorado Lottery

Report Summary

Years Ended June 30, 2006 and 2005

Purposes and Scope of Audit

Authority, Purpose and Scope

The audit of the Colorado Lottery (the Lottery) was performed under authority of Section 24-35-211, C.R.S., which requires the State Auditor to conduct an annual audit of the Lottery Fund. The purpose of the audit was to express an opinion on the financial statements of the Lottery for the year ended June 30, 2006.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. We obtained our information by reviewing documents, interviewing staff, analyzing data and performing other audit procedures as we deemed necessary.

The purposes and scope of this audit were:

- To express an opinion on the financial statements of the Lottery as of and for the year ended June 30, 2006, including a review of the related systems of internal controls as required by auditing standards generally accepted in the United States of America.
- To review the Lottery's compliance with rules and regulations governing the expenditure of State funds for the year ended June 30, 2006.
- To evaluate progress in implementing the prior audit recommendations.

Summary of Major Audit Comments

Audit Findings and Financial Statement Audit Report Section

The auditors' findings and recommendations section contains the following recommendations:

- The Lottery contracted with a new vendor, Scientific-Games, Inc., (SGI or Scientific-Games) for on-line games and related accounting services and converted to the new system in May 2005. Since the conversion, the Lottery has had to manually reconcile some of the daily systems balancing reports. The required reports needed to complete the daily system balancing have either not been provided by Scientific-Games or the reports have inaccurate or incomplete information. For instance, Scientific-Games has not been able to produce reports that show when the retailers sale process is complete and the funds should be paid to the Lottery. This issue was also noted in our report for the year ended June 30, 2005 and resulted in \$21 million dollars in accounts receivable not collected on a timely basis during 2005. Lottery personnel have developed workarounds for these issues so that the receivables are now being collected on a timely basis. However, this manual workaround is time consuming and more prone to human error. The Lottery should work with Scientific-Games to ensure that reports required by the contract are provided and contain accurate and complete information.
- The Lottery has a complex internal information system and significant reliance is placed on this system and the supporting controls. To reduce the risk of errors in the system, the Lottery should obtain an independent review of the Lottery's internal information system.

Colorado Lottery

Report Summary

Years Ended June 30, 2006 and 2005

- During the physical inventory count, a large volume of scratch tickets from expired games were observed that should have been destroyed. This has occurred due to Scientific-Games, the on-line vendor, inability to produce accurate reports to identify the remaining ticket inventory for expired games. It is recommended that the Lottery work out a system to timely destroy tickets from expired games and accurately track the tickets destroyed.

The recommendations and the responses from the Lottery can be found in the recommendation locator.

Audit Opinions and Reports

The independent accountants' reports, included herein, state that the financial statements of the Lottery are fairly stated, in all material respects, in accordance with accounting principles generally accepted in the United States of America, and that no material weaknesses in internal controls were discovered during the course of the audit.

Auditors' Communication to Legislative Audit Committee

The auditors' communication to the Legislative Audit Committee describes the auditors' responsibility under auditing standards generally accepted in the United States of America and significant management judgments and estimates. It also notes that there were no proposed audit adjustments for the year ending June 30, 2006. This communication is located on page 53.

Summary of Progress in Implementing Prior Year Audit Recommendations

The audit report for the year ended June 30, 2005, contained three recommendations for fiscal year 2005. Of the 2005 recommendations, two were partially implemented and one was not implemented. The Disposition of Prior Year Audit Recommendations begins on page 10.

Colorado Lottery
Recommendation Locator
Years Ended June 30, 2006 and 2005

Recommendation Number	Page Number	Recommendation Summary	Response	Implementation Date
1	6	The Colorado Lottery should continue to work with Scientific-Games to ensure that all reports required as part of the contract are provided and that the reports contain accurate and complete information.	Partially Agree	December 2007
2	8	The Lottery should have an independent examination performed on its internal information system.	Partially Agree	December 2007
3	9	The Lottery should implement a system to properly track the destruction process for expired tickets.	Agree	March 2007

Colorado Lottery

Background

Years Ended June 30, 2006 and 2005

The Lottery was created as a division within the Department of Revenue with the passage of Senate Bill 119 on April 30, 1982. The Lottery began operations on July 1, 1982 and sold its first lottery ticket on January 24, 1983.

During fiscal year 2006, the Lottery employed 121 employees in its headquarters in Pueblo and branch offices in Denver, Fort Collins and Grand Junction.

The Lottery games are governed by rules and regulations established by a Commission of five members appointed by the Governor and approved by the Senate. By statute, Lottery Commission members must include an attorney, a certified public accountant and a law enforcement officer. Members may serve up to two 4-year terms.

The Lottery's enabling legislation requires that no less than 50% of the total revenue from sales of lottery tickets be for prizes. The legislation also provides guidelines for distribution of net proceeds to beneficiary agencies. "Net lottery proceeds" (that is, proceeds after the payment of prizes and lottery expenses and a reserve for future operations) are to be distributed to the Conservation Trust Fund, the Division of Parks and Outdoor Recreation and the Great Outdoors Colorado Trust Fund (GOCO). The amount distributed to GOCO is limited by a constitutional cap. As of fiscal year 2002, amounts exceeding the GOCO cap (the spill-over) are distributed to the State Public School Fund Contingency Reserve. Prior to 2002, spill-over funds were distributed to the State General Fund.

Colorado Lottery

Auditors' Findings and Recommendations

Years Ended June 30, 2006 and 2005

System Balancing Reports

The Lottery converted to a new vendor, Scientific-Games, Inc., for its on-line games on May 2, 2005. In our audit for fiscal year 2003, we recommended that the Lottery obtain an independent test and examination of the new vendor system, prior to the go-live date, to gain assurance regarding the integrity and reliability of the new system and that the appropriate balancing or reconciliation capabilities were in place.

The Lottery contracted with a firm to perform an independent test of the new system. The evaluation was conducted throughout the implementation of the new system and was concluded on May 3, 2005 or the day after the new system was implemented. In its report, the firm found that some reports required for reconciling the on-line system and the Lottery's internal system, which were specified as deliverables by the Lottery in its contract with the new on-line vendor, were not being produced. In addition, other reports did not balance to the corresponding information in the Lottery's system. Therefore, in our audit for fiscal year 2005, we recommended that the Lottery work with Scientific-Games to ensure that all reports required as part of the contract are provided and that all reports are accurate and complete.

During our audit for fiscal year 2006, we selected a sample of reports from the new on-line system to test the reports and the reconciliation process. Our testing found that there were 17 systems balancing reports that are still unavailable this year compared to 19 reports unavailable last year. In addition, some of the reports generated by Scientific-Games are not accurate or report incomplete results. In the fiscal year 2005 audit, we found that the missing reports resulted in accounts receivable not being collected on a timely basis. As of June 30, 2005, \$21,543,586 was due to the Lottery, which is approximately \$5 million higher than expected. Because the Lottery has developed a workaround, we found that during our fiscal year 2006 audit, receiving payment on accounts receivable is no longer a problem. As of June 30, 2006, the accounts receivable balance was \$15,840,057. However, the required reports are still not being provided by Scientific-Games.

The 17 remaining reports that are still unavailable involve scratch inventory and billing reports. We found that the Lottery has taken steps to ensure that contract reporting requirements are fulfilled. The Lottery has:

- Set up two new deadlines for reports that will address the scratch inventory issues and to include tax reporting. Those deadlines are November 4, 2006 and April 1, 2007, respectively.
- Established regular meetings with the Department of Revenue management and Scientific-Games' management regarding the timely scheduling of future deployments of reporting functions.

Colorado Lottery

Auditors' Findings and Recommendations (continued)

Years Ended June 30, 2006 and 2005

- Reduced Scientific-Games' percent of sales fee for services not performed in accordance with the contract, and these penalties have been paid by Scientific-Games. Included in these reductions or penalties are \$862,528 in initial delay costs received in cash from Scientific-Games. \$108,800 was withheld from payments to Scientific-Games for penalties for missed deadlines (failure to provide reports/report modifications, failure to install additional games or game options, failure to provide critical interface functions and/or interface reports). In addition, throughout fiscal year 2006 the Lottery reduced Scientific-Game's percent of sales fee for services not being performed in accordance with the contract. During FY06, the Lottery reduced Scientific-Game's fee by a total of \$997,313.

The Lottery has indicated that many of the reports not available are not critical to the balancing of the system. Per discussion with management, these reports are considered balancing tools that facilitate the reconciliation process and do not reflect actual transactions being transmitted. Without these tools in place, the Lottery has a more manual and labor intensive balancing process in place, which could result in additional expense, loss of data, human error and inefficiencies in the system and the process.

In order to help ensure that the Lottery accurately and completely tracks revenues, receivables and collections related to the sale of lottery tickets, it must have controls in place to reconcile the on-line system with its internal system. The reconciliation process is critical to ensure the accuracy and completeness of the transactions reported by the Lottery and on the State's accounting system. The Lottery should continue efforts to ensure that the reporting function in the new on-line system that supports the reconciliation process fulfills the requirements agreed upon as part of the vendor's contract. In addition, the Lottery should create a firm timeline to ensure that the functions are completed no later than June 30, 2007.

Recommendation No. 1

The Colorado Lottery should continue to work with Scientific-Games to ensure that all reports required as part of the contract are provided and that the reports contain accurate and complete information. The Colorado Lottery, with Scientific-Games, should establish a timeline to ensure that reports are completed and available within the 2007 fiscal year.

Colorado Lottery Response: Partially Agree

Implementation Date: December 2007

The Colorado Lottery continues to work with Scientific-Games to ensure that all reports required as part of the contract are provided. The Lottery will verify that the reports contain accurate and complete information through verification performed in the acceptance testing process and through the daily systems balancing process in production. Scratch inventory reports are scheduled for completion in November 2006. The Lottery is actively working with Scientific-Games on implementation timelines and will make every effort to have retailer billing and tax reporting completed by June 30, 2007; however, it may not be completed until later in 2007. The Lottery will continue to work with Scientific-Games to obtain all required reports through mutually agreeable timelines.

Colorado Lottery

Auditors' Findings and Recommendations (continued)

Years Ended June 30, 2006 and 2005

Independent Reviews of Information Systems

During our 2003, 2004 and 2005 audits, we recommended that the Lottery have an annual independent examination performed of the WANG internal information system on-line used to record and track ticket sales. During our audit for 2005, the Lottery stated that it would reassess the need for an independent review if the planned migration of the WANG to on-line Scientific-Games, which was planned to occur in September of 2006, was implemented as planned. As of the end of our fiscal year 2006 audit, the scratch inventory, tax reporting, retailer billing and sales reporting were still tracked on the WANG system. The new date for the migration of the scratch inventory is November 4, 2006, with April 1, 2007, for the migration of the tax reporting, with no definite dates for retailer billing and sales reporting. With the conversion of the on-line system in 2005, it continues to be critical that the Lottery seek this independent review of the WANG system.

Prior to the conversion to its on-line system, the Lottery's internal information system was used to record and track gross ticket sales. With the conversion of the on-line games to a new system in fiscal year 2005, the new vendor, Scientific-Games, is now responsible for maintaining the transaction data received from the retailers and then transmitting this information into the Lottery's internal (WANG) system. The WANG system then records the revenue and tracks and records the accounts receivable information and transmits this information to the State's accounting system. In fiscal year 2006, the Lottery had gross ticket sales of approximately \$469,000,000. Because of the large number of transactions, high volume of activity and the fact that Scientific-Games has taken over maintaining and transmitting transaction data to the WANG system, the Lottery continues to have significant reliance on and risk associated with the operations of the WANG system.

The Lottery states that it has not implemented this recommendation to have an independent examination of the WANG system because under its contract with Scientific-Games, the vendor will be performing these functions. However, Scientific-Games still has not taken over the major functions currently performed by the WANG. Because of the anticipated migration of the system to Scientific-Games, the independent review has been delayed for at least two years. The information that is recorded in this system is critical to the information reported on the Lottery's financial statements and the internal controls of the Lottery's operation. By delaying this independent review, the Lottery continues to be at risk for recording and reporting inaccurate or incomplete financial information on its own financial statements and the State's financial statements. Through an independent examination, controls are evaluated and tested as to whether they are operating with sufficient effectiveness to provide a reasonable, but not absolute, assurance that the control objectives were achieved for a period specified. Third-party independent audits can be a mechanism to help identify weaknesses in the software and the internal control system internally within the Lottery's system.

Due to the complexity and the high dollar volume of the transactions, at both the Lottery and its vendors, there is significant risk related to information system controls, internal controls over financial processing and safeguarding of the Lottery's assets. This testing would help ensure there are quality controls and systems in place and that they are operating effectively to help reduce the risk of loss to the Lottery and to the State of Colorado.

Colorado Lottery
Auditors' Findings and Recommendations (continued)
Years Ended June 30, 2006 and 2005

Recommendation No. 2

The Colorado Lottery should minimize risks related to information system controls, internal controls over financial processing and safeguarding of assets by performing an annual independent examination of the internal system used to record and track ticket sales.

Colorado Lottery Response: Partially Agree

Implementation Date: December 2007

The Lottery agrees with this recommendation, but will defer the implementation and related costs since migration of the systems that currently process ticket sales transactions on the internal system (WANG) is expected to be completed in 2007. After the migration is completed, the major functions currently performed by the WANG system, including scratch inventory, tax reporting and retailer billing, will become the responsibility of Scientific-Games, and will be audited as a part of the SAS 70 audit of SGI. The Lottery will re-assess the need for an annual independent examination of the internal system if the migration is delayed past the 2007 calendar year.

