

**AUDIT REPORT
OF THE
NEBRASKA LOTTERY**

JULY 1, 2004 THROUGH JUNE 30, 2005

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the Auditor of Public Accounts.**

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Issued on October 13, 2005

NEBRASKA LOTTERY

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NEBRASKA LOTTERY

BACKGROUND

The Legislature created the Lottery Division of the Nebraska Department of Revenue in 1991. Nebraska voters passed a constitutional amendment allowing the creation of a State lottery in November 1992, and the Legislature established the State lottery in 1993. As the 37th lottery in the nation, the Nebraska Lottery began scratch ticket sales on September 11, 1993. Sales of on-line products began on July 21, 1994.

The Nebraska Lottery is responsible for contracting for scratch ticket production, on-line equipment, advertising, security, and related services. In addition, the Nebraska Lottery recruits and screens Nebraska Lottery retailers, develops Nebraska Lottery products, and collects Nebraska Lottery revenues.

Currently, the Nebraska Lottery offers Powerball®, Pick5®, Pick3®, 2by2®, and instant games.

Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004 requires, until January 1, 2008, a portion of the dollar amount of the lottery tickets, which have been sold on an annualized basis, to be transferred to the beneficiary funds, except that the dollar amount transferred shall not be less than the dollar amount transferred to the funds in fiscal year 2003. Of the money remaining after the payment of prizes and operating expenses; the first five hundred thousand dollars shall be transferred to the Compulsive Gamblers Assistance Fund. Thereafter, twenty-four and three-fourths percent shall be transferred to the Education Innovation Fund, twenty-four and three-fourths percent shall be transferred to the Nebraska Scholarship Fund, forty-nine and one-half percent shall be transferred to the Nebraska Environmental Trust Fund, and one percent shall be transferred to the Compulsive Gamblers Assistance Fund.

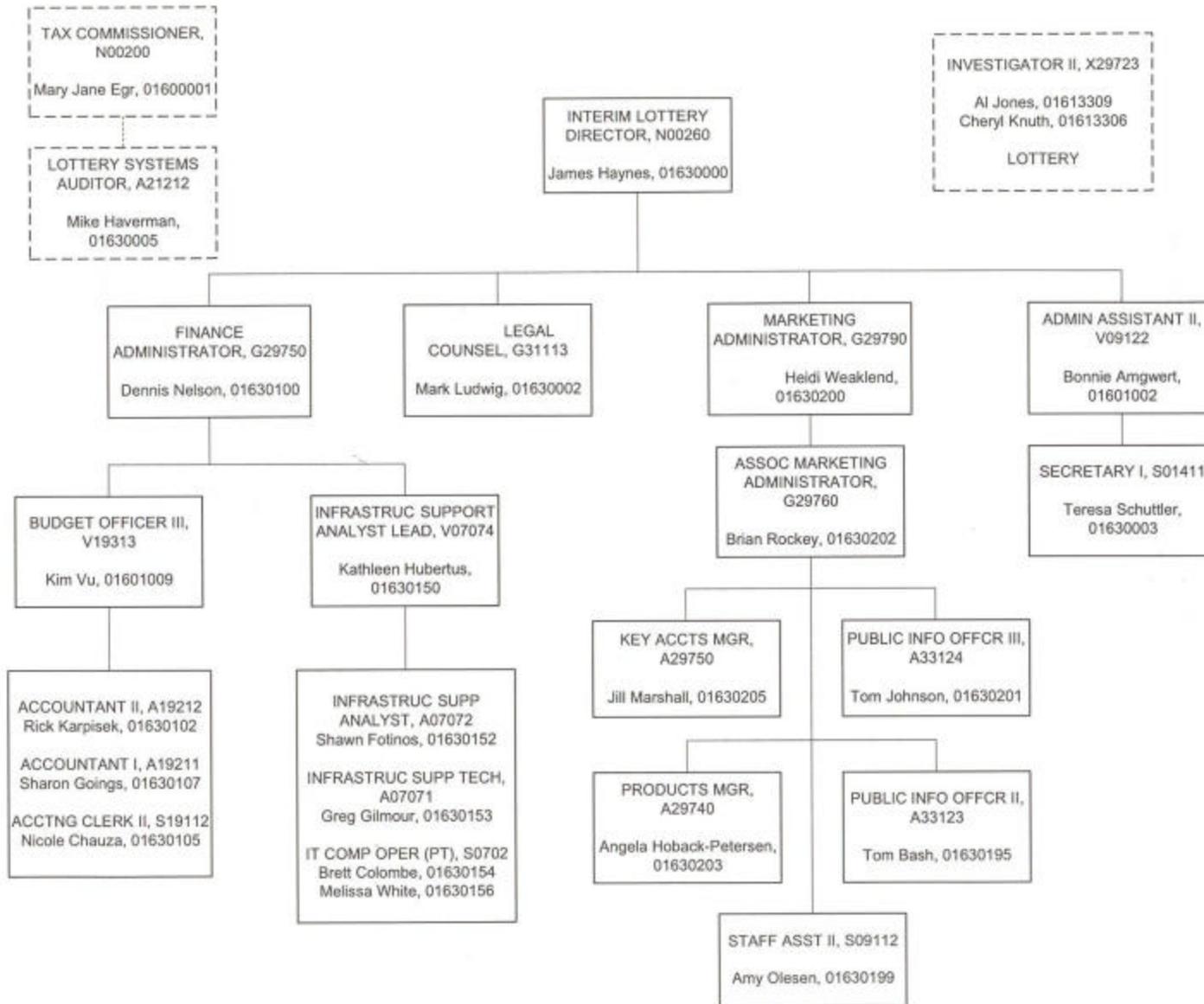
Due to the passing of Constitutional Amendment 4, from January 1, 2005 and forward, of the money remaining after the payment of prizes and operating expenses; the first five hundred thousand dollars shall be transferred to the Compulsive Gamblers Assistance Fund. Thereafter, twenty-two and one-fourth percent shall be transferred to the Education Innovation Fund, twenty-two and one-fourth percent shall be transferred to the Nebraska Scholarship Fund, forty-four and one-half percent shall be transferred to the Environmental Trust Fund, ten percent shall be transferred to the State Fair Support and Improvement Cash Fund a fund of the Nebraska State Fair Board, and one percent shall be transferred to the Compulsive Gamblers Assistance Fund.

