

Minnesota State Lottery
2006 Annual Report



How Lottery Dollars Benefit Minnesota

A portion of every dollar spent on Lottery tickets goes toward preserving, protecting and restoring Minnesota's environment through the Environment & Natural Resources Trust Fund, the Game & Fish Fund and the Natural Resources Fund.

The Environment & Natural Resources Trust Fund, which receives 40 percent of Lottery net proceeds, finances a variety of projects that benefit Minnesota's natural resources. The Trust Fund, which is administered by the Legislative-Citizen Commission on Minnesota Resources, has financed 342 projects worth \$208 million.

The Game and Fish Fund is a primary means of funding the

state's programs to improve, enhance and protect fish and wildlife resources, including conservation, restoration and enhancement of land, water and other natural resources of the state.

The Natural Resources Fund benefits state parks and trails; parks and trails in the Twin Cities metropolitan area; local trails; and the Duluth, Como and Apple Valley zoos.

Lottery dollars are also transferred to the state's General Fund to help finance state services that benefit all Minnesotans, including education, transportation and public safety. Sixty percent of Lottery net proceeds are directed to the General Fund.

Table of Contents

Letter from Director	1
Introduction and Fiscal Year Highlights	2
Games and Winners	3
Lucky, MN Players Club	7
Promotions and Marketing Campaigns	7
Problem Gambling Treatment and Prevention	10
Independent Auditor’s Report	11
Management Discussion and Analysis	12
Balance Sheets	15
Statements of Revenues, Expenses & Changes in Net Assets	16
Statements of Cash Flows.....	17
Notes to the Financial Statements	18
Certification of Chief Financial Officer	25
Certification of Director	26
Certificate of Achievement for Excellence in Financial Reporting	27
Lottery Contact Information	28



Dear Readers:

Fiscal year 2006 was another record year for the Minnesota State Lottery. Building on the successes of the past two years, the Lottery experienced record sales for the second consecutive year and record payments to the state for the third year in a row.

Lottery ticket sales reached \$449.7 million, an increase of \$41.7 million, or 10.2 percent. Most importantly, \$121.5 million was generated for state projects and programs. This is an increase of \$15.3 million, or 14.4 percent.

Record Powerball® and Gopher 5® jackpots were the main drivers behind the large increase in sales this year. Powerball produced two record jackpots during the fiscal year, while changes to the Gopher 5 game also resulted in larger jackpots for that game. Because jackpots drive sales of these lotto games, future sales increases will be dependent on jackpots of similar levels.

I'm very proud of these numbers. They are a reflection of the Lottery's mission — to offer fun, innovative and secure games that create excitement, reflect Minnesota values and maximize contributions to the State. The numbers also demonstrate that the Lottery continues to operate efficiently and is offering games that appeal to its players. This record performance is a tribute to the diligence of Lottery staff and retailers.

We'll keep working hard to raise money for the State programs that benefit all Minnesotans. I encourage you to look through this report to learn more about the Lottery's accomplishments.

Sincerely,

Clint Harris
Executive Director

Introduction

Minnesotans have benefited from three consecutive years of record sales and proceeds from their lottery, resulting in more hiking and biking trails, new and upgraded facilities at our state parks, enhancements at the Minnesota, Como and Duluth zoos and more money for education, transportation and criminal justice.

These are just a few of the programs that have received funding from the Minnesota State Lottery. Since the first Scratch Game was sold in April 1990, the Lottery has raised more than \$1.4 billion for the citizens of Minnesota. More than \$3.5 billion in prizes has been paid to players and Lottery retailers have earned \$354.6 million in commissions and incentives.

Highlights of Fiscal Year 2006

The Minnesota State Lottery ended fiscal year 2006 with record sales and profits. This is the second consecutive year of record sales and the third straight year of record payments to the state.

Lottery ticket sales reached a record \$449.7 million, an increase of \$41.7 million, or 10.2 percent, from 2005.



Ticket sales from Online Games (the games generated by the lottery terminals) totaled \$181.9 million, up \$27.3 million, or 17.7 percent, over the previous year. Record Powerball and Gopher 5 jackpots increased consumer enthusiasm and impulse sales for both games. Powerball produced two record jackpots during the fiscal year, while changes to the Gopher 5 game last September also resulted in larger jackpots for that game.