Destruction of Expired Game Scratch Tickets

A lottery scratch ticket game is considered to be officially at the “end of game” or expired when the following steps occur:

- ✓ The preparation of a notice to repeal is completed.
 - The notice to repeal is prompted by the Lottery director sending a notice to the Lottery Commission of the official “end of game” which consists of the passing of the official game end date and the last day to claim a prize.
- ✓ Filing the notice with the necessary state agencies, including the Secretary of State, the Governor’s office and DORA.
- ✓ Staff present and request approval by the Commission.
- ✓ Staff requests a review from the Attorney General’s office.
- ✓ Staff electronically files the rule with the Secretary of State’s office and the Office of Legislative Legal Services.
- ✓ Publishing the repeal of the rule on the 10th day of the following month.
- ✓ The repeal then becomes effective 20 days after publication.
- ✓ Lottery must then notify all retailers that tickets are to be immediately sent back to the Lottery.
- ✓ 180 days after the game ends and the tickets have been sent back to the Lottery the Lottery’s system produces a report listing the remaining ticket inventory of the expired game.
- ✓ From this report, the staff are to then perform an audit which includes a count of the remaining ticket inventory and a random sampling of the inventory. After completion of the audit, staff authorize the remaining game tickets to be destroyed.
- ✓ Warehouse staff then schedule the actual destruction of the tickets.

Colorado Lottery

Auditors' Findings and Recommendations (continued)

Years Ended June 30, 2006 and 2005

This process is to be followed for every game after the game's expiration. Prior to contracting with its new on-line vendor the Lottery's "end of game process" allowed for an efficient and effective accounting and destruction of expired tickets

During the observation of physical inventory for our audit this year, we noted that there were a large number of expired tickets in the Lottery's warehouse. We found that these tickets were from approximately forty-five scratch ticket games from June 17, 2005 to June 30, 2006. This is after the new vendor, Scientific-Games, had taken over operation of the on-line games.

With the new system, Scientific-Games (SGI) has been unable to perform this "end of game process" because the end of game transfer process on SGI's system is not functioning properly. Specifically, SGI's system is unable to identify the number of tickets remaining for a lottery scratch game that has been officially identified as "expired". Because of this, the audits of the expired tickets can not be performed because the information and reports needed to perform the audit can not be produced from the system. Therefore expired tickets have remained at the warehouse and not destroyed.

Alternative procedures are being developed by Lottery personnel, while SGI develops an "end of game" process. Lottery personnel have been working to verify expired game inventories and ultimately destroy the tickets by pulling individual reports from the SGI system showing the last reported location for the expired game packs. Further, since the game is identified as expired in the system no further sales or redemptions of prizes can occur on the expired game. In addition, SGI developers have been working on a method to obtain a listing of unavailable tickets or those expired tickets that remain at retailers from their system. The Lottery will use these individual reports to perform a complete physical inventory. If the reports reconcile with the physical inventory, a similar process will be performed on the remainder of expired tickets so that all expired tickets can be destroyed.

This solution should only be viewed as temporary because it is not efficient. When expired tickets are not destroyed timely, the Lottery loses available storage space.

Recommendation No. 3

The Colorado Lottery should ensure that its on-line vendor, Scientific-Games, implements an "end of game" process which allows for the accounting and destruction of all expired tickets. The Colorado Lottery should also work with Scientific-Games to implement a reasonable timeline for the completion of this process.

Colorado Lottery Response: Agree

Implementation Date: March 2007

The Lottery is currently working with Scientific-Games to correct the functionality of the end-of-game process and related reporting. The Lottery will ensure that the end-of-game process functions properly and that accurate and complete reports are available. This will provide the Lottery with the necessary information to perform the audits of remaining inventory from expired games and timely destruction of related tickets.

Colorado Lottery
Disposition of Prior Year Audit Recommendations
Year Ended June 30, 2006

Fiscal Year 2005 Recommendations

Number	Recommendation	Disposition
1	The Colorado Lottery should ensure that controls over the collection of accounts receivable for on-line games are adequate by:	
	a) Completing monthly analytical reviews of accounts receivables and correcting problems on a timely basis.	Implemented
	b) Following up and settling outstanding receivables related to the system error in accordance with the established schedule.	Partially implemented, the Lottery has developed a workaround, however, the proper reports are still not available from Scientific-Games. See Recommendation No. 1 in current report.
	c) Working with Scientific-Games to correct the system error.	Not implemented, while the Lottery has been working with Scientific-Games and has developed some workaround solutions the proper reports are still not available from Scientific-Games. See Recommendation No. 1 in current report.
2	The Colorado Lottery should continue to work with Scientific-Games to ensure that all reports required as part of the contract are provided and that the reports contain accurate and complete information.	Not implemented, See Recommendation No. 1 in current report.
3	The Lottery should minimize risks related to information system control, internal controls over financial processing and safeguarding of assets by:	
	a) Performing an annual independent examination of the internal system used to record and track ticket sales.	Not Implemented, See Recommendation No. 2 in current report.
	b) Requesting an independent SAS 70, Type II Audit on the external service provider and its subcontractor as the new system is being established and annually thereafter.	Implemented



Independent Accountants' Report on Financial Statements and Supplementary Information

Members of the Legislative Audit Committee

We have audited the accompanying basic financial statements of the Colorado Lottery, an enterprise fund of the State of Colorado, as of and for the years ended June 30, 2006 and 2005, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note 1, the financial statements present only the enterprise fund and do not purport to, and do not, present fairly the financial position of the State of Colorado, as of June 30, 2006, the changes in its financial position, or, where applicable, its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated August 17, 2006, on our consideration of the Lottery's internal control over financial reporting and 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 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 considered in assessing the results of our audit.

Members of the Legislative Audit Committee

The accompanying management's discussion and analysis, as listed in the table of contents is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying supplementary information is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

\s\ **BKD, LLP**

August 17, 2006

Colorado Lottery

Management's Discussion and Analysis

Years Ended June 30, 2006 and 2005

This discussion and analysis of the Colorado Lottery financial performance provides an overview of financial activities for the fiscal years ended June 30, 2006 and 2005. Please read it in conjunction with the Lottery's financial statements, which begin on page 23. These financial statements reflect only activities of the Colorado Lottery, a proprietary fund of the State of Colorado.

Financial Highlights

- The Lottery's overall sales performance of \$468.8 million reflected a \$51.8 million increase from last year's sales of \$417 million and, for the second year in a row, became the highest sales year since the Lottery's start-up in 1983. Fiscal year 2004 sales totaled \$401.3 million and ranks as the fourth-highest sales year ever.

Scratch sales hit a record high for the third year in a row with scratch sales totaling \$293.8 million. The second highest sales were in fiscal year 2005, with scratch sales totaling \$282.7 million. Fiscal year 2004, scratch sales totaling \$260.9 million ranks third in total scratch sales. An increase in marketing efforts, including offering a broader range of price points, innovative display cases, additional games and an overall upgrade to the look of our scratch tickets, contributed to this increase in scratch sales.

Lotto sales remained steady for the first time since the introduction of Powerball in fiscal year 2002. Fiscal years 2006 and 2005 both reflected Lotto sales of \$38.3 million. Fiscal year 2004 Lotto sales totaling \$40.8 million, reflected a \$7.5 million decrease from the prior fiscal year 2003 sales of \$48.3 million.

Powerball sales for fiscal year 2006 soared to \$119.8 million, a \$38.9 million increase from the prior fiscal year. A matrix change implemented in August 2005 allowed the Powerball jackpot to reach record heights of \$340 million and \$365 million, contributing to the extensive growth in Powerball sales. Powerball sales for fiscal year 2005 totaled \$80.9 million as compared to fiscal year 2004's sales of \$85 million.

Cash 5 sales for fiscal year 2006 showed an unexpected increase for the fourth year in a row. Sales increased nearly 12% to a total of \$16.9 million from \$15.1 million in fiscal year 2005. This followed a nearly 4% increase in sales in fiscal year 2005 from fiscal year 2004, whose sales totaled \$14.5 million.

- Funds distributed or available for distribution from 2006 sales hit a record high with a total of \$125.6 million, beating fiscal year 2002, which previously held the record with distributions totaling \$110 million. The \$125.6 million represented a 21% increase from fiscal year 2005's distributions total of \$103.7 million, which was down slightly from fiscal year 2004's distributions total of \$104.1 million. Fiscal year 2006 included, for the fifth time, a spill-over into the State Public School Fund Contingency Reserve; in the amount of \$12.5 million and was the largest one-year spill-over since the first spill-over occurred in fiscal year 2002. A spill-over occurs when the distribution cap for GOCO is reached in any one year. The cap for GOCO is the 1992 base year amount of \$35 million as adjusted for the annual change in the cost of living increase for the Denver-Boulder area. The total amount of the spill-over during the five-year period totals \$28.8 million.

Colorado Lottery

Management's Discussion and Analysis

Years Ended June 30, 2006 and 2005

- Gross profit as a percent of sales increased slightly by .3%, a reflection of the decrease in the scratch ticket costs and vendor fees from 2.4% (\$9,906,061) to 2.1% (\$9,727,730) of sales for the years ended June 30, 2005 and 2006, respectively. A reduction in scratch ticket costs resulted from the implementation of new contracts with the scratch ticket vendors, lowering the cost to purchase tickets. Fiscal year 2006 vendor fees were slightly lower due to a full year under a new contract. A decrease in the percentage of retailer compensation from 7.6% to 7.4% was also a contributing factor. Unclaimed prizes remained somewhat steady between fiscal year 2005 and fiscal year 2006 across all products. Fiscal year 2006 did, however, include the expiration of a bonus prize for the Powerball Game of \$853,492. Gross profit as a percent of sales decreased by .9% between fiscal years 2004 and 2005, a reflection of the increase in the prize costs from 59% (\$236,602,960) to 59.8% (\$249,502,651) of sales. Fiscal year 2004 prize expense was slightly lower due to the absorption of two expiring unclaimed Lotto jackpots.

Games Offered by the Colorado Lottery

Currently, the Lottery offers two different ways to play: scratch games and on-line games (Powerball, Lotto and Cash 5). Scratch games consist of pre-printed tickets that may be purchased for various prices (\$1, \$2, \$3, \$5 and \$10) at any Lottery retailer. When scratched, they provide immediate knowledge if the ticket is a winner and can be cashed immediately at the retailer level if the amount of the winnings is \$599 or less. Prizes over \$600 must be redeemed at the Lottery offices.

On-line games, however, require a longer playing time. Tickets are also purchased at the Lottery retailers and are printed on ticket stock as the purchase is made. Each ticket contains one or more playing boards. Each board consists of a set of numbers, the combination of numbers required for play varying by game. The winning numbers for each game are posted after their respective draw nights with drawings held on every night of the week, excluding Sunday. Players must check their numbers against the numbers drawn for each respective game to determine if they have a winning ticket. The tickets may also be cashed at the retailer level if the amounts of the winnings are \$599 or less. Prizes over \$600 must be redeemed at the Lottery offices.

Using this Annual Report

This annual report consists of a series of financial statements. The statement of net assets provides information about the Lottery's assets and liabilities and reflects the Lottery's financial position as of June 30, 2006 and 2005. The statement of revenues, expenses and changes in net assets reports the activity of selling the Lottery products and the expenses related to such activity for the years ended June 30, 2006 and 2005. Finally, the statement of cash flows outlines the cash inflows and outflows related to the activity of selling the Lottery products for the years ended June 30, 2006 and 2005.

Colorado Lottery
Management's Discussion and Analysis
Years Ended June 30, 2006 and 2005

Statements of Net Assets

The statements of net assets is a financial snapshot of the Lottery at June 30, 2006 and 2005. It presents the fiscal resources of the Lottery (assets), the claims against those resources (liabilities) and the residual available for future operations (net assets). Assets and liabilities are classified by liquidity as either current or noncurrent. Net assets are classified by the ways in which they may be used for future operations.

Condensed Statements of Net Assets
June 30, 2006, 2005 and 2004

	2006	2005	2004
Assets			
Current assets	\$ 45,946,060	\$ 49,400,246	\$ 39,951,270
Restricted assets	5,706,844	6,089,238	5,024,418
Capital assets	<u>754,051</u>	<u>861,066</u>	<u>1,029,114</u>
Total assets	<u>\$ 52,406,955</u>	<u>\$ 56,350,550</u>	<u>\$ 46,004,802</u>
Liabilities			
Current liabilities	\$ 49,104,926	\$ 52,415,997	\$ 43,576,344
Long-term liabilities	<u>947,001</u>	<u>965,078</u>	<u>782,863</u>
Total liabilities	<u>\$ 50,051,927</u>	<u>\$ 53,381,075</u>	<u>\$ 44,359,207</u>
Net Assets			
Investment in capital assets	\$ 754,051	\$ 861,066	\$ 1,029,114
Restricted – Licensed Agent			
Recovery Reserve	398,064	479,238	469,424
Unrestricted – Operating Reserve	1,600,000	1,700,000	—
Unrestricted	<u>(397,087)</u>	<u>(70,829)</u>	<u>147,057</u>
Total net assets	<u>\$ 2,355,028</u>	<u>\$ 2,969,475</u>	<u>\$ 1,645,595</u>

The Lottery's total assets at June 30, 2006 were \$52.4 million. Assets consisted primarily of cash and investments with the State Treasury of \$31.2 million, Prepaid Prize Expense with Multi-State Lottery (MUSL) of \$3.7 million, receivables from Lottery retailers for the sale of Lottery products of \$15.8 million and a net investment in fixed assets of \$.8 million.