MISSION STATEMENT

The Nebraska Lottery's mission is to offer winning opportunities to Nebraska citizens while maximizing dollars for Nebraska educational and environmental causes.

NEBRASKA LOTTERY

ORGANIZATIONAL CHART



NEBRASKA LOTTERY

EXIT CONFERENCE

An exit conference was held October 3, 2005 with the Nebraska Lottery to discuss the results of our audit. Those in attendance for the Nebraska Lottery were:

| NAME | TITLE |
|---------------|--------------------|
| James Haynes | Acting Director |
| Dennis Nelson | Finance Director |
| Kim Vu | Budget Officer III |
| Mike Haverman | Auditor |
| Mark Ludwig | Legal Counsel |

NEBRASKA LOTTERY

SUMMARY OF COMMENTS

During our audit of the Nebraska Lottery, we noted certain matters involving the internal control over financial reporting and other operational matters which are presented here. Comments and recommendations are intended to improve the internal control over financial reporting, ensure compliance, or result in operational efficiencies.

1. ***Information Systems Internal Control Review:*** The Nebraska Lottery has not had an information system review performed by a specialist since the current instant and on-line vendors started providing services.
2. ***Meal Expenses:*** Two of five meal logs tested did not have the restaurant name recorded per IRS requirements. The meals totaled \$94.
3. ***Reconciliation of Bank Records to the Nebraska Information System by DAS:*** The Department of Administrative Services' (DAS) reconciliation process is still not done in a timely manner and continues to reflect unknown variances.

More detailed information on the above items is provided hereafter. It should be noted this report is critical in nature since it contains only our comments and recommendations on the areas noted for improvement.

Draft copies of this report were furnished to the Nebraska Lottery to provide them an opportunity to review the report and to respond to the comments and recommendations included in this report. All formal responses received have been incorporated into this report. Responses have been objectively evaluated and recognized, as appropriate, in the report. Responses that indicate corrective action has been taken were not verified at this time but will be verified in the next audit.

We appreciate the cooperation and courtesy extended to our auditors during the course of the audit.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

1. Information Systems Internal Control Review

Good internal control requires a periodic review of the information system's internal controls by a specialist to ensure systems are properly functioning and serving their established purpose.

The Nebraska Lottery has not had an outside review performed by a specialist on the information system's internal control for the on-line vendor, instant ticket vendor, and Nebraska Lottery information systems since April 2000. Beginning July 1, 2001, a new instant ticket vendor provided services. In addition, as of July 1, 2004, the Nebraska Lottery contracted with a new on-line vendor. Provisions within the vendor contracts allow for the vendors to share in the cost of reviews performed.

Without a periodic review of information system's internal controls there is an increased risk of loss or misuse of State funds due to information system controls not properly functioning or serving their intended purposes.

We recommend the Nebraska Lottery consider contracting with a specialist to provide a review of information systems internal controls for the on-line vendor, the instant ticket vendor, and the Nebraska Lottery.

Nebraska Lottery's Response: The Nebraska Lottery believes that independent reviews of the various information systems are important. Lottery management has started evaluating the scope of activities a specialist would need to perform and the potential costs associated with an independent review. After that, we will begin preparing the Request for Proposals (RFP) for potential specialists.

2. Meal Expenses

We tested ten travel expense documents for a total of \$9,981. The Nebraska Lottery had \$38,196 in total travel disbursements for the fiscal year ended June 30, 2005.

Per Internal Revenue Service (IRS) Publication 463 and discussion with IRS officials, an actual receipt or a log showing the dates, restaurant name, city, meal, and amount is required for meal reimbursements. The IRS requires enough information on the log so the restaurant could be contacted to verify the amount was appropriate.

Of the ten travel expense documents tested, five had meal expense reimbursements. We noted two of the five meal logs did not have the restaurant name recorded. There were a total of seven meals claimed on the two meal logs for a total of \$94.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

(Continued)

2. Meal Expenses (Concluded)

Without an adequate accounting of meal expenses the State could lose its accountable plan. If the State does not have an accountable plan, the amounts reimbursed to employees for meal expenses would be considered taxable income.

We recommend the Lottery ensure the restaurant name is recorded on the meal logs in accordance with IRS requirements.

Nebraska Lottery's Response: The Nebraska Lottery follows the Nebraska Department of Revenue's travel policy which follows the Department of Administrative Services (DAS) travel policy guidelines. The DAS travel policy does not require that receipts be included as support for the meal expense reimbursements when amounts do not exceed stated guidelines.

The Internal Revenue Service (IRS) Publication 463, as written, does not require that the restaurant name be included if receipts are not required as support for the meal expense reimbursements. The approved expense reimbursement form also does not require or provide for the restaurant names to be included. It would be inefficient for the Nebraska Lottery to create additional forms just to document the restaurant names when it is not required by the authorizing policies.

The Nebraska Lottery has and will continue to enforce the written policies for the travel expense reimbursements. If DAS or the IRS should change the existing written policies to include the restaurant names, we will look forward to enforcing the revised policies.

APA's Response: IRS Publication 463 and discussions with IRS staff substantiate the requirement to include the name of the restaurant on meal logs. Meal logs should provide adequate information, which would include the restaurant name, to support a reasonable determination that the meal expense is appropriate. If the IRS rules for accountable plans are not followed, there is a risk the State of Nebraska will lose their accountable plan status and all employee meal reimbursements would become taxable income. In addition, Nebraska State employees traveling on State business are accountable to Nebraska taxpayers and owe a duty to Nebraska taxpayers to follow IRS requirements.

3. Reconciliation of Bank Records to the Nebraska Information System by DAS

Good internal control requires a plan of organization, procedures, and records designed to safeguard assets and provide reliable financial information. Without a timely and complete reconciliation of bank records to the Nebraska Information System (NIS), there is a greater risk for fraud and errors to occur and to remain undetected.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

(Continued)

3. Reconciliation of Bank Records to the Nebraska Information System by DAS

(Continued)

During the audit of the Comprehensive Annual Financial Report (CAFR) of the State of Nebraska, the Auditor of Public Accounts (APA) noted the absence of reconciliation between the Nebraska State Treasurer's actual bank statements and Nebraska accounting records (in both NIS and NAS, the Nebraska Accounting System before NIS). This has been an issue for the Department of Administrative Services (DAS) Accounting Division for many years. The APA's previous versions noted monthly reconciliations have not been completed in a timely manner and reconciliations performed have shown significant unknown variances between the bank records and the accounting records, with the bank being short compared to the accounting records. Although DAS Accounting Division continues to work on correcting the reconciliation of bank records to NIS, the APA continues to note areas where improvement is still needed in the reconciliation process to ensure NIS integrity and operational efficiency. Specifically, the APA noted the status of the reconciliation process as of August 11, 2005 to be as follows:

DAS Accounting Division has worked on the reconciliation process, but continued progress is needed. DAS Accounting Division's reconciliation process has developed into a very detailed process of analyzing bank activity, compared to activity recorded on NIS, to identify reconciling items. DAS Accounting Division has completed their reconciliation process for the months of June and July of 2004. The APA has reviewed these reconciliations. These two months show variances of \$2,944,126 and \$2,932,824, respectively. Again, the reconciliations show the bank being short compared to the accounting records. Per inquiry of management, DAS Accounting Division has started the reconciliation process for various months of the fiscal year ended June 30, 2005; however, the reconciliation process has not been a continuous monthly process and no monthly reconciliation has been completed since July of 2004.

Although DAS Accounting Division has worked on the reconciliation process, the process is still not done in a timely manner and the variance is inconsistent. The reconciliation continues to reflect unknown variances and shortages. Complete and timely reconciliation procedures between bank records and accounting records are required to provide control over cash and accurate financial information.

The APA recommends DAS Accounting Division continue their reconciliation process, in a more timely manner, and on at least a monthly basis, to ensure all financial information is correct on NIS. We also recommend, when a consistent cash variance between the bank records and the accounting records is obtained (based on at

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

(Continued)

3. **Reconciliation of Bank Records to the Nebraska Information System by DAS**
(Concluded)

least six months of reconciliations), DAS submit their plan for adjusting NIS to the Governor and the Legislature so they may take appropriate action to correct NIS and resolve the variances noted.

This issue is the responsibility of DAS Accounting Division; however, as the variances have not been identified by fund or agency, this issue directly affects all Nebraska State agencies' financial information and must be disclosed in this report.

Nebraska Lottery's Response: This audit finding pertains to the responsibility of DAS Accounting Division only and not the Nebraska Lottery. The Nebraska Lottery does perform compensating procedures in regards to this point. The Nebraska Lottery reconciles the cash balances for all Lottery funds on a monthly basis and compares the results to NIS balances. The Lottery cash balances have been properly reconciled with the NIS balances.

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NEBRASKA LOTTERY

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We have audited the accompanying financial statements of the business-type activities of the Nebraska Lottery, as of and for the year ended June 30, 2005, which collectively comprise the Nebraska Lottery's basic financial statements as listed in the Table of Contents. These financial statements are the responsibility of the Nebraska Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As discussed in Note 1, the financial statements of the Nebraska Lottery, a division of the Nebraska Department of Revenue, are intended to present the financial position and changes in financial position of only that portion of the business-type activities of the State that is attributable to the transactions of the Nebraska Lottery. They do not purport to, and do not, present fairly the financial position of the business-type activities of the State of Nebraska as of June 30, 2005, and its changes in financial position 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 respective financial position of the business-type activities of the Nebraska Lottery, as of June 30, 2005, and the respective changes in financial position thereof for the year 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 October 3, 2005, on our consideration of the Nebraska Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Nebraska Lottery's basic financial statements. The schedules and Management's Discussion and Analysis are presented for purposes of additional analysis and are not a required part of the basic financial statements. The schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The Management's Discussion and Analysis has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

Handwritten signature of Timothy J. Channer CPA in black ink.

Assistant Deputy Auditor

October 3, 2005

NEBRASKA LOTTERY

MANAGEMENT'S DISCUSSION AND ANALYSIS

This section of the Nebraska Lottery's annual audit presents management's discussion and analysis of the financial performance of the Lottery for the fiscal period ended June 30, 2005. This discussion should be read in conjunction with the accompanying financial statements and related notes. The financial statements, notes, and this discussion are the responsibility of the Nebraska Lottery's management.

OVERVIEW OF THE FINANCIAL STATEMENTS

The Nebraska Legislature established the Nebraska Lottery on February 24, 1993. The Nebraska Lottery is to provide instant win games and on-line random number selection games. The Nebraska Lottery is a division of the Nebraska Department of Revenue and as such, the financial summaries presented here and the related comments are for the Nebraska Lottery activities only and do not include the Department of Revenue's activities or statements.

The Nebraska Lottery accounts for its financial transactions as an enterprise fund. Enterprise funds are used to account for governmental operations that are financed and operated in a manner similar to private business. The Nebraska Lottery uses the accrual basis of accounting. In the annual report issued by the Nebraska Lottery, we include three financial reports.

- 1) **Statement of Net Assets**
This report will show the assets, liabilities, and net assets ("equity") of the Nebraska Lottery as of June 30, 2005. This report is basically the balance sheet for a private business.
- 2) **Statement of Revenues, Expenses, and Changes in Net Assets**
This report will show the revenue, expenses, transfers to other funds, and changes in net assets for the year. This report would be similar to an income statement or a profit-loss statement for a private business.
- 3) **Statement of Cash Flows**
This report is an analysis of the sources of cash flows into the Nebraska Lottery and out of the Nebraska Lottery via external transactions as well as internal transactions.

DISCUSSION OF NET ASSETS

While reviewing the Summary of Net Assets, it must be compared to the prior year's Net Assets to see the changes in the various classifications (see Table A below). The largest asset decrease was in the Cash and Cash Equivalents. The cash balance decreased by over \$2.7 million. This change in cash position is attributed to one significant transaction. During the 2004 Legislative session, the Legislature passed LB 1091 which instructed the State Treasurer to transfer \$5 million from the State Lottery Operations Trust Fund to the General Fund. This cash transfer was completed on July 15, 2004.

Another change that appears to be material when comparing this year's financial statements to last year's financial statements is the Accounts Receivable. It is due to an adjusting entry that we make at the end

NEBRASKA LOTTERY

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Continued)

of the fiscal year. On our books, instant ticket sales are recorded when they are settled (when the retailer must pay for them). One of the year-end adjustments is to record tickets that have been activated (when the retailer can begin selling them) but have not yet settled. This year's adjusting entry was larger than last year thus creating additional accounts receivable for instant tickets. (Note: The prior year's entry is reversed.)

For liabilities, the Prizes Payable increased by more than \$1 million. This is due to our increased sales during the year. The sales revenues increased by more than \$8 million and the related prizes that have not yet been claimed would increase as well. Also, the larger activations adjusting entry noted in the previous paragraph would have increased the prizes payable as well.