Scratch Games were also popular with players, ending the fiscal year at \$267.8 million, which is an increase of \$14.4 million, or 5.7 percent.

In fiscal year 2006, the Lottery generated \$121.5 million for state projects and programs, an increase of \$15.3 million, or 14.4 percent, over FY05. The \$32.5 million transferred to the Environment & Natural Resources Trust Fund and \$67.8 million transferred to the General Fund is the most ever transferred to these funds by the Lottery in a single year. In addition, the Game & Fish Fund and Natural Resources Fund each received \$10.6 million.

Since FY03, contributions to the state have increased by 53 percent.

Ninety-two cents of every dollar spent on Lottery tickets is returned to Minnesotans in the form of prize money, retailer commissions and contributions to the state for environmental projects, public services through the General Fund and problem gambling treatment and prevention programs.

Games and Winners

Changes were made to the Powerball and Gopher 5 games near the beginning of the fiscal year to increase the size of the jackpots and boost player interest in the games.

On Aug. 28, 2005, the Powerball matrix was changed to 1 of 55 (the white balls) plus 1 of 42 (the Powerball); the minimum Powerball jackpot was increased to \$15 million; and the Match 5 prize doubled, from \$100,000 to \$200,000. A Match 5 winner (\$200,000) who purchases the Power Play[®] option can now win up to \$1 million! The payout for matching four numbers plus the Powerball was also doubled — to \$10,000.

These changes resulted in two record Powerball jackpots during the fiscal year. The game set a then-record jackpot of \$340 million on Oct. 19, 2005, which was won in Oregon. This was followed by another record-setting jackpot of \$365 million — won on Feb. 18, 2006 by a group of eight meat-processing plant workers in Lincoln, Nebraska.



Both record Powerball jackpots activated the Match 5 Bonus feature. The Match 5 Bonus takes effect only when the Powerball jackpot reaches a record level. The amount of the jackpot is limited to increases of no more than \$25 million. The prize money collected in excess of the advertised jackpot is placed in a bonus prize pool and accumulates until there is a jackpot winner. The bonus prize pool is then divided equally among all winners of the \$200,000 Match 5 prize.

Four tickets sold in Minnesota matched the first five numbers drawn on Oct. 19, 2005 to win \$200,000. The Match 5 Bonus feature paid an additional \$653,492 to each of these ticketholders, making each prize worth \$853,492!



Gopher 5, Minnesota's own cash lotto game, also saw changes effective Sept. 21, 2005. In addition to the new matrix (5 of 47), the Bonus Ball was eliminated and players now win a prize for matching just two of the five numbers drawn.

These changes resulted in a record Gopher 5 jackpot of \$2,032,201 won on Nov. 8, 2005. The jackpot was shared by 22 co-workers of the Watonwan County Highway Department/Public Works Department.



Changes to the Gopher 5 game resulted in a record jackpot of \$2,032,201 won on Nov. 8, 2005. The jackpot was shared by 22 co-workers of the Watonwan County Highway Department/Public Works Department.

Lottery Winners



**\$29,520 Northstar Cash winner
Donald Ristvedt of Lake Park**



**\$1,000 Wally Walleye winner
Beverly DeVault of Deer River**



\$10,000 Powerball winners "ABF Freight Company"



**\$1,000 Super! Ruby Red 7s
winner Kate Balm of Burnsville**



**\$200,000 Hot Streak! winner
Stan Stanton of Owatonna**



**\$2,000 Red Line Crossword winner
Sharon Vang of Minneapolis**



**\$10,000 Powerball winner
Timothy Byers of Edina**



\$853,492 Powerball winners "Club 62", employees of USP Structural Connectors in Montgomery



**\$1,000 Ruby Red 7s winner
Jeffrey Krueger of Zimmerman**

Lottery Winners



\$10,000 Powerball winner
Sherman Brown Jr. of Cass Lake



\$10,000 Royal Jackpot winner
Reijo Rahkola of Cloquet



\$2,000 Red Line Crossword winner
Bonnie Jostock of Dawson



\$1,414,045 Gopher 5 winner Robert
Allred of Winona (with wife Beth)



\$200,000 Powerball winners "The Big 10" (employees of
HealthPartners Materials Management Division)



\$660 Daily 3 winner Gerald
Stephens of Minneapolis



\$1,000 Super! Ruby Red 7s
winner Derek Anhorn of Edina



\$100,000 High Roller Crossword
winner Delores Jedlicka of Clarissa



\$1,000 Winter Warmth winner
Amber Clarkin of LaCrosse, WI



\$762,252 Gopher 5 winner Dennis Anderson of Shakopee
(with wife Terry)

Lucky, MN Players Club

One of the biggest initiatives undertaken by the Lottery this fiscal year was the development of a players club.