Comparable figures at June 30, 2005 were \$56.4 million in total assets, including \$28.7 million in cash and investments with the State Treasury, Prepaid Prize Expense with MUSL of \$3.9 million, receivable from retailers of \$21.5 million and a net investment in fixed assets of \$.9 million.

Comparable figures at June 30, 2004 were \$46.0 million in total assets, including \$25.4 million in cash and investments with the State Treasury, Prepaid Prize Expense with MUSL of \$3.5 million, receivable from retailers of \$14.7 million and a net investment in fixed assets of \$1 million.

Colorado Lottery

Management's Discussion and Analysis

Years Ended June 30, 2006 and 2005

The \$6.8 million increase in receivables from retailers between fiscal year 2004 and fiscal year 2005 was partly the result of an undetected problem in the new on-line system, whereby billings of receivables to retailers were delayed. The error was detected in mid-July 2005 and was resolved in fiscal year 2006.

The Lottery's total liabilities at June 30, 2006 totaled approximately \$50.1 million, consisting primarily of proceeds distributions due to recipients of \$28.8 million and prize liability on all the Lottery products of about \$17.1 million.

The Lottery's total liabilities at June 30, 2005 totaled \$53.4 million, which consisted primarily of proceeds distributions due of \$27.8 million and prize liability on all the Lottery products of about \$17.1 million.

The Lottery's total liabilities at June 30, 2004 totaled \$44.4 million, which consisted primarily of proceeds distributions due of \$25.8 million and prize liability on all the Lottery products of about \$14 million.

Components of the Lottery's net assets are: 1) an amount to represent the Lottery's net investment in capital assets as required by the reporting model under GASB 34, (see "Total Capital Assets" on the statements of net assets); 2) a Licensed Agent Recovery Reserve (bonding reserve) funded by retailers to cover any uncollectible receivable accounts; 3) an amount representing the funds held by the Lottery in an operating reserve as mandated by Senate Bill 04-204 (see "Cash and Investments – Operating Reserve") on the statements of net assets; and 4) an adjustment made by the Lottery to reflect its share of unrealized gains or losses on investments held by the State Treasurer.

The change in net assets from June 30, 2005 to June 30, 2006 consisted of a decrease in investment in capital assets from \$.9 million to \$.8 million, a decrease in the bonding reserve from \$479,238 to \$398,064, the decrease in the operating reserve from \$1.7 million to \$1.6 million and a net decrease in unrealized gain and losses on investments of \$326,258 resulting from a net decrease in the adjustments on State Treasury investments.

Following is a schedule of net assets for fiscal years 2006 and 2005:

	<u>2006</u>	<u>2005</u>	<u>Change</u>
Investment in capital assets	\$ 754,051	\$ 861,066	\$ (107,015)
Bonding reserve	398,064	479,238	(81,174)
Operating reserve	1,600,000	1,700,000	(100,000)
Unrealized gain (loss) on investments	<u>(397,087)</u>	<u>(70,829)</u>	<u>(326,258)</u>
Total net assets	<u>\$ 2,355,028</u>	<u>\$ 2,969,475</u>	<u>\$ (614,447)</u>

The change in net assets from June 30, 2004 to June 30, 2005 consisted of a decrease in investment in capital assets from \$1 million to \$.9 million, a minor increase in the bonding reserve from \$469,424 to \$479,238, the establishment of the operating reserve of \$1.7 million and a net increase in unrealized gains and losses on investments of \$217,886 resulting from a net decrease in the adjustments on State Treasury investments.

Colorado Lottery
Management's Discussion and Analysis
Years Ended June 30, 2006 and 2005

Following is a schedule of net assets for fiscal years 2005 and 2004:

	2005	2004	Change
Investment in capital assets	\$ 861,066	\$ 1,029,114	\$ (168,048)
Bonding reserve	479,238	469,424	9,814
Operating reserve	1,700,000	—	1,700,000
Unrealized gain on investments	<u>(70,829)</u>	<u>147,057</u>	<u>(217,886)</u>
Total net assets	<u>\$ 2,969,475</u>	<u>\$ 1,645,595</u>	<u>\$ 1,323,880</u>

Statements of Revenues, Expenses and Changes in Net Assets

The statements of revenues, expenses and changes in net assets presents the financial activity of the Lottery over the fiscal year. The focus is on operating revenues and expenses that have a significant effect on the distributions paid to the proceeds recipients.

**Condensed Statements of Revenues, Expenses and
Changes in Net Assets
For the Fiscal Years Ended June 30, 2006, 2005 and 2004**

	2006	2005	2004
Operating Revenues	\$ 468,761,808	\$ 416,966,782	\$ 401,250,971
Direct Operating Expenses	<u>325,992,891</u>	<u>291,083,679</u>	<u>276,512,227</u>
Gross Profit on Sale of Tickets	<u>142,768,917</u>	<u>125,883,103</u>	<u>124,738,744</u>
Other Operating Expenses			
Marketing and communications	8,893,150	8,559,774	8,643,422
Wages and benefits	8,195,004	7,941,537	7,881,363
Other operating expenses	<u>3,624,150</u>	<u>6,022,481</u>	<u>5,550,032</u>
Total other operating expenses	<u>20,712,304</u>	<u>22,523,792</u>	<u>22,074,817</u>
Operating Income	<u>122,056,613</u>	<u>103,359,311</u>	<u>102,663,927</u>
Nonoperating Revenues (Expenses)			
Other revenue	1,761,259	953,328	156,990
Investment income	1,118,781	747,176	184
Proceeds distributions	<u>(125,551,100)</u>	<u>(103,735,935)</u>	<u>(104,071,458)</u>
Total nonoperating expenses	<u>(122,671,060)</u>	<u>(102,035,431)</u>	<u>(103,914,284)</u>
Increase (Decrease) in Net Assets	(614,447)	1,323,880	(1,250,357)
Net Assets, Beginning of Year	<u>2,969,475</u>	<u>1,645,595</u>	<u>2,895,952</u>
Net Assets, End of Year	<u>\$ 2,355,028</u>	<u>\$ 2,969,475</u>	<u>\$ 1,645,595</u>

Colorado Lottery
Management's Discussion and Analysis
Years Ended June 30, 2006 and 2005

Sales Activities

Revenues from the sale of the Lottery products for the fiscal year ended June 30, 2006 were the highest in the Lottery's 24-year history. As shown in the financial statements, overall sales increased by 12.4% from the prior year, from \$417.0 million in fiscal year ended June 30, 2005 to \$468.8 million in the current year. Furthermore, fiscal year 2006 sales increased by 14.9% over the third highest sales year of \$407 million in fiscal year 2002. The increase in scratch sales from \$282.7 million to \$293.8 million represented a percentage increase of 3.9%. Powerball had record sales of \$119.8 million in the current fiscal year, which represented a percentage increase from last year's sales of 48.1% and an increase of 40.8% from the prior record year's sales of \$85.0 million established in fiscal year 2004. Lotto sales remained steady in fiscal year 2006 at \$38.3 million. This was the first year since the start up of Powerball that Lotto sales didn't experience a large percentage decrease in sales. In fiscal year 2005, Lotto sales reflected a 6.1% decrease from fiscal year 2004.

The following tables compare Lottery product sales between fiscal years. All sales are presented in millions of dollars:

Product Sales	2006	2005	Difference	Change
Scratch	\$ 293.8	\$ 282.7	\$ 11.1	3.9%
Powerball	119.8	80.9	38.9	48.1
Lotto	38.3	38.3	0.0	0.0
Cash 5	<u>16.9</u>	<u>15.1</u>	<u>1.8</u>	<u>11.9</u>
Total	\$ <u>468.8</u>	\$ <u>417.0</u>	\$ <u>51.8</u>	<u>12.4%</u>

Product Sales	2005	2004	Difference	Change
Scratch	\$ 282.7	\$ 260.9	\$ 21.8	8.4%
Powerball	80.9	85.0	(4.1)	(4.8)
Lotto	38.3	40.8	(2.5)	(6.1)
Cash 5	<u>15.1</u>	<u>14.5</u>	<u>.6</u>	<u>4.1</u>
Total	\$ <u>417.0</u>	\$ <u>401.2</u>	\$ <u>15.8</u>	<u>3.9%</u>

Colorado Lottery

Management's Discussion and Analysis

Years Ended June 30, 2006 and 2005

Total Revenues

Nonoperating revenues for the year ended June 30, 2006 totaled \$2.9 million as compared with \$1.7 million for the year ended June 30, 2005 and as compared with \$.2 million for the year ended June 30, 2004. Two major factors contributed to the increase from fiscal year 2005 to fiscal year 2006. First, interest received from the treasury increased by approximately \$317,000 from fiscal year 2005 to fiscal year 2006. This increase was a result of carrying larger cash balances resulting from the large increase in sales, as well as, an increase in interest rates from an average of 3.18% in fiscal year 2005 to 3.92% in fiscal year 2006. Second, other income in fiscal year 2006 included reimbursements from the on-line vendor of approximately \$1,570,000 as compared to approximately \$855,000 in fiscal year 2005. The fiscal year 2006 reimbursements relates to fines and penalties assessed for non or delayed performance. The fiscal year 2005 reimbursements relates to amounts owed by the new vendor relating to the delay in the conversion of the on-line gaming system.

Two major factors contributed to the increase in non-operating revenues from fiscal year 2004 to fiscal year 2005. First, investment income for fiscal year 2004 included a net loss of \$860,931 to record the Lottery's share of unrealized gains and losses on cash held at the State Treasurer as compared to a net loss of only \$217,886 in fiscal year 2005. In addition, Senate Bill 03-300, required that, for fiscal year 2004, 15% of the Lottery's Treasury interest be sent to the General Fund. Second, other income in fiscal year 2005 included reimbursements from the on-line vendor of approximately \$855,000. Again, these reimbursements relate to amounts owed by the new vendor relating to the delay in the conversion.

Total revenues were \$471.6 million and \$418.7 million for the years ended June 30, 2006 and 2005, respectively. As mentioned elsewhere, the two major contributors to the increase of approximately \$52.9 million were an increase in Lottery sales of \$51.8 million and an increase in nonoperating revenues of \$1.2 million.

Total revenues for the year ended June 30, 2004 were \$401.4 million. The major contributing factor for the increase in total revenues from fiscal year 2004 to 2005 of \$17.2 million, was an increase in ticket sales of \$15.7 million. Non-operating revenues increased by \$1.5 million for the same period.

Major Expenses

Approximately \$326.0 million of the Lottery's total expenses of \$346.7 for the fiscal year ended June 30, 2006, were incurred in direct support of the Lottery games. This included prize expense, retailer compensation, money spent to purchase scratch tickets and compensation to the vendor who maintains and supports the on-line gaming system.

In comparison, \$291.1 million of the Lottery's total expenses of \$313.6 million for the fiscal year ended June 30, 2005, were game-related expenses.

In comparison, \$276.5 million of the Lottery's total expenses of \$298.6 million for the fiscal year ended June 30, 2004, were game-related expenses.

Colorado Lottery
Management's Discussion and Analysis
Years Ended June 30, 2006 and 2005

Following are tables comparing the game-related expenses between fiscal years. All expenses are presented in millions of dollars.

Game-Related Expenses	2006	2005	Difference	Change
Prize expense/Powerball prize variance	\$ 281.6	\$ 249.5	\$ 32.1	12.9%
Retailer compensation				
Commissions	31.1	27.8	3.3	11.9
Bonuses	3.6	3.9	(.3)	(7.7)
Ticket costs	2.9	3.2	(.3)	(9.4)
Vendor fees	<u>6.8</u>	<u>6.7</u>	<u>.1</u>	<u>1.5</u>
Total	\$ <u>326.0</u>	\$ <u>291.1</u>	\$ <u>34.9</u>	<u>12.0%</u>

Game-Related Expenses	2005	2004	Difference	Change
Prize expense/Powerball prize variance	\$ 249.5	\$ 236.6	\$ 12.9	5.5%
Retailer compensation				
Commissions	27.8	26.6	1.2	4.5
Bonuses	3.9	3.6	.3	8.3
Ticket costs	3.2	3.0	.2	6.7
Vendor fees	<u>6.7</u>	<u>6.7</u>	<u>.0</u>	<u>.0</u>
Total	\$ <u>291.1</u>	\$ <u>276.5</u>	\$ <u>14.6</u>	<u>5.3%</u>

The increase in the game-related expenses, including prize expense, commission expense and bonus expense (fiscal year 2004 to fiscal year 2005) is reflective of the increase in product sales. (See the product sales schedule above.) In addition, the prize expense percentage was further increased in fiscal year 2005 over the prize expense percentage in fiscal year 2004, as the prize expense percentage in fiscal year 2004 had been reduced by the expiration of two unclaimed Lotto jackpots. The decrease in bonus expense from fiscal year 2005 to fiscal year 2006, is the result of the implementation of a new retailer marketing bonus plan in fiscal year 2006, making it more difficult for retailers to achieve full bonus. The decrease in ticket costs from fiscal year 2005 to fiscal year 2006 was a result of the implementation of new contracts with the scratch ticket vendors which reduced the cost to purchase tickets.