The Other Liabilities and Payables decreased substantially (approximately \$791,000). This correlates to the amounts that we owed the designated trust funds. Last year, we owed these funds more than \$800,000. This year we have transferred additional cash to the trust funds to reduce the amounts owed. The amount owed to the trust funds this year is zero.

The Unreserved Assets decreased about \$2.5 million during this year. This occurred because the Nebraska Lottery had income before transfers of around \$23.9 million but made transfers to other funds in excess of \$26.3 million. This can be seen in Table B.

Table A
Summary of Net Assets

| | FY 2005 | FY 2004 | Change |
|--------------------------------------|----------------------|----------------------|-----------------------|
| CURRENT ASSETS | | | |
| Cash and Cash Equivalents | \$ 5,267,568 | \$ 8,014,088 | \$ (2,746,520) |
| Accounts Receivable | 3,726,933 | 3,207,464 | 519,469 |
| Prepaid Prizes and Costs | 406,847 | 413,900 | (7,053) |
| TOTAL CURRENT ASSETS | <u>9,401,348</u> | <u>11,635,452</u> | <u>(2,234,104)</u> |
| NONCURRENT ASSETS | | | |
| Reserves on Deposit | 1,743,914 | 1,712,039 | 31,875 |
| Furniture, Fixtures, Equipment (Net) | 43,776 | 40,631 | 3,145 |
| TOTAL NONCURRENT ASSETS | <u>1,787,690</u> | <u>1,752,670</u> | <u>35,020</u> |
| TOTAL ASSETS | <u>\$ 11,189,038</u> | <u>\$ 13,388,122</u> | <u>\$ (2,199,084)</u> |
| CURRENT LIABILITIES | | | |
| Accounts Payable | \$ 1,227,109 | \$ 1,232,598 | \$ (5,489) |
| Accrued Payroll Payable | 212,465 | 185,667 | 26,798 |
| Prizes Payable | 4,685,494 | 3,602,222 | 1,083,272 |
| Other Liabilities and Payables | 124,096 | 915,553 | (791,457) |
| TOTAL LIABILITIES | <u>\$ 6,249,164</u> | <u>\$ 5,936,040</u> | <u>\$ 313,124</u> |
| NET ASSETS | | | |
| Invested in Capital Assets | \$ 43,776 | \$ 40,632 | \$ 3,144 |
| Restricted for Future Prizes | 1,743,914 | 1,712,039 | 31,875 |
| Unreserved Assets | 3,152,184 | 5,699,411 | (2,547,227) |
| TOTAL NET ASSETS | <u>\$ 4,939,874</u> | <u>\$ 7,452,082</u> | <u>\$ (2,512,208)</u> |

NEBRASKA LOTTERY

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Continued)

DISCUSSION OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

During this year, the Nebraska Lottery experienced higher sales. Overall, revenues increased by about \$8 million. (See Table B below.) This overall increase is attributed to instant ticket sales (increased \$10.2 million). Sales of on-line tickets decreased during the year (decreased \$2.2 million). The increase in instant ticket sales is attributable to the introduction of a \$10 game. The sales for this new game were more than \$6.1 million. The remaining increase in instant sales can not be readily identified. We believe it to be from better rotation of the \$3 games which keeps player interest high and from our \$5 Price is Right instant game which had tremendous sales last spring. The on-line ticket sales decreased due to the reduced number of large Powerball jackpots (greater than \$100 million) that occurred during the year. Last year, there were six large jackpots while this year only had three large jackpots.

On the expense side, the Prize Expense went up more than \$5.7 million. This is due to the increased sales. Also, as our sales increase, so does the Retailer Commission that we pay our retailers to sell our products and the Marketing Expense that we incur to advertise and promote the Nebraska Lottery. Our marketing plan costs are usually based on a percentage of sales, so as we have greater sales, we usually incur higher marketing expenses.

The Contractual Services Expense (payments to our instant ticket contractor, our on-line ticket contractor, and our security contractor) decreased during the year. The instant ticket contractor costs were greater as we pay GTECH a set percentage of our instant sales which increased. The on-line ticket contractor costs decreased substantially as we switched from GTECH to Intralot as of July 1, 2004. The GTECH on-line rate was 10.952% of on-line sales while our current Intralot rate is 2.39% of on-line sales. Also, as noted above, on-line sales decreased this year.

The Transfers to Other Funds increased substantially due to the \$5 million statutory transfer discussed above.

Table B
Statement of Revenues, Expenses, and Changes in Net Assets

| REVENUES | FY 2005 | FY 2004 | Change |
|-----------------------------------|-----------------------|----------------------|---------------------|
| Sales | \$ 102,672,465 | \$ 94,078,583 | \$ 8,593,882 |
| Sales Returns | (2,014,294) | (1,469,940) | (544,354) |
| OPERATING REVENUE | 100,658,171 | 92,608,643 | 8,049,528 |
| Interest Income | 264,651 | 400,646 | (135,995) |
| Multi-State Lottery Assoc. Income | 65,414 | 51,997 | 13,417 |
| NON-OPERATING REVENUE | 330,065 | 452,643 | (122,578) |
| TOTAL REVENUES | \$ 100,988,236 | \$ 93,061,286 | \$ 7,926,950 |

NEBRASKA LOTTERY

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Continued)

EXPENSES

| | | | |
|--|---------------------------|-------------------------|---------------------------|
| Prize Expense | \$ 58,352,134 | \$ 52,607,966 | \$ 5,744,168 |
| Retailer Commissions | 6,433,299 | 5,632,372 | 800,927 |
| Contractual Services Expense | 6,511,219 | 9,753,242 | (3,242,023) |
| Marketing Expense | 4,193,292 | 3,400,374 | 792,918 |
| Lottery Operating Expense | 1,637,777 | 1,870,417 | (232,640) |
| TOTAL EXPENSES | <u>\$ 77,127,721</u> | <u>\$ 73,264,371</u> | <u>\$ 3,863,350</u> |
| NET INCOME BEFORE TRANSFERS | \$ 23,860,515 | \$ 19,796,915 | \$ 4,063,600 |
| TRANSFERS TO OTHER FUNDS | <u>26,372,723</u> | <u>20,590,486</u> | <u>5,782,237</u> |
| CHANGE IN NET ASSETS | <u>\$ (2,512,208)</u> | <u>\$ (793,571)</u> | <u>\$ (1,718,637)</u> |