Lucky, MN was introduced to Minnesota's lottery players in early May of 2006. Players sign up (for free) to be a "resident" of Lucky, MN. As a resident, players can read about recent winners in the "Who's the Luckiest of Them All" section, find out where winning tickets have been sold on the "Lucky Hot Spots" page, enter for the chance to win great prizes, get a preview of upcoming lottery games and sign up to have the winning numbers e-mailed to them. Lucky, MN welcomed about 3,000 residents during the final two months of FY06.



Promotions and Marketing Campaigns

To support new games and initiatives introduced during the fiscal year, a wide variety of promotions and marketing campaigns were implemented to catch players' attention.

The "Don't Belittle Powerball. It's Always Big" marketing campaign included vehicles "crushed" by giant red Powerballs that appeared to have fallen from the sky. The vehicles made appearances at events across Minnesota, as well as at the 18 retail locations that sold winning Powerball jackpot tickets.



Gopher 5 "Go-fer a Drive" promotion winners at the Mall of America.

Players entered a second-chance drawing for the chance to win a 2006 Ford® Mustang Coupe or one of four cash prizes in the “Go-fer a Drive” promotion that built awareness of the changes made to the Gopher 5 game. On Nov. 12, 2005, five contestants participated in events at the Mall of America to determine which contestant held the key that unlocked the car door.

In March 2006, a “10” was added to the Power Play wheel for eight drawings. Players who purchased this option with their Powerball tickets could multiply all prizes (except the jackpot) by 10! To support this month-long promotion, the Lottery ran a second-chance drawing from March 1 through April 11. Players mailed their non-winning Powerball with Power Play tickets purchased during this time period to the Lottery for the chance to win one of three Visa® gift cards (one worth \$10,000 and two worth \$1,000).



To pique players’ interest in the Harley-Davidson® Scratch Game that was introduced in April 2006, the Lottery awarded Harley-Davidson® merchandise prize packs through second-chance drawings. One of the 500 prize pack winners won a 2006 Harley-Davidson® Heritage Softail® Classic motorcycle!

Jeneta (Jay) Carlson of Garvin won a Harley-Davidson® Heritage Softail® Classic motorcycle playing the Harley-Davidson® Scratch Game.



© 2006 H-D. All Rights Reserved. Harley-Davidson, the Bar & Shield logo and Heritage Softail Classic are among the trademarks of H-D Michigan.

In June the Lottery promoted the fact that 72,000 winning Scratch tickets are redeemed each day in Minnesota. An eight-foot Scratch ticket was displayed at malls in Mankato, Minneapolis, Duluth and Rochester. Players at these events scratched one of 280 separate areas on each ticket to win prizes.

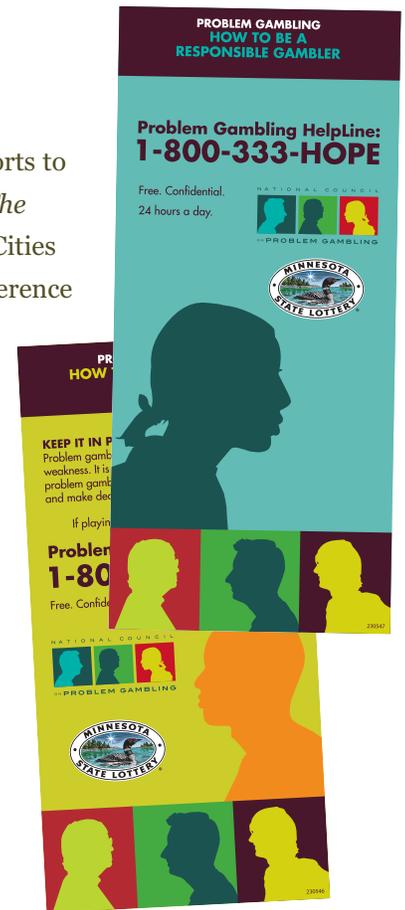
A 4,116 pound cake, a Minnesota record, was displayed at Taste of Minnesota in St. Paul to celebrate the 72,000 winning Scratch tickets redeemed each day. The finished product, which was 26 ft. x 25 ft., took 220 working hours to produce and received nationwide television coverage.