Of the \$20.7 million in fiscal year 2006 expenses that were non game-related, nearly \$8.9 million was for promotions and institutional and product advertising and about \$8.2 million in compensation to the Lottery employees.

In comparison, of the fiscal year 2005 non game-related expenses of \$22.5 million, \$8.5 million was for promotions and institutional and product advertising and \$7.9 million was for compensation to the Lottery employees.

Colorado Lottery

Management's Discussion and Analysis

Years Ended June 30, 2006 and 2005

In comparison, of the fiscal year 2004 non game-related expenses of \$22.1 million, more than \$8.6 million was for promotions and institutional and product advertising and \$7.9 million was for compensation to Lottery employees.

Distributions to the Proceeds Recipients

The Lottery's efforts generated funds available for distributions of \$125.6 million in the current fiscal year, the highest year ever. Of these total proceeds, \$50.2 million was allocated to the Great Outdoors Colorado Trust Fund, \$50.2 million to the Conservation Trust Fund and \$12.6 million to the Division of Parks and Outdoor Recreation per the distribution formula stated in Colorado Revised Statutes (C.R.S.) 24-35-210. The maximum distribution to Great Outdoors Colorado of \$50.2 million, pursuant to C.R.S. 33-60-104(1)(c) and 33-60-104(2), was reached, thus creating a spill-over into the State Public School Fund Contingency Reserve of \$12.5 million, pursuant to C.R.S. 22-54-117(1.6)(a).

The Lottery's proceeds distributions for the fiscal year 2005 totaled \$103.7 million. Approximately \$50.2 million was distributed to Great Outdoors Colorado, \$41.5 million to the Conservation Trust Fund, \$10.3 million to the Division of Parks and Outdoor Recreation and a spill-over into the State's Public School Fund Contingency Reserve of nearly \$1.7 million.

The Lottery's proceeds distributions for fiscal year 2004 was the fourth-highest year on record, totaling \$104.1 million. Approximately \$49.6 million was distributed to Great Outdoors Colorado, \$41.6 million to the Conservation Trust Fund, \$10.4 million to the Division of Parks and Outdoor Recreation and a spill-over into the State's Public School Fund Contingency Reserve of nearly \$2.4 million.

Budgetary Highlights

The Lottery's budget is determined by a variety of methods. The majority of the budget is set by the annual appropriations bill (the Long Bill), which determines budgets for every agency within the State. The Long Bill and department level allocations are approved shortly before the start of each fiscal year. Agencies may also request a supplemental appropriation during the fiscal year to cover unexpected expenses (or a negative supplemental for less than expected expenses), as well as year-end transfers of spending authority, if needed. In the third quarter of fiscal year 2006, the Legislature approved supplemental appropriation adjustments for the Lottery. Supplemental appropriations and department level re-allocations were approved in operating, vendor fees, prizes, Powerball prize variance, retailer compensation, ticket costs, amortization equalization, health and life, administrative law judge, purchased services-computer center, MNT payments, vehicle lease payments, Grand Junction leased space and communications service lines, offset by reductions in workmen's compensation and risk management lines. The final method of funding is special legislation. There was no special legislation affecting the Lottery's budget in fiscal year 2006.

Colorado Lottery

Management's Discussion and Analysis

Years Ended June 30, 2006 and 2005

The approved Lottery budget at the beginning of fiscal year 2006 was \$350.6 million. Supplemental appropriations and adjustments made in the third quarter increased the budget by \$22.1 million, department level allocations approved at the beginning of the fiscal year increased the budget by \$1.8 million to an amended total of \$374.6 million. Total expenditures and roll-forwards for fiscal year 2006 on a budget basis came to \$352.1 million, resulting in excess appropriations (or savings) of more than \$22.5 million.

Contacting the Lottery's Financial Management

This management discussion and analysis report is designed to provide Colorado citizens, Colorado government officials, our players, retailers and other interested parties with a general overview of the Lottery's financial activity for fiscal year 2006 and to demonstrate the Lottery's accountability for the money generated from the sale of the Lottery products. If you have questions about this report or need additional information, contact Barbara Aggson, the Colorado Lottery's Controller, 212 W. 3rd Street, Suite 210, Pueblo, CO 81003.

Colorado Lottery
Statements of Net Assets
June 30, 2006 and 2005

Assets

	<u>2006</u>	<u>2005</u>
Current Assets		
Cash and investments	\$ 29,235,248	\$ 26,580,839
Accounts receivable, net of the allowance for doubtful accounts; 2006 – \$227,823 and 2005 – \$79,044	15,840,057	21,543,586
Game prizes inventory, at cost	—	22,560
Consignment ticket inventory, at cost	119,939	170,900
Warehouse ticket inventory, at cost	705,596	1,039,705
Prepaid expenses	<u>45,220</u>	<u>42,656</u>
Total current assets	<u>45,946,060</u>	<u>49,400,246</u>
Restricted Assets		
Cash and investments – Licensed Agent Recovery Reserve	398,064	479,238
Cash and investments – Operating Reserve	1,600,000	1,700,000
Prepaid prize expense – Multi-State Lottery Association	<u>3,708,780</u>	<u>3,910,000</u>
Total restricted assets	<u>5,706,844</u>	<u>6,089,238</u>
Capital Assets		
Equipment	3,902,715	3,883,759
Leasehold improvements	14,053	14,053
Less accumulated depreciation and amortization	<u>(3,162,717)</u>	<u>(3,036,746)</u>
Total capital assets	<u>754,051</u>	<u>861,066</u>
Total assets	<u>\$ 52,406,955</u>	<u>\$ 56,350,550</u>

Liabilities

	2006	2005
Current Liabilities		
Accounts payable	\$ 1,610,794	\$ 5,460,542
Prize liability	17,148,271	17,067,680
Payable to MUSL	125,926	142,962
Wages and benefits	780,257	694,337
Accrued annual and sick leave	—	12,030
Retailer bonus liability	409,318	1,104,390
Funds available for distribution	28,796,304	27,779,840
Deferred revenue	<u>234,056</u>	<u>154,216</u>
Total current liabilities	<u>49,104,926</u>	<u>52,415,997</u>
Long-term Liabilities		
Accrued annual and sick leave	839,099	835,856
Expired warrants liability	<u>107,902</u>	<u>129,222</u>
Total long-term liabilities	<u>947,001</u>	<u>965,078</u>
Total liabilities	<u>50,051,927</u>	<u>53,381,075</u>
Net Assets		
Investment in capital assets	754,051	861,066
Restricted – Licensed Agent Recovery Reserve	398,064	479,238
Unrestricted – Operating Reserve	1,600,000	1,700,000
Unrestricted	<u>(397,087)</u>	<u>(70,829)</u>
Total net assets	<u>2,355,028</u>	<u>2,969,475</u>
Total liabilities and net assets	<u>\$ 52,406,955</u>	<u>\$ 56,350,550</u>

Colorado Lottery
Statements of Revenues, Expenses and Changes in Net Assets
Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Operating Revenues		
Gross ticket sales	\$ <u>468,761,808</u>	\$ <u>416,966,782</u>
Direct Operating Expenses		
Prize expense	279,953,707	248,809,641
Powerball prize variance	1,640,538	693,010
Retailer commissions and bonuses	34,670,916	31,674,967
Cost of tickets and vendor fees	<u>9,727,730</u>	<u>9,906,061</u>
Total direct operating expenses	<u>325,992,891</u>	<u>291,083,679</u>
Gross Profit on Sale of Tickets	<u>142,768,917</u>	<u>125,883,103</u>
Other Operating Expenses		
Marketing and communications	8,893,150	8,559,774
Administration fees paid to MUSL	114,104	117,286
Wages and benefits	8,195,004	7,941,537
Professional services	198,979	956,988
State agencies services	197,312	215,969
Department of Revenue services	312,057	309,814
Travel	68,750	80,795
Equipment (including \$5,846 and \$149,445, respectively, of loss on disposition of equipment)	162,446	1,231,910
Depreciation	182,055	193,227
Space rental	752,350	766,063
Rents for equipment	26,342	252,285
Motorpool leasing	337,438	250,302
Materials and supplies	150,042	121,720
Telephone	122,986	161,262
On-line telecommunications	346,912	567,189
Data processing supplies and services	23,834	31,427
Equipment maintenance	218,886	284,248
Postage	49,182	40,593
Printing	17,988	20,243
Other	<u>342,487</u>	<u>421,160</u>
Total other operating expenses	<u>20,712,304</u>	<u>22,523,792</u>
Operating Income	<u>122,056,613</u>	<u>103,359,311</u>

Colorado Lottery
Statements of Revenues, Expenses and Changes in Net Assets (continued)
Years Ended June 30, 2006 and 2005

	2006	2005
Operating Income	<u>122,056,613</u>	<u>103,359,311</u>
Nonoperating Revenues (Expenses)		
Other revenue	1,761,259	953,328
Investment income	1,118,781	747,176
Funds distributed for current year	(96,754,796)	(75,956,095)
Funds available for distribution for current year	<u>(28,796,304)</u>	<u>(27,779,840)</u>
Total nonoperating expenses	<u>(122,671,060)</u>	<u>(102,035,431)</u>
Increase (Decrease) in Net Assets	(614,447)	1,323,880
Net Assets, Beginning of Year	<u>2,969,475</u>	<u>1,645,595</u>
Net Assets, End of Year	<u>\$ 2,355,028</u>	<u>\$ 2,969,475</u>

Colorado Lottery
Statements of Cash Flows
Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Operating Activities		
Cash received from retailers	\$ 476,625,977	\$ 411,122,036
Cash paid in prizes	(282,138,724)	(246,822,873)
Cash paid in retailer commissions	(31,038,482)	(27,804,768)
Cash payments to suppliers	(25,158,060)	(21,274,511)
Cash payments to employees for services	(8,112,380)	(7,735,836)
Cash paid in retailer bonus	(4,336,059)	(3,351,226)
Cash received – other	<u>127,705</u>	<u>389,626</u>
Net cash provided by operating activities	<u>125,969,977</u>	<u>104,522,448</u>
Noncapital Financing Activities		
Distribution of net proceeds	<u>(124,534,636)</u>	<u>(101,761,616)</u>
Capital and Related Financing Activities		
Sale of capital assets	—	7,500
Acquisition of capital assets	<u>(80,887)</u>	<u>(174,624)</u>
Net cash used by financing activities	<u>(80,887)</u>	<u>(167,124)</u>
Investing Activities		
Interest received	<u>1,445,039</u>	<u>965,062</u>
Increase in Cash and Investments	2,799,493	3,558,770
Change in Fair Market Value of Investments	(326,258)	(217,886)
Cash and Investments, Beginning of Year (Including \$2,179,238 and \$469,424, Respectively, in Restricted Accounts)	<u>28,760,077</u>	<u>25,419,193</u>
Cash and Investments, End of Year (Including \$1,998,064 and \$2,179,238, Respectively, in Restricted Accounts)	<u>\$ 31,233,312</u>	<u>\$ 28,760,077</u>

Colorado Lottery
Statements of Cash Flows (continued)
Years Ended June 30, 2006 and 2005

	2006	2005
Reconciliation of Operating Income to Net Cash Provided by		
Operating Activities		
Operating income	\$ 122,056,613	\$ 103,359,311
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	182,055	193,227
Loss of disposal of equipment	5,847	141,946
Other revenue	1,761,259	953,327
Change in		
Accounts receivable	5,875,131	(6,872,402)
Ticket inventory	385,070	(9,636)
Prepaid prize expense with MUSL	201,220	(384,120)
Other assets	19,996	93,246
Liabilities (excluding funds available for distribution)	<u>(4,517,214)</u>	<u>7,047,549</u>
Net cash provided by operating activities	<u>\$ 125,969,977</u>	<u>\$ 104,522,448</u>
Statement of Net Assets Classification		
Cash and investments	\$ 29,235,248	\$ 26,580,839
Cash and investments – Licensed Agent Recovery Reserve	398,064	479,238
Cash and investments – Operating Reserve	<u>1,600,000</u>	<u>1,700,000</u>
	<u>\$ 31,233,312</u>	<u>\$ 28,760,077</u>

Colorado Lottery
Notes to Financial Statements
June 30, 2006 and 2005

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

The Colorado Lottery (the Lottery) began operations April 30, 1982 under the provisions of Section 24-35-202, C.R.S. The Lottery operates under a commission and provides operation and service of lottery games as authorized by the statute. The Lottery's revenues are predominantly earned from the sale of lottery products, including scratch, Lotto, Powerball and Cash 5.

The financial statements reflect only activities of the Lottery, an enterprise fund of the State of Colorado, for the fiscal years ended June 30, 2006 and 2005. The Lottery is an agency of the State of Colorado. The financial statements are intended to present the financial position and results of operations and cash flows of only that portion of the State of Colorado that is attributable to the transactions of the Lottery in accordance with accounting principles generally accepted in the United States of America.

The accounting policies of the Lottery conform to accounting principles generally accepted in the United States of America as applicable to governments. The following is a summary of the more significant policies.