OTHER ITEMS OF NOTE

In the prior fiscal year, after the first \$500,000 was transferred to the Compulsive Gamblers Assistance Fund, the Nebraska Lottery transferred funds to the Education Innovation Fund (24.75%), the Environmental Trust Fund (49.5%), the Compulsive Gamblers Assistance Fund (1%), and the Nebraska Scholarship Fund (24.75%). Effective January 1, 2005, there was another beneficiary fund that we began to include in our transfers due to the passage of a Constitutional Amendment. The new fund is the State Fair Support and Improvement Cash Fund. With the inclusion of the State Fair Fund, the beneficiary trust funds receive the following percentages:

| | |
|--|------------------------|
| Environmental Trust Fund | 44.5% |
| Education Innovation Fund | 22.25% |
| Nebraska Scholarship Fund | 22.25% |
| Compulsive Gamblers Assistance Fund | 1% + (first \$500,000) |
| State Fair Support and Improvement Cash Fund | 10% |

CONTACTING LOTTERY MANAGEMENT

This financial report is required as part of Governmental Accounting Standards Board (GASB) Statement 34 and is prepared to provide the readers such as the Legislature, the public, and other interested parties with an overview of the financial results of the Nebraska Lottery's activities. If you have any questions about this report, please contact the Nebraska Lottery at PO Box 98901, Lincoln, NE 68509-8901.

NEBRASKA LOTTERY
STATEMENT OF NET ASSETS
 JUNE 30, 2005

ASSETS:

CURRENT ASSETS

| | | |
|--|--|--------------|
| Cash and Cash Equivalents | | \$ 5,267,568 |
| Accounts Receivable, Net of Allowance (Note 4) | | 3,726,933 |
| Prepaid Prizes | | 153,191 |
| Prepaid Contract Costs - Instant | | 253,656 |

| | | |
|-----------------------------|--|------------------|
| TOTAL CURRENT ASSETS | | <u>9,401,348</u> |
|-----------------------------|--|------------------|

NONCURRENT ASSETS

| | | |
|---|----------------|---------------|
| Reserves on Deposit (Note 6) | | 1,743,914 |
| Furniture, Fixtures, and Equipment (Note 5) | 447,698 | |
| Less: Accumulated Depreciation | <u>403,922</u> | |
| Capital Assets, Net | | <u>43,776</u> |

| | | |
|--------------------------------|--|------------------|
| TOTAL NONCURRENT ASSETS | | <u>1,787,690</u> |
|--------------------------------|--|------------------|

| | | |
|---------------------|--|-----------------------------|
| TOTAL ASSETS | | <u><u>\$ 11,189,038</u></u> |
|---------------------|--|-----------------------------|

LIABILITIES:

CURRENT LIABILITIES

| | | |
|-------------------------------|--|------------|
| Accounts Payable | | \$ 357,704 |
| Vendors Payable | | 869,405 |
| Compensated Absences Payable | | 143,976 |
| Accrued Payroll Payable | | 68,489 |
| Withheld Taxes on Prizes Paid | | 28,052 |
| Prize Payable | | 4,685,494 |
| Due to Other Funds | | 20,825 |
| Other Accrued Liabilities | | 75,219 |

| | | |
|----------------------------------|--|----------------------------|
| TOTAL CURRENT LIABILITIES | | <u><u>\$ 6,249,164</u></u> |
|----------------------------------|--|----------------------------|

NET ASSETS

| | | |
|------------------------------|------------------|--|
| Invested in Capital Assets | \$ 43,776 | |
| Restricted for Future Prizes | 1,743,914 | |
| Unreserved (Note 8) | <u>3,152,184</u> | |

| | | |
|-------------------------|--|----------------------------|
| TOTAL NET ASSETS | | <u><u>\$ 4,939,874</u></u> |
|-------------------------|--|----------------------------|

The accompanying Notes to the Financial Statements are an integral part of this statement.

NEBRASKA LOTTERY
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
 FOR THE YEAR ENDED JUNE 30, 2005

| | | |
|--|------------------|----------------------------|
| OPERATING REVENUE: | | |
| Sales | | \$ 102,672,465 |
| Less: Sales Returns | | <u>2,014,294</u> |
| TOTAL OPERATING REVENUE | | <u>100,658,171</u> |
| OPERATING EXPENSES: | | |
| Prize Expense | 58,352,134 | |
| Retailer Commissions | 6,433,299 | |
| Contractual Services Expense | 6,511,219 | |
| Marketing | 4,193,292 | |
| Lottery Operating | <u>1,637,777</u> | |
| TOTAL OPERATING EXPENSES | | <u>77,127,721</u> |
| OPERATING INCOME | | 23,530,450 |
| NON-OPERATING REVENUE: | | |
| Interest Income | 264,651 | |
| Multi-State Lottery Association Income | <u>65,414</u> | |
| TOTAL NON-OPERATING REVENUE | | <u>330,065</u> |
| INCOME BEFORE OPERATING TRANSFERS | | 23,860,515 |
| TRANSFERS TO OTHER FUNDS | | <u>(26,372,723)</u> |
| CHANGE IN NET ASSETS | | (2,512,208) |
| TOTAL NET ASSETS, BEGINNING OF YEAR | | <u>7,452,082</u> |
| TOTAL NET ASSETS, END OF YEAR | | <u><u>\$ 4,939,874</u></u> |

The accompanying Notes to the Financial Statements are an integral part of this statement.