Problem Gambling Treatment and Prevention Efforts

The Minnesota State Lottery continues to play a leading role in raising awareness of the signs of problem gambling and the efforts to treat and prevent it. The Lottery sponsored the documentary, *The Hidden Addiction: Problem Gambling in Minnesota*, on Twin Cities Public Television (TPT); hosted the 20th Annual National Conference on Prevention, Research and Treatment of Problem Gambling in St. Paul; and produced brochures that promote responsible play and awareness of problem gambling. These brochures were distributed to all 3,000 Lottery retailers in Minnesota and were also made available nationwide through the National Council on Problem Gambling.

The Lottery remains an active member of the National Council on Problem Gambling and Northstar Problem Gambling Alliance. In FY06, \$1.8 million was appropriated to the Department of Human Services for problem gambling treatment and prevention, bringing the Lottery's contributions for these efforts to \$22 million since 1990.



Top 10 Retailers in Fiscal Year 2006:

1. Metropolitan Public Airport Foundation – Minneapolis/St. Paul International Airport
2. M & H Gas, Moorhead
3. M & H Gas, St. Paul (Arcade St.)
4. Clark on Rice, St. Paul
5. Holiday, St. Paul (Rice St.)
6. SuperAmerica, Roseville (N. Lexington Ave.)
7. Cub Foods, Brooklyn Center
8. SuperAmerica, Blaine (University Ave. N.E.)
9. East Main SuperAmerica, Anoka
10. Cub Foods, Maple Grove



INDEPENDENT AUDITOR'S REPORT

The Director
Minnesota State Lottery
Roseville, Minnesota

Schechter Dokken Kanter
Andrews & Selcer Ltd

Suite 1600

100 Washington Avenue South

Minneapolis, MN

55401-2192

Phone 612-332-5500

Fax 612-332-1529

E-mail info@sdkepa.com

www.sdkepa.com

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

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

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

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

The Management's Discussion and Analysis on pages 13 through 18 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of supplementary information. However, we did not audit the information and express no opinion on it.

*Schechter Dokken Kanter
Andrews & Selcer Ltd*

August 18, 2006

Management Discussion and Analysis

Overview of the Financial Statements

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

Financial Highlights

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

Summary of Contributions to State

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

Contributions to State

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net proceeds to the State	\$81,232,065	\$69,982,049	\$66,703,798
In-lieu-of-sales tax	29,231,193	26,520,677	25,149,720
Compulsive gambling contribution	1,821,000	1,896,000	1,896,000
Unclaimed prizes to the State	7,008,290	7,777,552	6,960,534
Unclaimed prizes — Held in Trust	<u>2,186,831</u>	<u>0</u>	<u>0</u>
Total paid to State	<u>\$121,479,379</u>	<u>\$106,176,278</u>	<u>\$100,710,052</u>

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

Beneficiary Contributions: Total Paid to State Since Inception (1990 to 2006)

Total to General Fund	\$868,407,150
Total to Environment and Natural Resources Trust Fund	399,013,659
Total to Game and Fish Fund	61,453,477
Total to Natural Resources Fund	61,453,477
Total Other	<u>38,418,031</u>
Total Paid to State	<u>\$1,428,745,794</u>

Note: Compulsive Gambling contribution is included in the General Fund

Summary Results of Operation

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

Operating Income:

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

Operating Expenses:

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

Gross Revenue by Game

	2006	2005	2004
Scratch ticket sales	\$267,793,640	\$253,425,269	\$215,696,083
Online ticket sales			
Daily 3 [®]	12,958,518	13,134,177	13,250,961
Gopher 5 [®]	23,751,551	14,531,607	18,333,018
Powerball [®]	112,184,974	89,562,348	114,291,526
Power Play [®]	4,393,871	2,945,483	3,233,759
Hot Lotto [®]	10,823,419	16,274,511	10,421,797
Northstar Cash [®]	9,585,521	9,373,889	6,268,682
G3 [®] Games	<u>8,219,169</u>	<u>8,763,134</u>	<u>5,422,945</u>
Operating revenue	449,710,663	408,010,418	386,918,771
Other income	<u>49,982</u>	<u>2,743</u>	<u>17,049</u>
Total operating revenue	449,760,645	408,013,161	386,935,820
Less in-lieu-of-sales tax	<u>29,231,193</u>	<u>26,520,677</u>	<u>25,149,720</u>
Gross Revenue	<u>\$420,529,452</u>	<u>\$381,492,484</u>	<u>\$361,786,100</u>

Scratch Games:

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

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

Online Games:

Online Games sales were 40.5 percent of total sales in fiscal year 2006. Online sales increased \$27.3 million or 17.7 percent to \$181.9 million from fiscal year 2005. The increase in Online sales was mainly due to the large number of high Powerball jackpots; including two record jackpots of \$340 million in October 2005 and \$365 million in February 2006. The higher jackpots were the result of the change to the game matrix for Powerball. Powerball and Power Play sales increased 25.3 percent and 49.2 percent respectively in fiscal year 2006. Gopher 5 also experienced a matrix change, which improved the odds of winning a prize while increasing average jackpots. Gopher 5 sales increased 63.4 percent in fiscal year 2006. Northstar Cash saw a slight increase of 2.3 percent and Daily 3, Hot Lotto, and G3 Games all experienced sales decreases.

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

Balance Sheet Summary

Condensed Balance Sheet

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

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

Cash and cash equivalents:

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

Receivables:

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

Capital assets and other assets:

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

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

Due to State and State Agencies:

The fiscal year 2006 decrease of \$871 thousand over fiscal year 2005 was mainly due to a decrease in unclaimed prize money due to the state. The fiscal year 2005 increase of \$834 thousand from fiscal year 2004 was due mainly to the increase of unclaimed prize money due to the state.

Accounts payable & accrued expenses and current accrued prizes and prize annuity liabilities:

A decrease of \$1.5 million for fiscal year 2006 over fiscal year 2005 was mainly due to a reduction in amounts owed to vendors. The vendors include the advertising agency in the amount of \$.7 million and ticket and Online Game vendors in the amount of \$.6 million which was not owed at the end of fiscal year 2005. The fiscal year 2005 decrease of approximately \$3 million over fiscal year 2004 was mainly due to the reduction in the prize liability outstanding on Scratch tickets.

Balance Sheets

June 30, 2006 and June 30, 2005

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

See Accompanying Notes to Financial Statements

Statements of Revenues, Expenses & Changes in Net Assets Years ended June 30, 2006 and June 30, 2005

	2006	2005
Operating Revenues:		
Scratch Ticket Sales	\$267,793,640	\$253,425,269
Online Ticket Sales	181,917,023	154,585,149
Other Income	<u>49,982</u>	<u>2,743</u>
Total Operating Revenues	449,760,645	408,010,418
Less: In-Lieu-of-Sales Tax	<u>29,231,193</u>	<u>26,520,677</u>
Gross Receipts	<u>420,529,452</u>	<u>381,489,741</u>
 Direct Costs:		
Scratch Ticket Prizes	177,592,560	166,740,541
Online Ticket Prizes	90,204,335	74,553,796
Online Vendor Expense	11,121,657	9,447,919
Ticket Costs	3,038,105	4,287,651
Retailer Commissions and Incentives (Note 11)	<u>27,290,934</u>	<u>24,967,304</u>
Total Direct Costs	<u>309,247,591</u>	<u>279,997,211</u>
Gross Profit	<u>111,281,861</u>	<u>101,492,530</u>
 Operating Expenses: (Note 12)		
Advertising (Note 12)	6,090,612	4,701,021
Salaries and Benefits (Note 13)	9,944,117	10,080,101
Promotion	1,478,677	2,364,686
Purchased Services	1,214,638	1,027,980
Communication	407,169	441,433
Occupancy Costs (Note 9)	1,777,911	1,760,919
Supplies and Materials	788,147	1,086,508
Computer and Omnipoint Maintenance	235,839	212,122
Depreciation	367,759	388,719
Other Expense	<u>477,537</u>	<u>507,995</u>
Gain on Settlement of Prize Annuity (Note 4)		
Total Operating Expenses	<u>22,782,406</u>	<u>22,571,484</u>
 Operating Income	<u>88,499,455</u>	<u>78,921,046</u>
Nonoperating Revenue (Expense)		
Interest Earned on Investments	1,366,853	734,555
Unused Compulsive Gambling Contribution	195,047	0
Payments to State:		
Compulsive Gambling Contribution from Prize Fund (Note 10)	(1,821,000)	(1,896,000)
Unclaimed Prizes to State (Note 6)	(7,008,290)	(7,777,552)
Net Proceeds to State (Note 8)	<u>(81,232,065)</u>	<u>(69,982,049)</u>
Total Nonoperating Revenue (Expense)	<u>(88,499,455)</u>	<u>(78,921,046)</u>
 Net Income	<u>0</u>	<u>0</u>
 Net Assets at Beginning of Year (Note 8)	<u>0</u>	<u>0</u>
 Net Assets at End of Year (Note 8)	<u>\$0</u>	<u>\$0</u>