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 estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues, expenses, gains, losses and other changes in net assets during the reporting period. Actual results could differ from those estimates.

Fund Accounting

Government resources are allocated to, and accounted for, in separate sub-entities called funds, based upon the purposes for which the resources are to be spent and the means by which spending activities are controlled. A fund is a fiscal and accounting entity with a self-balancing set of accounts that comprise its assets, liabilities, net assets, revenues and expenditures.

Colorado Lottery

Notes to Financial Statements

June 30, 2006 and 2005

Enterprise Fund

The Lottery accounts for its operations as an enterprise fund. The intent of the State of Colorado Legislature is that the Lottery's cost (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges. As permitted by Governmental Accounting Standards Board Statement No. 20, *Accounting and Financial Reporting Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Lottery has elected to apply only those applicable Financial Accounting Standards Board Statements and interpretations issued prior to November 30, 1989.

The Lottery defines operating revenues as those earned as a direct result of the fund's principal ongoing operations, (*i.e.*, the sale of lottery products). Operating expenses include expenses incurred in earning those revenues such as the cost of tickets, vendor fees, retailer commissions and bonuses, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting these definitions are reported as nonoperating revenues and expenses.

Basis of Accounting

Basis of accounting refers to when revenues, expenditures or expenses are recognized in the accounts and reported in the financial statements. The Lottery accounts for funds using the accrual basis of accounting. Revenues from scratch ticket sales are recognized at the point of ticket pack activation. Revenues from Lotto, Powerball, Cash 5 and subscription ticket sales are recognized using the specific performance method whereby sales are recognized at the point that the play becomes active for the next drawing. Expenses are recognized when they are incurred.

Budget

By October 24th of each year, the Department of Revenue Executive Director submits to the Office of State Planning and Budgeting a proposed legislative budget for the fiscal year commencing the following July 1. The legislative budget includes proposed expenditures and the means of financing them.

Public hearings are conducted by the Joint Budget Committee to obtain clarification and taxpayer comments. Prior to June 30, the budget is legally enacted through passage of a law referred to as the Long Bill.

During the fiscal year, the approved legislative budget may be modified due to roll-forward authorization, supplemental budget approval or line item transfer authorization. All modifications must be approved by the State Controller and the Office of State Planning and Budgeting and/or the Legislature.

Colorado Lottery
Notes to Financial Statements
June 30, 2006 and 2005

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist of amounts due from retailers for activated ticket packets. Accounts receivable are stated at the amount billed to retailers. Accounts receivable are ordinarily due seven days after the issuance of the invoice and are electronically transferred from the retailers accounts into the Lottery's account.

Allowance for doubtful accounts represents a provision for receivables that will probably not be collected in the future. Consideration of the economic climate, credit-worthiness of individual account debtors, bankruptcy of debtor, discontinuance of debtor's business, failure of repeated attempts to collect and barring of collection by statute of limitations are factors used in considering when an account becomes uncollectible. The accrual of a loss contingency is required when a loss is probable and/or can be reasonably estimated.

The Lottery uses the specific identification method to determine expected uncollectibles. Under the provisions of Section 24-35-219, C.R.S., Licensed Agent Recovery Reserve receipts are collected from the retailers to cover uncollectible accounts. The accounts receivable and the Licensed Agent Recovery Reserve are shown net of estimated uncollectible receivables of \$227,823 and \$79,044 as of June 30, 2006 and 2005, respectively.

Game Prizes Inventory

Game Prizes inventory represents merchandise prizes connected to certain scratch games that, as of the statements of net assets date, have not been claimed.

Consignment Inventory

Inventory on consignment represents non-activated ticket inventory in the possession of retailers who act as agents of the Lottery. The Lottery retains title to these tickets since retailers have the right to return non-activated tickets; therefore, the tickets are included in the inventory and reported on the statements of net assets. Consignment inventory is stated at cost using the specific identification method.

Warehouse Inventory

Warehouse inventory represents unsold tickets in possession of the Lottery and is stated at cost, using the specific identification method.

Colorado Lottery

Notes to Financial Statements

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Supplies Inventory

The State of Colorado's threshold for recording supplies inventories is \$100,000 per location. The supplies inventory of the Lottery consistently falls below the \$100,000 threshold per location. Accordingly, no supplies inventory appears on the statements of net assets.

Prepaid Prize Expense

As part of the Lottery's agreement with Multi-State Lottery Association (MUSL) for the Powerball game, a certain percentage of sales must be paid to MUSL for set prize and grand prize reserves.

Fixed Assets

Equipment and leasehold improvements are stated at cost. Beginning January 1, 2004, the Lottery adopted the state policy of capitalizing equipment if the cost exceeds \$5,000 and has a useful life of more than one year. Depreciation for equipment is computed on the straight-line method over estimated useful lives ranging from three to ten years. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful lives of the improvements. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and resulting gains or losses are recognized in current operations.

Accrued Wages and Benefits

Starting in 2003, State has deferred the last working day in the fiscal year June 30 to the first working day of July for all State employees. For the Lottery, this created a liability for accrued wages at June 30, 2006 and 2005 of \$780,257 and \$694,337, respectively.

Prize Liability and Prize Expense

Under the provisions of Section 24-35-210 (9), C.R.S., the Lottery must pay no less than fifty percent (50%) of total ticket sales as prizes. In the aggregate, all games to date are planned to pay 50% or more of total ticket sales in prizes. Additional prize expense and corresponding liability may be incurred as a result of market fluctuations in the cost of annuities used to pay Lotto jackpots (see Note 10).

All scratch, on-line and special drawing prizes are accounted for using the accrual basis of accounting. The liability for scratch prizes and on-line prizes is recognized at the point of retail sale. The liability for special drawing prizes is accrued on the first day of sales.

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Payments of scratch prize amounts of \$150 or less may be made at the Lottery or at the retail outlet; payment of scratch prize amounts of \$151 to \$599 may be made at the retailer level at the option of the retailer or at the Lottery. Scratch prizes of \$600 or more are paid by the Lottery. Retailers are given credit for prize payments they make on a daily basis. Prizes may be claimed up to 180 days after a game ends. After the final claim date, any unclaimed scratch prizes will result in a decrease to prize expense and any prizes claimed in excess of the liability accrued will result in an increase to prize expense. Net unclaimed scratch prizes resulted in a decrease to prize expense of \$4,227,000 for the fiscal year ended June 30, 2006 and \$3,706,845 for the fiscal year ended June 30, 2005. During the fiscal year ended June 30, 2006, there were a total of 45 games ended, as compared with 36 games ended through fiscal year ended June 30, 2005.

Payments of cumulative on-line prize amounts of \$150 or less on a single ticket may be made at the Lottery or at the retail outlet; payment of cumulative prize amounts of \$151 to \$599 on a single ticket may be done at the retailer level at the option of the retailer or at the Lottery. Payment of cumulative prize amounts of \$600 or more on a single ticket must be made at the Lottery. Retailers are given credit for prize payments they make on a daily basis. On-line prizes may be claimed up to 180 days after the date of the drawing. After the final claim date, unclaimed on-line prizes will result in a decrease to prize expense so long as the aggregate prize expense of all games exceeds or equals the statutory 50% of sales. In the event that the expiration of an unclaimed prize would result in the aggregate prize expense of all games to fall below the statutory 50% level, the unclaimed prize amount would remain in prize expense and be paid out to players as a guaranteed additional prize. Unclaimed on-line prizes resulted in a decrease to prize expense of \$5,556,042 for the fiscal year ended June 30, 2006 and \$5,694,443 for the fiscal year ended June 30, 2005.

Powerball prize variance expense (revenue) represents a portion of the Powerball 50% prize expense accrual (as mandated by game rule) that is transferred to or received from the Multi-State Lottery Association (MUSL). Powerball prize variance expense occurs when Colorado's liability, which consists of the low-tier prizes won by Colorado players plus Colorado's contribution to the jackpot, is less than the 50% accrual. If Colorado's Powerball liability, at the end of any interim reporting period, exceeds the 50% accrual, revenue is recognized. In the event that Colorado's total Powerball liability in any week should exceed the 50% accrual, MUSL will reimburse the excess to the Lottery.

Retailer Bonus Liability

Under provisions 5.10 and 10.10 of the Colorado Lottery Commission Rules and Regulations effective as of July 1, 1997:

“ . . .the Director may provide such additional compensation to licensees as is deemed appropriate by the Director to further the sale of lottery tickets, so long as such additional compensation is made equally available to all licensees and does not exceed a total of One and Thirteen Hundredths Percent (1.13%) for scratch, Seven Tenths Percent (.7%) for Lotto, Sixty-five Hundredths Percent (.65%) for Powerball, and Ninety-six Hundredths Percent (.96%) for Cash 5.”

A portion of the additional compensation shall be used to pay each licensee, as a bonus, an amount (cashing bonus) equal to one percent (1%) of each prize paid by the licensee up to and including \$599.99.

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At the Director's discretion, the residual resulting after paying the cashing bonuses may be used to provide additional compensation to licensees and/or to decrease the bonus expense by reverting the excess amount.

The cashing bonus is accrued as tickets are sold and paid as winning tickets are redeemed. Any cashing bonuses unclaimed at the end of the claim period result in a reduction of bonus expense.

Licensed Agent Recovery Reserve

Under the provisions of Section 24-35-219, C.R.S., a Licensed Agent Recovery Reserve was established on January 1, 1988 to maintain surety bond receipts collected from the Lottery retailers. Billing rates are established by the Department of Revenue and are reviewed on an annual basis. Retailers have the option to obtain private surety bond coverage at a rate of \$2,000 surety coverage per outlet at their discretion. In 2006 and 2005, the Lottery has reserved \$398,064 and \$479,238, respectively.

Lottery Fund Net Assets

In accordance with Section 24-35-210 (4.1)(a), C.R.S., the Lottery Commission shall reserve "sufficient monies, as of the end of the fiscal year, to ensure the operation of the Lottery for the ensuing year." The Lottery Commission approved a reserve of \$1 million of the net assets for fiscal year 1989. This remained in effect until the implementation of GASB 34, which required a net asset balance sufficient to cover the net value of an agency's capital assets. Accordingly, at the June 2002 Commission meeting, the Lottery Commission approved a balance in net assets "equal to net value of the Lottery's capital assets." Effective July 1, 2004, under Senate Bill 04-204, this reserve is required to be held in cash and investments. In April 2005, the Lottery set up a separate operating reserve independent of the net capital asset reserve in the amount of \$1.7 million. The amount held in this operating reserve will be reviewed annually and adjusted accordingly. The annual review was completed in September 2005 and the reserve was reduced to \$1.6 million in accordance with the review.

Equipment Expense

Included in the statement of revenues, expenses and changes in fund net assets is an account titled equipment. This account reports the book value of assets which are disposed of during the year, fixed asset purchases made during the year which are not capitalized (see Fixed Asset footnote, page 31), software purchases and other miscellaneous equipment transactions. During fiscal year 2005, significant expenses in the amount of \$1,056,420 were incurred related to the new on-line and scratch vendor, Scientific-Games.

Colorado Lottery
Notes to Financial Statements
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Compensated Leave

All permanent employees of the Lottery may accrue annual and sick leave based on length of service subject to certain limitations on the amount that will be paid on termination. In addition, employees who are classified as non-exempt from overtime pay have accumulated overtime, which must be taken as compensatory time or paid. The estimated cost of compensated absences for which employees are vested is as follows:

	June 30, 2006	June 30, 2005	Increase
Annual leave	\$ 718,215	\$ 696,620	\$ 21,595
Sick leave	<u>118,548</u>	<u>146,684</u>	<u>(28,136)</u>
Total annual and sick leave	836,763	843,304	(6,541)
Compensatory time	<u>2,336</u>	<u>4,582</u>	<u>(2,246)</u>
Total compensated leave	<u>\$ 839,099</u>	<u>\$ 847,886</u>	<u>\$ (8,787)</u>

Expired Warrants Liability

Expired warrants liability represents the expiration of aged uncashed warrants and imprest checks over one (1) year old which expired on or before June 30, 2003. In accordance with Section 15-12-914 (2), C.R.S., recipients are entitled to claim payment up to 21 years after original date of issue. Pursuant to Section 24-35-212 (2), C.R.S., the amount of these uncashed warrants shall remain in the Lottery fund. Pursuant to the Unclaimed Property Act, Section 38-13-113, C.R.S., the funds to cover the liability for any uncashed warrants, which expire after June 30, 2003 are transferred to the Unclaimed Property Fund. The Lottery must request reimbursement from the Unclaimed Property Fund for any warrants presented for payment that expired after June 30, 2003.

Deferred Revenue

The Lottery offers two methods of purchasing on-line tickets for future draws. One method is that tickets are purchased through the terminal, referred to as Advance Play, which allows the player to purchase on-line tickets good for up to 13 weeks. The second method is restricted to Lotto tickets only and is purchased through the mail via a preprinted form, referred to as subscription, which allows the player to purchase Lotto tickets good for up to 104 draws. Subscription plays were suspended indefinitely with the last subscription plays being recognized as of September 26, 2004. The revenues generated from both methods are recognized as the draws occur. Revenues for future draws are classified as a liability.