NEBRASKA LOTTERY
STATEMENT OF CASH FLOWS
 FOR THE YEAR ENDED JUNE 30, 2005

CASH FLOWS FROM OPERATING ACTIVITIES:

| | | |
|--|----------------|--|
| Ticket Sales | \$ 100,120,375 | |
| Prizes Paid to Winners | (57,286,608) | |
| Commissions Paid to Retailers | (6,436,011) | |
| Paid to Contractors for Goods and Services | (10,769,988) | |
| Paid to Employees | (1,238,192) | |
| Other Operating Expenses | (368,731) | |
| POWERBALL® Grand Prize Winner Receipts from MUSL | 10,692,888 | |
| Payments to POWERBALL® Grand Prize Winners | (10,692,888) | |
| Reserves on Deposit | (31,875) | |
| Advances for Vendors | 28,741 | |
| Prepaid Prize Expense | 85,608 | |
| Net Cash Provided by Operating Activities | 24,103,319 | |

CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES:

| | | |
|---|--------------|--|
| Paid to Education Innovation Fund | (5,100,683) | |
| Paid to Nebraska Scholarship Fund | (5,100,683) | |
| Paid to State Fair Support and Improvement Fund | (1,075,788) | |
| General Fund Transfer | (5,000,000) | |
| Paid to Environmental Trust Fund | (10,201,368) | |
| Paid to Compulsive Gamblers Assistance Fund | (716,956) | |
| Net Cash Used in Non-Capital Financing Activities | (27,195,478) | |

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:

| | | |
|------------------------------------|--|----------|
| Purchase of Property and Equipment | | (29,733) |
|------------------------------------|--|----------|

CASH FLOWS FROM INVESTING ACTIVITIES

| | | |
|--|---------|--|
| Interest on Cash | 264,651 | |
| Multi-State Lottery Association Income | 110,721 | |
| Net Cash Provided by Investment Activities | 375,372 | |

NET DECREASE IN CASH AND CASH EQUIVALENTS (2,746,520)

CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR 8,014,088

CASH AND CASH EQUIVALENTS AT END OF YEAR \$ 5,267,568

RECONCILIATION OF INCOME FROM OPERATIONS TO NET CASH PROVIDED BY OPERATING ACTIVITIES:

| | | |
|---|--|---------------|
| Income from Operations | | \$ 23,530,450 |
| Adjustments to Reconcile Income from Operations to Net Cash Provided by Operating Activities: | | |
| Reserves on Deposit | | (31,875) |
| Prepaid Prize Expense | | 85,608 |
| Advances for Vendors | | 28,740 |
| Depreciation | | 26,589 |
| Changes in Assets and Liabilities: | | |
| (Increase) Decrease in: | | |
| Accounts Receivable (Net) | | (592,025) |
| Advance Sales | | 23,622 |
| Accounts Payable and Accrued Liabilities | | (77,861) |
| Prizes Payable | | 1,083,272 |
| Compensated Absences Payable | | 26,799 |
| Net Cash Provided by Operating Activities | | \$ 24,103,319 |

The accompanying Notes to the Financial Statements are an integral part of this statement.

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

For the Fiscal Year Ended June 30, 2005

1. Summary of Significant Accounting Policies

A. **Basis of Presentation**

The accompanying basic financial statements of the Nebraska Lottery have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) as applied to governmental units. As the Nebraska Lottery is a business-type activity, the financial statements are in the format of fund financial statements as required by Governmental Accounting Standards Board (GASB) Statement Number 34. GASB is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The financial statements have been prepared primarily from data maintained by the Nebraska Lottery on computer systems provided by the instant and on-line games vendor and from accounts maintained by the State Accounting Administrator of the Department of Administrative Services.

B. **Reporting Entity**

The Nebraska Lottery was established on February 24, 1993, by the Nebraska Legislature as a division of the Nebraska Department of Revenue, which is a State agency established under and governed by the laws of the State of Nebraska. As such, the Nebraska Lottery is exempt from State and Federal income taxes. The financial statements include all funds of the Nebraska Lottery. The Nebraska Lottery is to provide an instant win and a random number selection on-line lottery. The net proceeds as outlined in Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004, are to be transferred to the Education Innovation Fund, the Nebraska Scholarship Fund, the Nebraska Environmental Trust Fund, and the Compulsive Gamblers Assistance Fund. As of January 1, 2005, Constitutional Amendment 4 required an additional transfer to the State Fair Support and Improvement Cash Fund, a fund of the State Fair Board. The financial statements include only the Nebraska Lottery and are not intended to present the financial position of the Nebraska Department of Revenue or the results of operations and changes in fund balances of the Department as a whole. The Nebraska Department of Revenue is part of the primary government for the State of Nebraska's reporting entity.

The Nebraska Lottery has also considered all potential component units for which it is financially accountable, and other organizations which are fiscally dependent on the Nebraska Lottery, or the significance of their relationship with the Nebraska Lottery is such that exclusion would be misleading or incomplete. GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

1. Summary of Significant Accounting Policies (Continued)

governing body, and (1) the ability of the Nebraska Lottery to impose its will on that organization, or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on the Nebraska Lottery.

These financial statements present the Nebraska Lottery. No component units were identified.

C. **Basis of Accounting, Measurement Focus**

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus and basis of accounting.

Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported in the financial statements. Basis of accounting relates to the timing of the measurements made, regardless of the measurement focus applied.

The Nebraska Lottery financial statements were reported using the economic resources measurement focus and the accrual basis of accounting. With the economic resources measurement focus, all assets and all liabilities associated with the operations are included on the Statement of Net Assets. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Fund equity (i.e., net total assets) is segregated into restricted and unrestricted net assets. The Nebraska Lottery's operating statements present increases (e.g., revenues) and decreases (e.g., expenses) in net total assets.

Instant ticket revenue is recognized when tickets are sold to the retailer and on-line revenue is recognized after the drawing is completed for the respective wagers. A 5% or 6% retailer commission and prize expense are recognized at the same time. Revenues from the sale of on-line tickets for future drawings and the related agent commission and prize expense are deferred until the drawings are held.

Revenues generated from the sale of lottery tickets are reported as operating revenues. Transactions which are capital financing, non-capital financing, or investing related are reported as non-operating revenues. All expenses related to operating the Nebraska Lottery are reported as operating expenses. All other expenses are reported as non-operating expenses.

Prize expense is recognized in the same period ticket revenue is recognized based on the predetermined prize structure for each game. Because the instant prize winning tickets are randomly distributed throughout the tickets and because some winning tickets will be lost, destroyed, or unredeemed for other reasons, there will be differences between amounts

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

1. Summary of Significant Accounting Policies (Continued)

accrued and the amounts actually paid. These differences, denoted as unclaimed prizes, are recognized as a reduction of prize expense 181 days after the end of each instant game and 181 days after each draw for on-line games as prizes unclaimed for 180 days expire. Total unclaimed prizes for the fiscal year ended June 30, 2005 was \$1,657,055.

In September 1993, GASB issued Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting." This Statement is effective for financial statement periods beginning after December 15, 1993. As permitted by the Statement, the Nebraska Lottery has elected not to adopt Financial Accounting Standards Board (FASB) statements and interpretations issued after November 30, 1989, unless GASB specifically adopts such FASB statements or interpretations.