See Accompanying Notes to Financial Statements

Statements of Cash Flows

Years ended June 30, 2006 and June 30, 2005

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

See Accompanying Notes to Financial Statements

NOTES TO THE FINANCIAL STATEMENTS JUNE 30, 2006 AND 2005

1. ORGANIZATION OF THE MINNESOTA STATE LOTTERY

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

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

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

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

(a) Basis of Accounting

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

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

(b) Accounting Standard: GASB No. 34

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

(c) Measurement Focus

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

(d) Operating Revenue and Expenses

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

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

(e) Cash and Cash Equivalents

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

(f) Prizes and Reserves

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

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

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

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

Powerball	\$5,038,000
Hot Lotto	<u>538,725</u>
	\$5,576,725

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

(g) Scratch Ticket Inventory

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

(h) Capital Assets

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

(i) In-Lieu-of-Sales Tax

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

(j) Income Taxes

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

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(l) Reclassifications

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

3. CASH AND CASH EQUIVALENTS

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

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

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

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

4. PRIZE ANNUITY INVESTMENTS AND PAYABLES

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

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

5. CAPITAL ASSETS

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

	2006			
	July 1, 2005	Additions	Deletions	
Depreciable Capital Assets:				
Office Equipment & Furniture	\$2,312,094	\$73,557	\$(1,135)	\$2,384,516
PC & Printer Equipment	1,184,547		(268,258)	916,289
Software Costs		59,965		59,965
Leasehold Improvements	1,634,348		(5,089)	1,629,259
Vehicles	1,028,726	218,282	(205,697)	1,041,311
Computer Equipment	1,455,535	9,825	(12,634)	1,452,726
Online Drawing Equipment	694,498			694,498
Signs	196,691			196,691
Warehouse Equipment	201,775			201,775
Total	8,708,214	361,629	(492,813)	8,577,030
Less - Accumulated Depreciation				
Office Equipment & Furniture	(2,150,691)	(66,165)	1,135	(2,215,721)
PC & Printer Equipment	(1,176,505)	(8,042)	268,258	(916,289)
Software Costs		(3,331)		(3,331)
Leasehold Improvements	(1,536,426)	(29,187)	4,316	(1,561,297)
Vehicles	(860,582)	(55,703)	205,697	(710,588)
Computer Equipment	(1,107,356)	(98,883)	12,634	(1,193,605)
Online Drawing Equipment	(426,893)	(98,195)		(525,088)
Signs	(196,691)			(196,691)
Warehouse Equipment	(157,145)	(8,253)		(165,398)
Total Accumulated Depreciation	(7,612,289)	(367,759)	492,040	(7,488,008)
Net Capital Assets	\$1,095,925	\$(6,130)	\$(733)	\$1,089,022
2005				
	July 1, 2004	Additions	Deletions	June 30, 2005
Depreciable Capital Assets:				
Office Equipment & Furniture	\$2,236,137	\$92,085	\$(16,128)	\$2,312,094
PC & Printer Equipment	1,398,388		(213,841)	1,184,547
Leasehold Improvements	1,670,407		(36,059)	1,634,348
Vehicles	979,579	170,081	(120,934)	1,028,726
Computer Equipment	1,184,463	312,278	(41,206)	1,455,535
Online Drawing Equipment	694,498			694,498
Signs	196,691			196,691
Warehouse Equipment	201,775			201,775
To Be Placed in Service	14,841	(14,841)		0
Total	8,576,779	559,603	(428,168)	8,708,214
Less - Accumulated Depreciation:				
Office Equipment & Furniture	(2,080,822)	(85,997)	16,128	(2,150,691)
PC & Printer Equipment	(1,350,582)	(39,486)	213,563	(1,176,505)
Leasehold Improvements	(1,529,689)	(34,412)	27,675	(1,536,426)
Vehicles	(935,777)	(45,739)	120,934	(860,582)
Computer Equipment	(1,072,046)	(76,516)	41,206	(1,107,356)
Online Drawing Equipment	(328,698)	(98,195)		(426,893)
Signs	(196,570)	(121)		(196,691)
Warehouse Equipment	(148,892)	(8,253)		(157,145)
Total Accumulated Depreciation	(7,643,076)	(388,719)	419,506	(7,612,289)
Net Capital Assets	\$933,703	\$170,884	\$(8,662)	\$1,095,925