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A detail of deferred revenue at June 30, 2006 and 2005 is as follows:

	<u>2006</u>	<u>2005</u>
Advance Play – Lotto	\$ 88,710	\$ 66,749
Advance Play – Powerball	101,915	55,795
Advance Play – Powerplay	27,510	14,979
Advance Play – Cash 5	<u>15,921</u>	<u>16,693</u>
Total deferred revenue	<u>\$ 234,056</u>	<u>\$ 154,216</u>

Promotional Activity

The Lottery has engaged in two types of promotional activities in an attempt to enhance sales and to increase the player base. Specific promotional coupons and Lottery Bucks coupons are distributed to players through special promotions and can be redeemed at any retailer for a lottery product. The use of promotional coupons has now ended. During the fiscal years ended June 30, 2006 and 2005, 0 and 640 coupons were redeemed, respectively. Scratch tickets for specific games are given away as a more direct approach to introduce players to lottery games. The Lottery gave away \$79,650 and \$43,624 worth of free scratch tickets during the fiscal years ended June 30, 2006 and 2005, respectively. Scratch tickets and coupons are valued at cost. For the fiscal years ended June 30, 2006 and 2005, \$47,442 and \$29,334, respectively, in promotional ticket expense was recorded as marketing and communications expense in the statements of revenues, expenses and changes in fund net assets for coupons redeemed and scratch tickets given away.

Note 2: Cash and Investments

Cash

Cash includes petty cash, change funds, an imprest fund, two depository accounts and cash on deposit with the State Treasurer. A detail of cash at June 30, 2006 and 2005 is as follows:

	<u>2006</u>	<u>2005</u>
Petty cash	\$ 800	\$ 800
Change funds	70,000	70,000
Imprest fund	722,000	706,000
Depository accounts	24,382	30,000
Cash on deposit with State Treasurer	<u>28,418,066</u>	<u>25,774,039</u>
Total unrestricted cash and investments	<u>29,235,248</u>	<u>26,580,839</u>
Restricted cash and investments – Licensed Agent Recovery		
Reserve Receipts on deposit with State Treasurer	398,064	479,238
Operating Reserve on deposit with State Treasurer	<u>1,600,000</u>	<u>1,700,000</u>
Total restricted cash and investments	<u>1,998,064</u>	<u>2,179,238</u>
Total cash and investments	<u>\$ 31,233,312</u>	<u>\$ 28,760,077</u>

Colorado Lottery
Notes to Financial Statements
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Cash on Deposit with State Treasurer

Under the provisions of Section 24-35-210 (6), C.R.S., the State Treasurer shall invest the monies of the Lottery in excess of operating and prize payment expenses and all authorized transfers. Interest or any other return on investments is paid to the Lottery Fund account on a monthly basis. Actual interest payments are determined by the State Treasurer. The actual allocated interest rate for fiscal years 2006 and 2005 was 3.92% and 3.18%, respectively.

In addition, the State Treasurer pools these deposits and invests them in securities approved by Section 24-75-601.1, C.R.S. The Lottery reports its share of the Treasurer's unrealized gains and losses based on its participation in the State Treasurer's pool only at fiscal year-end. Effective July 1, 1997, with the Lottery's initial adoption of Governmental Accounting Standards Board Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, all of the Treasurer's investments, which include the net Licensed Agent Recovery Reserve Receipts, are reported at fair value, which is determined based on quoted market prices. The State Treasurer does not invest any of the pool resources in any external investment pool, and there is no assignment of income related to participation in the pool. Additional information on the Treasurer's pool may be obtained in the State of Colorado's Comprehensive Annual Financial Report.

Deposits

Custodial credit risk is the risk that in the event of a bank failure, a government's deposits may not be returned to it. The Lottery's deposit policy for custodial credit risk requires compliance with the provisions of state law.

State law requires collateralization of all deposits with federal depository insurance; bonds and other obligations of the U.S. Treasury, U.S. agencies or instrumentalities or the State of Colorado; bonds of any city, county, school district or special road district of the State of Colorado; bonds of any state; or a surety bond having an aggregate value at least equal to the amount of the deposits.

At June 30, 2006 and 2005, \$647,069 and \$641,744, respectively, of the Lottery's bank balances of \$747,069 and \$741,744, respectively, were exposed to custodial credit risk as follows:

	2006	2005
Uninsured and uncollateralized	\$ 647,069	\$ 641,744
Uninsured and collateral held by pledging financial institution	100,000	100,000
	\$ 747,069	\$ 741,744

The Lottery accounts are held in Public Deposit Protection Act (PDPA) qualified institutions, thus balances held in the Lottery's accounts in excess of \$100,000 are secured through PDPA with guaranteed securities.

Colorado Lottery
Notes to Financial Statements
June 30, 2006 and 2005

Statements of Cash Flows

The statements of cash flows is prepared under the direct method then adjusted for prize payments and commission and bonus payments to retailers, which are netted from cash received from retailers and applied against accounts receivable balances. For cash flow purposes, cash and investments include restricted cash and investments held by the State Treasurer in its cash and investment pool.

Note 3: Schedule of Changes in Fixed Assets

Capital assets being depreciated:

	June 30, 2005	Increases	Decreases	June 30, 2006
Equipment	\$ 3,883,759	\$ 80,887	\$ (61,931)	\$ 3,902,715
Leasehold improvements	<u>14,053</u>	<u>—</u>	<u>—</u>	<u>14,053</u>
Total capital assets being depreciated	<u>3,897,812</u>	<u>80,887</u>	<u>(61,931)</u>	<u>3,916,768</u>
Less accumulated depreciation for equipment	(3,024,099)	(182,055)	56,084	(3,150,070)
Leasehold improvements	<u>(12,647)</u>	<u>—</u>	<u>—</u>	<u>(12,647)</u>
Total accumulated depreciation	<u>(3,036,746)</u>	<u>(182,055)</u>	<u>56,084</u>	<u>(3,162,717)</u>
Total capital assets, being depreciated, net	<u>\$ 861,066</u>	<u>\$ (101,168)</u>	<u>\$ (5,847)</u>	<u>\$ 754,051</u>

	June 30, 2004	Increases	Decreases	June 30, 2005
Equipment	\$ 4,455,227	\$ 174,624	\$ (746,092)	\$ 3,883,759
Leasehold improvements	<u>327,287</u>	<u>—</u>	<u>(313,234)</u>	<u>14,053</u>
Total capital assets being depreciated	<u>4,782,514</u>	<u>174,624</u>	<u>(1,059,326)</u>	<u>3,897,812</u>
Less accumulated depreciation for equipment	(3,516,924)	(178,664)	671,489	(3,024,099)
Leasehold improvements	<u>(236,476)</u>	<u>(14,563)</u>	<u>238,392</u>	<u>(12,647)</u>
Total accumulated depreciation	<u>(3,753,400)</u>	<u>(193,227)</u>	<u>909,881</u>	<u>(3,036,746)</u>
Total capital assets, being depreciated, net	<u>\$ 1,029,114</u>	<u>\$ (18,603)</u>	<u>\$ (149,445)</u>	<u>\$ 861,066</u>

Colorado Lottery

Notes to Financial Statements

June 30, 2006 and 2005

Note 4: Operating Leases

The Lottery occupies office and warehouse space in Pueblo, Denver, Colorado Springs, Grand Junction and Fort Collins. Rental payments are contingent upon the continuing availability of funds. Specific lease information follows:

Pueblo

Office – The Lottery occupied office space in the Wells Fargo Bank Building in Pueblo. The lease agreement with 200 South Broadway Limited Partnership began on July 1, 1995 and expired on June 30, 2005. The Lottery entered into an agreement with Midtown RLLLP on April 19, 2005. The lease agreement began on June 27, 2005 and expires on June 30, 2015. The lease contains an option to renew for two additional five-year terms commencing on July 1, 2015. There are no other provisions for extension or renewal.

Warehouse – The Lottery leases primary warehouse space from Santa Fe 250 LLC. The Lottery entered into a lease extension agreement, which began September 1, 2002 and expires June 30, 2007. There is no provision for renewal.

Interlott – The Lottery entered into a rental agreement with International Lottery, Inc., subsequently purchased by G-Tech, to rent Scratch Ticket Vending Machines (STVMs). The agreement covered the period from July 1, 2000 through June 30, 2002. The Lottery had the option to exercise two 12-month extensions. On June 3, 2002, the Lottery entered into a contract with Interlott to exercise both 12-month extensions plus an additional four-month extension, which expired on October 31, 2004. There are no other provisions for extension or renewal.

Colorado Springs

The Lottery occupies warehouse space in a building located at 2818 Janitell Road in Colorado Springs, Colorado. The lease agreement, which began on August 1, 2003, expired on June 30, 2006. The Lottery has the option to exercise two 12-month extensions under the new lease, extending the lease through June 30, 2008. On June 5, 2006, the Lottery exercised its option to extend the lease through June 30, 2007.

Denver

Office – The Lottery occupies office and warehouse space in the Galleria Towers Building in Denver. The lease agreement, which began on October 30, 1990, was amended on May 14, 1999 and extended the ending date for the lease from June 30, 1999 to June 30, 2006. On March 10, 2006 the Lottery entered into a second amendment to the lease agreement with Galleria extending the original lease for a thirty six month period ending on June 30, 2009. The amended lease includes a five year renewal option. There are no other provisions for extension or renewal.

Warehouse – The Lottery entered into a lease agreement with Yukon Denver Valley, Inc. to occupy warehouse space. The lease agreement began on September 1, 1999 and expired on August 31, 2004. The Lottery exercised the option to extend the lease through August 31, 2009 on June 11, 2004.

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Fort Collins

The Lottery occupies space leased by the Department of Revenue and is responsible for reimbursing the Department of Revenue for lease payments.

Grand Junction

The Lottery occupies space in the Grand Junction State Services Building and is responsible for reimbursing the Capital Complex Division for lease payments.

Operating lease expense incurred for the fiscal years ended June 30, 2006 and 2005 and future minimum lease payments for fiscal years ending June 30, 2007 through 2012+ are as follows:

Location	Expense		Future Minimum Lease Payments					
	2005	2006	2007	2008	2009	2010	2011	2012 +
Pueblo office	\$ 293,553	\$ 265,764	\$ 218,013	\$ 218,013	\$ 218,013	\$ 218,013	\$ 224,630	\$ 967,571
Pueblo warehouse	96,218	99,072	78,623	—	—	—	—	—
Interlott	217,404	—	—	—	—	—	—	—
Colorado Springs warehouse	12,040	12,438	12,974	—	—	—	—	—
Denver office	209,833	219,180	139,557	179,430	191,392	—	—	—
Denver warehouse	102,937	100,046	98,553	101,473	104,486	17,499	—	—
Fort Collins	34,298	40,378	—	—	—	—	—	—
Grand Junction	6,637	6,717	—	—	—	—	—	—
	<u>\$ 972,920</u>	<u>\$ 743,595</u>	<u>\$ 547,720</u>	<u>\$ 498,916</u>	<u>\$ 513,891</u>	<u>\$ 235,512</u>	<u>\$ 224,630</u>	<u>\$ 967,571</u>

Note 5: Other Revenue

A schedule of other revenue for the fiscal years ended June 30, 2006 and 2005 follows:

	2006	2005
License fees	\$ 71,819	\$ 50,824
On-line vendor reimbursements	106,242	855,421
Fines and penalties	1,580,015	209
Assignment fees	2,414	4,219
Net Licensed Agent Recovery Reserve receipts	(81,174)	9,814
Reimbursement excess budget/production cost of game show from MUSL	28,460	21,943
Other	<u>53,483</u>	<u>10,898</u>
Total	<u>\$ 1,761,259</u>	<u>\$ 953,328</u>

Colorado Lottery
Notes to Financial Statements
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Note 6: Distribution of Net Proceeds

In accordance with Section 33-60-104, C.R.S., distributions of net proceeds shall be made on a quarterly basis. The State Treasurer shall distribute net lottery proceeds as follows: forty percent (40%) to the Conservation Trust Fund, ten percent (10%) to the Division of Parks and Outdoor Recreation and all the remaining net lottery proceeds in trust to the State Board of the Great Outdoors Colorado Trust Fund up to the statutory limit. Under Section 33-60-104(2), C.R.S., the limit is \$35 million for 1992, as adjusted annually, based on the consumer price index. Any excess over the limit shall be transferred to the State Public School Fund as a contingency reserve set forth in Section 22-54-117(1.6)(a), C.R.S.