The activities of the Nebraska Lottery are accounted for as an enterprise fund. Enterprise funds are used to account for governmental operations that are financed and operated in a manner similar to private business enterprises and where the governing body has decided that periodic determination of revenues earned, expenses incurred, and net assets is appropriate.

D. Cash and Cash Equivalents

Cash and cash equivalents represent the cash balance as reflected on the Nebraska Information System (NIS). Also included in the cash and cash equivalents amount is Petty Cash and Deposits with Vendors. Investment of all available cash is made by the State Investment Officer on a daily basis, based on total bank balances. Investment income is distributed based on the average daily book cash balance of funds designated for investment. Interest on funds held by the State Treasurer is periodically distributed to the participating agencies. These funds are considered to be cash and cash equivalents which are available for expenditures as needed. These funds are held in the State of Nebraska Operating Investment Pool (OIP), an internal investment pool. The investment policy of the OIP includes the objectives of:

- Safety – Investments will be undertaken in a manner that seeks to ensure preservation of capital on a total return basis.
- Liquidity – The OIP will remain sufficiently liquid to meet the daily cash flow needs of the State and other entities participating in the OIP.
- Return on Investment – The objective is to attain a competitive income rate of return given the risk constraints and cash flow characteristics of the portfolio.

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

1. **Summary of Significant Accounting Policies** (Continued)

The investment strategy is to minimize short-term investments while maintaining sufficient funds to provide for required cash outflows. The investments of the OIP at June 30, 2005 include Commercial Paper, U.S. Government Securities, Federal Agency Debt Instruments, Corporate Bonds, Money Market Funds, and Bank Deposits. Additional information on the OIP can be found in the State of Nebraska's Comprehensive Annual Financial Report (CAFR) for the fiscal year ended June 30, 2005.

E. Budgetary Process

The State's biennial budget cycle ends on June 30 of the odd-numbered years. By September 15, prior to a biennium, the Nebraska Lottery and all other State agencies must submit their budget requests for the biennium beginning the following July 1. The requests are submitted on forms that show estimated funding requirements by programs, sub-programs, and activities. The Executive Branch reviews the requests, establishes priorities, and balances the budget within the estimated resources available during the upcoming biennium.

The Governor's budget bill is submitted to the Legislature in January. The Legislature considers revisions to the bill and presents the appropriations bill to the Governor for signature. The Governor may: a) approve the appropriations bill in its entirety, b) veto the bill, or c) line item veto certain sections of the bill. Any vetoed bill or line item can be overridden by a three-fifths vote of the Legislature.

The approved appropriations will generally set spending limits for a particular program within the agency. Within the agency or program, the Legislature may provide funding from one to five budgetary fund types. Thus, the control is by fund type, within a program, within an agency. Appropriations are usually made for each year of the biennium, with unexpended balances being reappropriated at the end of the first year of the biennium. For most appropriations, balances lapse at the end of the biennium.

All State budgetary expenditures for the enterprise fund type are made pursuant to the appropriations, which may be amended by the Legislature, upon approval by the Governor. State agencies may reallocate the appropriations between major objects of expenditure accounts, except that the Legislature's approval is required to exceed the personal service limitations contained in the appropriations bill.

F. Allowance for Uncollectible Amounts

Estimated allowances for uncollectible amounts are determined based upon past collection experience and current economic conditions.

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

1. Summary of Significant Accounting Policies (Concluded)

G. Capital Assets

Capital assets include equipment which is valued at cost where historical records are available and at estimated historical cost where no historical records exist. Donated capital assets are valued at their estimated fair market value on the date received. Generally, equipment which has a cost in excess of \$1,500 at the date of acquisition and has an expected useful life of three to seven years is capitalized.

The cost of normal maintenance and repairs that do not add to the value of the asset or extend asset life is not capitalized.

H. Compensated Absences

All permanent employees working for the Nebraska Lottery earn sick and annual leave and are allowed to accumulate compensatory leave rather than being paid overtime. Temporary and intermittent employees are not eligible for paid leave. The liability has been calculated using the vesting method, in which leave amounts, for both employees who are currently eligible to receive termination payments and other employees who are expected to become eligible in the future to receive such payments upon termination, are included.

Nebraska Lottery employees accrue vested annual leave at a variable rate based on years of service. Generally, accrued annual leave cannot exceed 35 days at the end of a calendar year. Employees accrue sick leave at a variable rate based on years of service. In general, accrued sick leave cannot exceed 180 days. There is no maximum limit on the accumulation of sick leave days for employees under certain labor contracts. Sick leave is not vested except upon death or upon reaching the retirement eligibility age of 55, at which time the State is liable for 25 percent of the employee's accumulated sick leave. Employees under certain labor contracts can only be paid a maximum of 50 days.

The Nebraska Lottery financial statements recognize the expense and accrued liability when vacation and compensatory leave is earned or when sick leave is expected to be paid as termination payments.

I. 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 at fiscal year end and revenues and expenditures during the reporting period. Actual results could differ from those estimates.

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

2. Contingencies and Commitments

Risk Management. The Nebraska Lottery is exposed to various risks of loss related to torts, theft of, damage to, or destruction of assets, errors or omissions, injuries to employees, and natural disasters. The Nebraska Lottery, as part of the primary government for the State, participates in the State's risk management program. The Nebraska Department of Administrative Services (DAS) Division of Risk Management is responsible for maintaining the insurance and self-insurance programs for the State with the exception of the health and life insurance programs which are maintained by the DAS Personnel Division. The State generally self-insures for general liability and workers' compensation. The State has chosen to purchase insurance for:

- A. Motor vehicle liability, which is insured for the first \$5 million of exposure per accident with a self-insured retention of \$300,000 per accident, except for accidents involving vehicular pursuit which have a \$1,000,000 self-insured retention per accident. Insurance is also purchased for medical payments, physical damage, and uninsured and underinsured motorists with various limits and deductibles. State agencies have the option to purchase coverage for physical damage to vehicles.
- B. Health care and life insurance for eligible employees.
- C. Crime coverage, with a limit of \$1 million for each loss, and a \$25,000 self-insured retention per incident.
- D. Real and personal property on a blanket basis for losses up to \$100,000,000, with a self-insured retention of \$200,000 per loss occurrence. Newly acquired properties are covered up to \$1,000,000 for 60 days or until the value of the property is reported to the insurance company. The perils of flood and earthquake are covered up to \$10,000,000. Acts of terrorism are covered up to \$2,500,000 aggregate per year. State agencies have the option to purchase building contents and inland marine coverage.