6. UNCLAIMED PRIZES

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

7. COMPENSATED ABSENCES

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

Compensated Absences	<u>Beginning</u>	<u>Additions</u>	<u>Retirements</u>	<u>Ending</u>
2006	\$1,147,934	\$912,270	\$(963,744)	\$1,096,460
2005	908,212	1,169,021	(929,299)	1,147,934

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

8. NET ASSETS

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

9. COMMITMENTS AND CONTINGENCIES

(a) Risk Management

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

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

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

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

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

The Lottery purchased sixteen lifetime annuities from Principal Financial Group. If Principal Financial Group was to default on those obligations, these policies would be covered under a "Guaranty Fund Law" which is administered by

the State of Minnesota. The amount guaranteed per annuity is \$300,000. The Lottery may be ultimately responsible for the lifetime annuities; however, management feels that the possibility of Principal Financial Group defaulting on its obligations in a material sum in excess of the \$300,000 guaranteed by the State is remote.

(b) Operating Leases

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

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

(c) Sales Tax Contingency

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

10. COMPULSIVE GAMBLING TREATMENT CONTRIBUTION PROVIDED FROM PRIZE FUND

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

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

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

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

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

11. RETAILER COMMISSIONS

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

12. STATUTORY LIMITATION ON OPERATING AND ADVERTISING EXPENSES

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

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

13. RETIREMENT PLANS

The Lottery is involved in two pension programs as follows:

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

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

Funding Policy:

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

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

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

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

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

Funding Policy:

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

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

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



CERTIFICATION OF CHIEF FINANCIAL OFFICER

IN CONSIDERATION OF SECTION 302 OF THE SARBANES-OXLEY ACT OF
2002 AS IT RELATES TO THE MINNESOTA STATE LOTTERY

I, Joseph Pahl, Chief Financial Officer of the Minnesota State Lottery, certify that:

1. I have reviewed these Financial Statements for the fiscal year ended June 30, 2006 of the Minnesota State Lottery;
2. Based on my knowledge, these statements do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by these statements;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Minnesota State Lottery as of, and for, the periods presented in these Financial Statements;
4. The Minnesota State Lottery's other certifying officer and I have disclosed, based on our most recent review of internal control over financial reporting, to the Minnesota State Lottery's auditors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Minnesota State Lottery's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Minnesota State Lottery's internal control over financial reporting.

Date: December 30, 2006

By:

Joseph Pahl, Chief Financial Officer



CERTIFICATION OF DIRECTOR

IN CONSIDERATION OF SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002 AS IT RELATES TO THE MINNESOTA STATE LOTTERY

I, Clint Harris, Executive Director of the Minnesota State Lottery, certify that:

1. I have reviewed these Financial Statements for the fiscal year ended June 30, 2006 of the Minnesota State Lottery;
2. Based on my knowledge, these statements do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by these statements;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Minnesota State Lottery as of, and for, the periods presented in these Financial Statements;
4. The Minnesota State Lottery's other certifying officer and I have disclosed, based on our most recent review of internal control over financial reporting, to the Minnesota State Lottery's auditors:
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Minnesota State Lottery's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Minnesota State Lottery's internal control over financial reporting.