Income available for distribution at June 30:

	2006	2005
Income before distributions	\$ 124,936,653	\$ 105,059,815
Change in Licensed Agent Recovery Reserve	81,174	(9,814)
Change in fair market value of investments	326,258	217,886
Change in Operating Reserve	100,000	(1,700,000)
Other changes in net assets	<u>107,015</u>	<u>168,048</u>
Income available for distribution	125,551,100	103,735,935
Less distributions prior to year-end	<u>(96,754,796)</u>	<u>(75,956,095)</u>
Income available for distribution	<u>\$ 28,796,304</u>	<u>\$ 27,779,840</u>

	Accrued at June 30, 2005	Proceeds Distributions Expenses	Distributions Paid	Accrued at June 30, 2006
Great Outdoors Colorado	\$ 12,198,467	\$ 50,230,238	\$ (60,575,868)	\$ 1,852,837
State Public School Fund	1,691,454	12,545,316	(1,691,454)	12,545,316
Conservation Trust Fund	11,111,935	50,220,437	(49,813,851)	11,518,521
Division of Parks and Outdoor Recreation	<u>2,777,984</u>	<u>12,555,109</u>	<u>(12,453,463)</u>	<u>2,879,630</u>
	<u>\$ 27,779,840</u>	<u>\$ 125,551,100</u>	<u>\$ (124,534,636)</u>	<u>\$ 28,796,304</u>

	Accrued at June 30, 2004	Proceeds Distributions Expenses	Distributions Paid	Accrued at June 30, 2005
Great Outdoors Colorado	\$ 10,506,324	\$ 50,176,516	\$ (48,484,373)	\$ 12,198,467
State Public School Fund	2,396,438	1,691,454	(2,396,438)	1,691,454
Conservation Trust Fund	10,322,209	41,494,373	(40,704,647)	11,111,935
Division of Parks and Outdoor Recreation	<u>2,580,550</u>	<u>10,373,592</u>	<u>(10,176,158)</u>	<u>2,777,984</u>
	<u>\$ 25,805,521</u>	<u>\$ 103,735,935</u>	<u>\$ (101,761,616)</u>	<u>\$ 27,779,840</u>

Colorado Lottery

Notes to Financial Statements

June 30, 2006 and 2005

Note 7: Pension Plan

Plan Description

Virtually all of the Lottery employees participate in a defined benefit pension plan. The plan's purpose is to provide income to members and their families at retirement or in case of death or disability. The plan is a cost-sharing multiple-employer plan administered by the Public Employees' Retirement Association (PERA). PERA was established by state statute in 1931. Responsibility for the organization and administration of the plan is placed with the Board of Trustees of PERA. Changes to the plan require legislation by the General Assembly. The state plan and other divisions' plans are included in PERA's financial statements, which may be obtained by writing PERA at 1300 Logan Street, Denver, Colorado 80203, by calling PERA at 303-832-9550 or 800 729-PERA (7372) or by visiting www.copera.org.

Prior to January 1, 2006, state employees and employees of local school districts were members of the combined State and School Division of PERA. On January 1, 2006, that combined division was segregated into a State Division and a separate School Division. Separate actuarial assessments are made for each division.

Employees hired by the state after January 1, 2006, are allowed 60 days to elect to participate in a defined contribution retirement plan administered by the state's Deferred Compensation Committee rather than becoming a member of PERA. If that election is not made, the employee becomes a member of PERA and the member is allowed 60 days from commencing employment to elect to participate in a defined contribution plan administered by PERA rather than the defined benefit plan. PERA members electing the defined contribution plan are allowed an irrevocable election between the second and fifth year to use their defined contribution account to purchase service credit and be covered under the defined benefit retirement plan. Employer contributions to both defined contribution plans are the same as the contributions to the PERA defined benefit plan.

Defined benefit plan members vest after five years of service, and if they were hired before July 1, 2005, most are eligible for retirement benefits at age 50 with 30 years of service, age 60 with 20 years of service or at age 65 with 5 years of service. Persons hired on or after July 1, 2005, (except state troopers, plan members, inactive plan members, and retirees) are eligible for retirement benefits at any age with 35 years of service, at age 55 with 30 years of service, at age 60 with 20 years of service, or at age 65 with 5 years of service. Members are also eligible for retirement benefits, without a reduction for early retirement, if they are at least 55 and have a minimum of 5 years of service credit and their age plus years of service equals 80 or more. State troopers and judges comprise a small percentage of plan members but have higher contribution rates and state troopers are eligible for retirement benefits at different ages and years of service. Monthly benefits are calculated as a percentage of highest average salary (HAS). HAS is one-twelfth of the average of the highest salaries on which contributions were paid, associated with three periods of 12 consecutive months of service credit.

Colorado Lottery

Notes to Financial Statements

June 30, 2006 and 2005

Members disabled who have five or more years of service credit, six months of which has been earned since the most recent period of membership, may receive retirement benefits if determined to be permanently disabled. If a member dies before retirement, their spouse or their eligible children under the age of 18 (23 if a full-time student) are entitled to monthly benefit payments. If there is no eligible spouse, financially-dependent parents will receive a survivor's benefit.

Funding Policy

Most employees contribute 8% (10% for state troopers) of their salary, as defined in CRS 24-51-101(42), to an individual account in the plan.

From July 1, 2005 to December 31, 2005, the state contributed 10.15% (12.85% for state troopers and 13.66% for the judicial branch) of the employee's salary. From January 1, 2006, through June 30, 2006, the state contributed these same percentage amounts plus an additional .5% for the Amortization Equalization Disbursement discussed below. During all of Fiscal Year 2005-2006, 1.02% of the total contribution was allocated to the Health Care Trust Fund.

At December 31, 2004, the State and School Division of PERA was underfunded with an infinite amortization period, which means that the unfunded actuarially accrued liability would never be fully funded at the current contribution rate. In the 2004 legislative session, the general assembly authorized an Amortization Equalization Disbursement to address the funding shortfall that requires PERA employers to pay an additional .5% of salary in 2006, 1% of salary in 2007, and subsequent year increases of .4% of salary until the additional payment reaches 3% in 2012.

Salary subject to PERA contribution is gross earnings less any reduction in pay to offset employer contributions to the state-sponsored IRC 125 plan established under Section 125 of the Internal Revenue Code. The contribution requirements of plan members and their employers are established, and may be amended, by the General Assembly.

The Lottery's contributions to the three programs described above for the fiscal years ended June 30, 2006, 2005 and 2004 were \$651,980, \$622,597 and \$656,365, respectively. These contributions met the contribution requirement for each year.

Note 8: Voluntary Tax-deferred Retirement Plans

PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. The State offers a 457 deferred compensation plan and certain agencies and institutions of the State offer a 403(b) or 401(a) plans. Members who contribute to any of these plans also receive the State match, when available.

In January 2001, the MatchMaker Program established a State match for PERA member's voluntary contributions to tax-deferred retirement plans. The PERA Board sets the level of the match annually based on the actuarial funding of the defined benefit pension plan. The match is only available when the actuarial value of the defined benefit pension plan assets is 110% of actuarially accrued plan liabilities. This condition was not met during fiscal year 2006.

Colorado Lottery
Notes to Financial Statements
June 30, 2006 and 2005

Note 9: Post Retirement Health Care and Life Insurance Benefits

PERACare, formerly known as the PERA Health Care Program (the Program), began covering benefit recipients and qualified dependents on July 1, 1986. This benefit was developed after legislation in 1985 established the Program and the Health Care Trust Fund. Under this program, PERA subsidizes a portion of the monthly premium for health care coverage. The benefit recipient pays any remaining amount of that premium through an automatic deduction from the monthly retirement benefit. During the fiscal year ended June 30, 2006, the premium subsidy was \$115.00 for those with 20 years of service credit (\$230.00 for members under age 65 and not eligible for Medicare), and it was reduced by 5% for each year of service fewer than 20.

The Health Care Trust Fund is maintained by an employer's contribution as discussed above in Note 7.

Monthly premium costs for participants depend on the health care plan selected, the number of persons being covered, Medicare eligibility and the number of years of service credit. PERA contracts with a major medical indemnity carrier to administer claims for self-insured medical and prescription benefit plans and with several health maintenance organizations providing services within Colorado. As of December 31, 2005 and 2004, there were 41,080 and 39,668 enrollees, respectively, including spouses and dependents, from all contributors to the plan.

Life Insurance Program

Previously, PERA provided its members access to two group life insurance plans offered by Prudential Insurance Company and Anthem Life. Effective, April 1, 2005, PERA consolidated the two plans, and UnumProvident became the administrator. Members who transition to the new plan may continue coverage into retirement. Premiums are collected by monthly payroll deduction or other means.

Note 10: Contingencies and Commitments

Prize Annuities – The Lottery purchases annuity contracts in the name of individual jackpot prize winners. Although the annuity contracts are in the name of the individual winners, the Lottery retains title to the annuity contracts. The Lottery remains liable for the payment of the guaranteed minimum prizes in the event the insurance companies issuing the annuity contracts default. The following guaranteed minimum prize payments for which annuity contracts have been purchased are due in varying amounts through July 28, 2029.

Specified prize payments	\$ 516,030,335
Lifetime prize payments	<u>42,817,000</u>
Total guaranteed minimum prize payments	\$ <u>558,847,335</u>

Colorado Lottery
Notes to Financial Statements
June 30, 2006 and 2005

Self-insurance – The State of Colorado currently self-insures its agencies, officials and employees for the risks of losses to which they are exposed. That includes general liability, motor vehicle liability, workers’ compensation and medical claims. The State Risk Management Fund is a restricted General Fund used for claims adjustment, investigation, defense and authorization for the settlement and payment of claims or judgments against the State except for employee medical claims. The State Employees and Officials Insurance Fund is an Internal Service Fund established for the purpose of risk, financing employees’ and officials’ medical claims. Property claims are not self-insured; rather, the State has purchased insurance.

Colorado employers are liable for occupational injuries and diseases of their employees. Benefits are prescribed by the Worker’s Compensation Act of Colorado for medical expenses and loss of wages resulting from job-related disabilities. The State utilizes the services of Pinnacol Assurance (formerly Colorado Compensation Insurance Authority), a related party, to administer its plan. The State reimburses Pinnacol Assurance for the current cost of claims paid and related administrative expenses.

The Lottery participates in the Risk Management Fund. State agency premiums are based on an assessment of risk exposure and historical experience. Liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. Because actual claims liabilities depend on such complex factors as inflation, changes in legal doctrines and damage awards, the process used in computing claims liability does not necessarily result in an exact amount. Claims liabilities are reevaluated periodically to take into consideration recently settled claims, the frequency of claims and other economic and social factors.

The limits of liability for which the State accepts responsibility pursuant to Section 24-10-114(1), C.R.S., are as follows:

Liability	Limits of Liability
General and automobile	Each person \$150,000 Each occurrence \$600,000

Medical and Disability Benefits – The Group Benefit Plans Fund is a Pension and Other Employee Benefits Fund established for the purpose of risk financing employee and state-official medical claims. The fund includes several medical plan options ranging from provider of choice to managed care. Before January 1, 2000, the State offered a variety of medical plans; some of the plans were fully insured while others were self-insured using Anthem Blue Cross Blue Shield as the plan administrator. Between January 1, 2000 and June 30, 2005, self-insured plans were no longer offered, and the state and its employees paid premiums for insurance purchased to cover medical claims. The State’s contribution to the premium is fixed in statute; state employees pay the difference between the statutory contribution and the premium set by the insurer. Employee healthcare premiums are allowed on a pretax basis under the State’s flexible spending account benefits plan.

Colorado Lottery

Notes to Financial Statements

June 30, 2006 and 2005

Effective July 1, 2005. The State terminated the Anthem Blue Cross Blue Shield plans and began offering five self-funded plan options administered by Great-West Healthcare. After July 1, 2005, the State will continue to offer the fully insured Kaiser HMO plan and the San Luis Valley HMO plan, as well as, three self-funded dental options administered by Delta Dental Plan of Colorado.

Before January 1, 1999, the Group Benefit Plans Fund provided an employer-paid short-term disability plan for all employees. On January 1, 1999, PERA began covering short-term disability claims for state employees eligible under its retirement plan. The Group Benefit Plans Fund continues to provide short-term disability coverage for employees not yet qualified for the retirement plan and secondary benefits for employees also covered under the PERA short-term disability plan.

The Group Benefit Plans program provides an employee with 60 percent of their pay beginning after 30 days of disability or the exhaustion of the employee's sick leave balance, whichever is later. This benefit expires six months after the beginning of the disability. Although fully insured, the Group Benefit Plans disability program includes a risk-sharing feature that provides experience rating refunds and a termination premium that is calculated as earned premium less the aggregate of incurred claims, claim reserve, retention charge and refunds paid previously over the term of the contract. Refunds, when applicable, are paid annually while deficits are carried forward.

Furniture and Equipment – The State of Colorado carries a \$15,000 deductible replacement policy on all state owned furniture and equipment. For each loss incurred, the Lottery is responsible for the first \$1,000 of the deductible and the State of Colorado is responsible for the next \$14,000. Any loss in excess of \$15,000 is covered by the insurance carrier up to replacement cost.

Gaming Operations Commitments – The Lottery has entered into long-term contracts with certain significant vendors related to providing scratch tickets and online data processing services in support of the Lottery's gaming operations. The online data processing contract expired October 31, 2004. The total amount to be paid on the online data contract was not to exceed \$51,800,000 over the period of the contract. The Lottery entered into a new online data processing contract with a new vendor on May 13, 2003. The initial contract period began on June 1, 2003 and will expire on October 31, 2012, per the contract amendment dated January 26, 2005. These contracts overlapped in order for the new vendor to set up the new system. Renewal options include one additional two-year period and two additional periods of ninety days for conversion and turnover purposes. The total cost of the initial contract period is not to exceed \$70,616,975. The scratch ticket contracts expired on June 30, 2004 with one annual renewal available on each contract. The renewal options were exercised extending the contracts through June 30, 2005. On May 16, 2005 the Lottery received approval to extend both of the scratch ticket contracts for a six month period ending December 31, 2005 to complete the RFP process and execute new contracts. The total cost of the extended contract period is \$1,950,000. Ticket rates are based upon ticket volume, physical size and design. The total costs of the contracts for the initial contract period, plus the extension period, were not to exceed \$15,745,184 and \$6,950,000 for the respective contracts.

Colorado Lottery

Notes to Financial Statements

June 30, 2006 and 2005

The Lottery entered into two new contracts with the scratch vendors on January 9 and 16, 2006. The contracts expire on November 30, 2007. The State, in its sole discretion, may require continued performance for three additional twelve (12) month periods on both contracts. In addition, in the event that a contract with a successor contractor cannot be signed prior to the expiration or termination date of this contract, the State reserves the right to extend this contract for a maximum of one hundred eighty (180) days or until a new contract is executed. There are no other provisions for extension or renewal. The total costs of the contracts for the initial contract period are not to exceed \$5,666,667 each for the respective contracts.

The Lottery was approved as a member of the MUSL on February 26, 2001 and thus entered into an agreement with MUSL on June 6, 2001 to become a member and participate in Powerball games. As a member, the Lottery agrees to abide by the terms of the Multi-State Agreement dated September 16, 1987 and to any amendments to that agreement duly made by the board. The Lottery will remain a member indefinitely. Pursuant to this agreement, the Lottery will make payments to MUSL for administrative fees, weekly prize expenses, promotional purchases, miscellaneous reimbursements and assessments and contributions to the prize reserves. The total amount to be contributed by the Lottery to the prize reserves as of June 30, 2006 is \$3,450,000 and is based on a percentage of sales. The total amount of the prize reserves funded as of June 30, 2006 was \$3,708,780 shown as prepaid prize expense – MUSL on the statements of net assets. MUSL reserves the right to hold funds which do not exceed 110% of the required balance. If the actual balance in the reserves should exceed 110% of the required balance, MUSL will refund any funds in excess of the 110% threshold.

Other Major Vendor Commitments – The Lottery entered into a long-term contract with an advertising agency to provide advertising services to promote the Lottery’s products. The contract provided for expiration on June 30, 2002 with an option to renew up to three additional years through June 30, 2005. The total cost of the initial contract period was not to exceed \$16,320,000. On May 15, 2002, the Lottery exercised its option to renew the contract for a period of two years, extending it until June 30, 2004. The maximum was not to exceed \$8,500,000 in fiscal year 2003 and not to exceed \$17,000,000 for the extended contract period. On June 10, 2004, the Lottery entered into a new long-term contract with the same agency. The contract period began on July 1, 2004 and expires on June 30, 2006 with an option to renew up to three additional one year periods through June 30, 2009. On February 7, 2006, the Lottery exercised its option to extend the contract until June 30, 2007. The total cost of the initial contract period and the extension is not to exceed \$9,000,000 for each year.

Litigation – In fiscal year 2001, a plaintiff filed a class action suit claiming that the Lottery breached its contract with players by continuing to sell instant tickets in games in which the top prize had already been claimed. In fiscal year 2006, the District Court found in favor of the Lottery. Although the plaintiff exercised his right to appeal, it is the opinion of Lottery’s management that the ultimate outcome of this matter will not have a material impact on the Lottery’s financial statements.

Colorado Lottery
Notes to Financial Statements
June 30, 2006 and 2005

Note 11: Tax, Spending and Debt Limitations

In November 1992, the Colorado voters passed Section 20, Article X of the Colorado Constitution, commonly known as the Taxpayer's Bill of Rights (TABOR). TABOR contains revenue, spending, tax and debt limitations that apply to the State of Colorado and all local governments. In the same general election, Article XXVII was passed creating the State Board of the Great Outdoors Colorado Trust Fund. The simultaneous passage of these two constitutional amendments raised questions as to whether there are irreconcilable conflicts between the two amendments.

The General Assembly determined in Section 24-77-102 (17) (b) (IX), C.R.S., that the net proceeds from the Lottery are excluded from the scope of "state fiscal year spending" for purposes of TABOR. The Colorado Supreme Court, in response to an interrogatory from the General Assembly, approved that determination.

TABOR is complex and subject to further legislative and judicial interpretation. The Lottery believes it is in compliance with both of these constitutional amendments.

Note 12: Related Party Transactions

The Lottery, as an agency of the State of Colorado, paid fees to other agencies of the State for auditing, legal and other services and vehicle and office rent. The Lottery also pays fees to the Department of Revenue for indirect costs. Interagency charges were \$892,025 and \$836,683 for the fiscal years ended June 30, 2006 and 2005, respectively.

Supplementary Information

Colorado Lottery
Schedule of Revenue and Costs for Scratch and On-line Games
For the Fiscal Year Ended June 30, 2006
(With Comparative Totals for the Fiscal Year Ended June 30, 2005)

	Games in Progress				Fiscal Year 2006	Fiscal Year 2005
	Scratch	Lotto	Powerball	Cash 5	Total	Scratch and On-line
Gross ticket sales	\$ 293,812,628	\$ 38,332,996	\$ 119,757,642	\$ 16,858,542	\$ 468,761,808	\$ 416,966,782
Prize expense	(193,719,020)	(22,875,469)	(54,575,265)	(8,783,953)	(279,953,707)	(248,809,641)
Powerball prize variance	—	—	(1,640,538)	—	(1,640,538)	(693,010)
Net revenue after prizes	<u>100,093,608</u>	<u>15,457,527</u>	<u>63,541,839</u>	<u>8,074,589</u>	<u>187,167,563</u>	<u>167,464,131</u>
Commissions, bonuses, ticket costs and vendor fees						
Retailer commission	(20,536,670)	(2,301,297)	(7,189,049)	(1,011,466)	(31,038,482)	(27,804,768)
Retailer bonus	(2,435,031)	(250,543)	(789,656)	(157,204)	(3,632,434)	(3,870,199)
Cost of tickets sold	(2,907,934)	—	—	—	(2,907,934)	(3,174,878)
Telecomm reimbursements	462,761	60,375	188,621	26,553	738,310	0
On-line vendor fees	(4,734,318)	(618,056)	(1,933,657)	(272,075)	(7,558,106)	(6,731,183)
Total	<u>(30,151,192)</u>	<u>(3,109,521)</u>	<u>(9,723,741)</u>	<u>(1,414,192)</u>	<u>(44,398,646)</u>	<u>(41,581,028)</u>
Gross profit on sale of tickets	<u>\$ 69,942,416</u>	<u>\$ 12,348,006</u>	<u>\$ 53,818,098</u>	<u>\$ 6,660,397</u>	<u>\$ 142,768,917</u>	<u>\$ 125,883,103</u>
Average daily ticket sales	<u>\$ 804,966</u>	<u>\$ 105,022</u>	<u>\$ 328,103</u>	<u>\$ 46,188</u>	<u>\$ 1,284,279</u>	<u>\$ 1,142,375</u>

Colorado Lottery
Schedule of Percent of Prize Expense to Gross Ticket Sales
For the Fiscal Year Ended June 30, 2006

	Games in Progress				Powerball Prize Variance	Fiscal Year 2006 Total
	Scratch	Lotto	Powerball	Cash 5		
Prize expense	\$ 193,719,020	\$ 22,875,469	\$ 54,575,265	\$ 8,783,953	\$ 1,640,538	\$ 281,594,245
Ticket sales	<u>293,812,628</u>	<u>38,332,996</u>	<u>119,757,642</u>	<u>16,858,542</u>	N/A	<u>468,761,808</u>
Prize %	65.93%	59.68%	45.57%	52.10%		60.07%

Note 1: Administrative costs of the Lottery operations, including wages, advertising and other expenses are not shown.

Colorado Lottery
Budgetary Comparison
For the Fiscal Year Ended June 30, 2006

	Fiscal Year 2006 Original Budget	Supplementals Pots Allocations and Internal Transfers	Fiscal Year 2006 Final Budget	Fiscal Year 2006 Actual Expenditures	Under Expended	Percent Under Expended
Personal services	\$ 8,035,664	\$ 10,931	\$ 8,046,595	\$ 7,888,086	\$ 158,509	1.97%
Amortization Equalization	—	16,620	16,620	16,347	273	1.64
Operating	1,203,156	148,746	1,351,902	1,330,829	21,073	1.56
Vehicle lease payments	—	128,203	128,203	118,929	9,274	7.23
Purchase of Services –						
Computer Center	—	5,422	5,422	5,422	—	0.00
Communications services	—	2,181	2,181	2,181	—	0.00
MNT payments	—	344,970	344,970	344,970	—	0.00
Payments to other agencies	340,488	—	340,488	154,453	186,035	54.64
Legal services	—	42,859	42,859	42,859	—	0.00
Administrative Law Judge	—	903	903	903	—	0.00
Workers' compensation	—	72,863	72,863	72,863	—	0.00
Unemployment benefits	—	1,968	1,968	1,968	—	0.00
Health and life	—	342,793	342,793	342,793	—	0.00
Short-term disability	—	10,398	10,398	9,519	879	8.45
Leased space	—	797,239	797,239	745,633	51,606	6.47
Grand Junction –						
leased space	—	6,717	6,717	6,717	—	0.00
Risk management	—	13,441	13,441	13,441	—	0.00
Travel expenses	113,498	—	113,498	68,749	44,749	39.43
Marketing and						
communications	8,643,420	—	8,643,420	8,643,150	270	0.00
Indirect costs	312,057	—	312,057	312,057	—	0.00
Ticket costs	3,454,050	94,990	3,549,040	2,907,934	641,106	18.06
Research	250,000	—	250,000	250,000	—	0.00
Vendor fees	7,663,231	1,234,416	8,897,647	6,819,113	2,078,534	23.36
Prizes	280,095,384	15,373,756	295,469,140	279,953,707	15,515,433	5.25
Powerball prize variance	4,610,000	3,011,973	7,621,973	7,160,019	461,954	6.06
Retailer compensation	35,566,840	2,287,920	37,854,760	34,670,916	3,183,844	8.41
Computer migration	175,569	—	175,569	86,623	88,946	50.66
Multi-State Lottery fees	<u>177,433</u>	<u>—</u>	<u>177,433</u>	<u>141,990</u>	<u>35,443</u>	<u>19.98</u>
Total	<u>\$350,640,790</u>	<u>\$ 23,949,309</u>	<u>\$374,590,099</u>	<u>\$ 352,112,171</u>	<u>\$ 22,477,928</u>	<u>6.00%</u>

Fiscal year 2006 staffing
(FTE) 126.00 (Appropriated) 120.7 (Actual)

*Certain amounts may not tie due to rounding.

Colorado Lottery
Budgetary Comparison (continued)
For the Fiscal Year Ended June 30, 2006

Reconciliation of expenses per statements of revenues, expenses and changes in fund net assets to budgeted expenditures:

Operating Expenses Per Statement of Revenues, Expenses and Changes in Fund Net Assets	
Prize expense	\$ 279,953,707
Powerball prize variance	1,640,538
Commissions and bonuses	34,670,916
Cost of tickets and vendor fees	9,727,730
Other operating expenses	<u>20,712,304</u>
Total operating expenses per statement of revenues, expenses and changes in fund net assets	346,705,195
Plus Powerball variance classified as revenue	5,519,481
Less: Non-appropriated expenses	
Depreciation	(182,055)
Accrued annual and sick leave	(5,489)
Book value of assets written-off	<u>(5,846)</u>
	352,031,286
Plus capitalized fixed assets	<u>80,885</u>
	<u>\$ 352,112,171</u>



Independent Accountants' Report on Compliance and Internal Control Over Financial Reporting Based on the Audit of Financial Statements in Accordance with *Government Auditing Standards*

Members of the Legislative Audit Committee

We have audited the financial statements of the Lottery as of and for the year ended June 30, 2006, and have issued our report thereon dated August 17, 2006. 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, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, 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*.

This report is intended solely for the information and use of the State of Colorado Legislative Audit Committee, the Lottery Commission and the Lottery's management and is not intended to be and should not be used by anyone other than these specified parties.

\s\ **BKD, LLP**

August 17, 2006
Colorado Springs, Colorado



Members of the Legislative Audit Committee

As part of our audit of the financial statements of the Lottery as of and for the year ended June 30, 2006, we wish to communicate the following to you.

Auditor's Responsibility under Auditing Standards Generally Accepted in the United States of America

An audit performed in accordance with auditing standards generally accepted in the United States of America (GAAS) is designed to obtain reasonable, rather than absolute, assurance about the financial statements. In performing GAAS procedures, we establish scopes of audit tests in relation to the financial statements taken as a whole. Our engagement does not include a detailed audit of every transaction. Our engagement letter more specifically describes our responsibilities.

Significant Accounting Policies

The Lottery's significant accounting policies are described in Footnote 1 of the financial statements.

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of financial statement preparation by management, based on its judgments. The following areas involve significant areas of such estimates for which we are prepared to discuss management's estimation process and our procedures for testing the reasonableness of those estimates:

- Allowance for doubtful accounts
- Fair value of investments
- Prize liability
- Useful lives of capital assets
- Compensated absence liability

Audit Adjustments

During the course of any audit, an auditor may propose adjustments to financial statement amounts. Management evaluates our proposals and records those adjustments which, in its judgment, are required to prevent the financial statements from being materially misstated. We did not propose adjustments for the year ended June 30, 2006.

This letter is intended for the information and use of the State of Colorado Legislative Audit Committee, the Lottery Commission and management of the Lottery and is not intended to be and should not be used by anyone other than these specified parties.

\s\ **BKD, LLP**

Colorado Springs, Colorado
August 17, 2006

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