Date: December 30, 2006

By: 

Clint Harris, Director

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Minnesota State Lottery

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2005

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



President

Executive Director

Lottery Contact Information

Lottery Headquarters

2645 Long Lake Road, Roseville, MN 55113
(651) 297-7456 (651) 635-8268 (TTY)

Regional Offices

Detroit Lakes (218) 846-0700
1111 Highway 10 E.
Detroit Lakes, MN 56501

Marshall (507) 537-6041
750 W. College Drive
Marshall, MN 56258

Owatonna (507) 444-2400
205 Cedardale Drive
Owatonna, MN 55060

Virginia (218) 748-2450
5463 Mountain Iron Drive
Virginia, MN 55792

**24-hour Automated Winning
Numbers Hotline** (651) 634-1111

E-mail: lottery@mnlottery.com

Website: www.mnlottery.com

Senior Staff

Executive Director:

Clint Harris

Legal Counsel/Assistant Director:

Dale McDonnell

Director for Operations:

Don Masterson

Director for Marketing:

John Mellein

Public Relations Manager:

Debbie Hoffmann

Research & Planning Director:

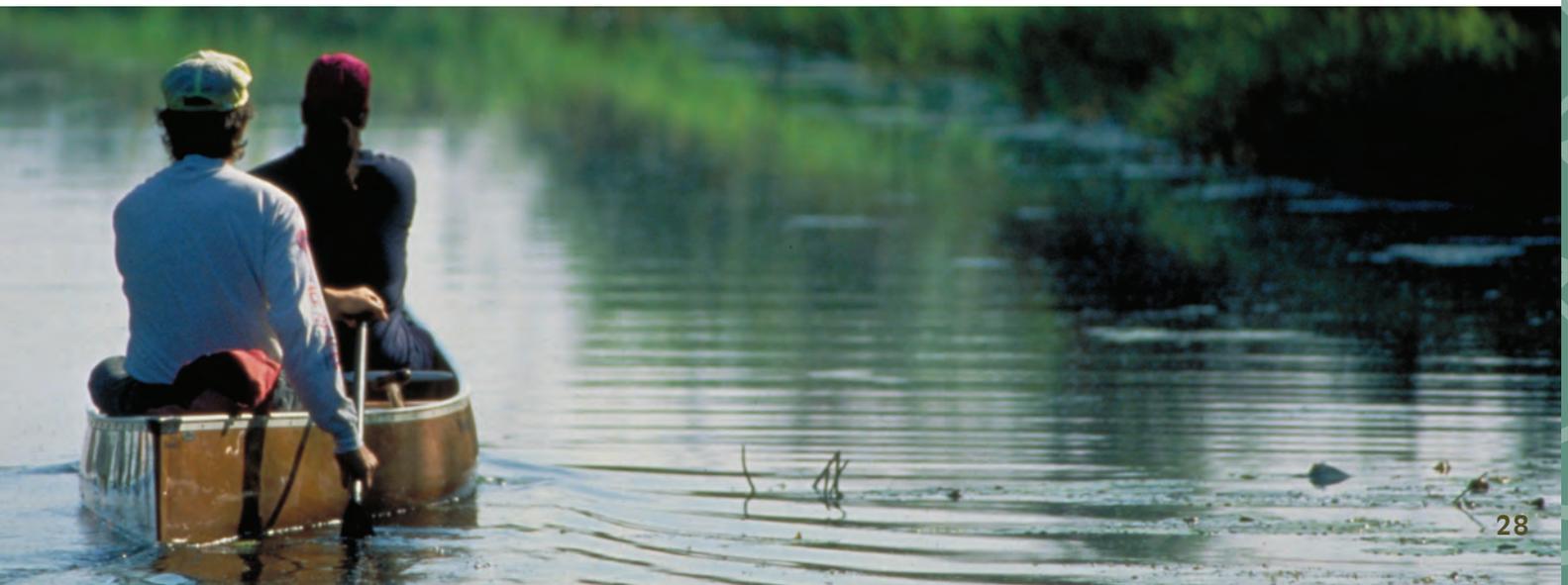
Don Feeney

Chief Financial Officer:

Joe Pahl

Chief of Security:

Doug Wills





Printed on recycled paper containing
80% post-consumer fiber.