No settlements exceeded commercial insurance coverage in any of the past three fiscal years. Health care insurance is funded in the Compensation Insurance Trust Fund through a combination of employee and State contributions. Workers' compensation is funded in the Workers' Compensation Internal Service Fund through assessments on each agency based on total agency payroll and past experience. Tort claims, theft of, damage to, or destruction of assets, errors or omissions, and natural disasters would be funded through the State General Fund or by individual agency assessments as directed by the Legislature, unless covered by purchased insurance. No amounts for estimated claims have been reported in the Nebraska Lottery's financial statements.

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

2. Contingencies and Commitments (Concluded)

Litigation. The potential amount of liability involved in litigation pending against the Nebraska Lottery, if any, could not be determined at this time. However, it is the Nebraska Lottery's opinion that final settlement of those matters should not have an adverse effect on the Nebraska Lottery's ability to administer current programs. Any judgment against the Nebraska Lottery would have to be processed through the State Claims Board and be approved by the Legislature.

3. State Employees Retirement Plan (Plan)

The single-employer plan became effective by statute on January 1, 1964. Prior to January 1, 2003, the plan consisted of a defined contribution plan that covered State employees. Effective January 1, 2003, a cash balance benefit was added to the State Employees Retirement Act. The cash balance benefit is a type of defined benefit plan. Each member employed and participating in the retirement system prior to January 1, 2003 elected to either continue participation in the defined contribution benefit or begin participation in the cash balance benefit. The defined contribution benefit is closed to new entrants. All new members of the Plan on and after January 1, 2003, become members of the cash balance benefit. The benefits and funding policy of the Plan is established and can only be amended by the Nebraska Legislature.

All permanent full-time employees who have 12 continuous months of service are required to begin participation in the retirement system. All permanent full-time or permanent part-time employees who have 12 months of service within a five-year period, and who have attained the age of 20, may exercise the option to begin participation in the retirement system.

Contribution. Each member contributes 4.33% of his or her monthly compensation until \$864 has been contributed and 4.8% of his or her monthly compensation for the remainder of the calendar year. The Nebraska Lottery matches the member's contribution at a rate of 156%. The employee's and employer's contributions are kept in separate accounts.

The employee's account is fully vested. The employer's account is vested 100% after a total of three years of participation in the system, including the twelve-month eligibility period or credit for participation in another governmental plan prior to actual contribution to the Plan.

Defined Contribution Benefit. Upon attainment of age 55, regardless of service, the retirement allowance shall be equal to the sum of the employee and employer account. Members have several forms of payment available, including withdrawals, deferrals, annuities, or a combination of these.

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

3. State Employees Retirement Plan (Plan) (Concluded)

Cash Balance Benefit. Upon attainment of age 55, regardless of service, the retirement allowance shall be equal to the accumulated employee and employer cash balance accounts, including interest credits, annuitized for payment in the normal form. The normal form of payment is a single life annuity with five year certain, payable monthly. Members will have the option to convert their member cash balance account to a monthly annuity with built in cost-of-living adjustments of 2.5% annually. Also available are additional forms of payment allowed under the Plan which are actuarially equivalent to the normal form, including the option of lump-sum or partial lump-sum.

For the fiscal year ended June 30, 2005, employees contributed \$41,693 and the Nebraska Lottery contributed \$65,041. A separate plan report is issued and can be obtained from the Nebraska Public Employees Retirement System. This report contains full pension-related disclosures.

4. Receivables

Retailers comprised principally of grocery stores, convenience stores, and off sale liquor stores serve as the primary distribution channel for lottery sales to the general public. No one retailer accounts for a significant amount of the Nebraska Lottery's sales or accounts receivable. Retailers must pay for instant lottery tickets 45 days after activation or when the pack is 70% sold whichever comes first. Retailers pay for on-line tickets each Wednesday for balances due through the previous Saturday. The retailers account receivable is net of allowance for uncollectible in the amount of \$19,213.

| | |
|----------------------|----------------------------|
| Accounts Receivable: | |
| Retailers (net) | \$ 3,549,555 |
| Other | <u>177,378</u> |
| Total | <u><u>\$ 3,726,933</u></u> |

5. Capital Assets

Capital asset activity for the fiscal year ended June 30, 2005, was as follows:

| | Beginning Balance | Increases | Decreases | Ending Balance |
|--------------------------------|-------------------------|------------------------|--------------------|-------------------------|
| Total Capital Assets | \$ 417,965 | \$ 29,733 | \$ - | \$ 447,698 |
| Total Accumulated Depreciation | <u>377,334</u> | <u>26,588</u> | <u>-</u> | <u>403,922</u> |
| Total Capital Assets, Net | <u><u>\$ 40,631</u></u> | <u><u>\$ 3,145</u></u> | <u><u>\$ -</u></u> | <u><u>\$ 43,776</u></u> |

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

6. On-Line Games

During the fiscal year ended June 30, 2005, the Nebraska Lottery offered a variety of on-line games as described in the following table.

| Game Name | Operated by | Nebraska's Share of Prize Reserves |
|------------------|------------------|---------------------------------------|
| POWERBALL® | MUSL | \$ 1,629,427 |
| NEBRASKA PICK 5® | Nebraska Lottery | n/a |
| NEBRASKA PICK 3® | Nebraska Lottery | n/a |
| 2by2® | MUSL | 114,487 |
| | | \$ 1,743,914 |

The Nebraska Lottery is a member of the Multi-State Lottery Association (MUSL) which operates games on behalf of participating state lotteries. Each MUSL member sells on-line game tickets through its agents and makes weekly payments to MUSL in an amount equal to each game's prize structure, less amounts retained for prizes paid directly to the winners by each member lottery. MUSL maintains prize reserve funds on each game to serve as a contingency reserve to protect from unforeseen prize liabilities. The money in these reserve funds are to be used at the discretion of the MUSL Board of Directors. The prize reserve funds are refundable to MUSL members if MUSL disbands or if a member leaves MUSL. Members leaving MUSL must wait one year before receiving their remaining share of the prize reserve funds.

The Powerball® grand prize can be paid either as annual installments or a lump sum cash payment, depending on the selection of the winner when claiming the prize. If the winner selects annual installments, MUSL purchases bonds which are held in trust to fund the future installments. Maturities are staggered in order to provide adequate cash flow for each installment. MUSL is responsible for paying amounts owed to the grand prize winners. The assets and related liabilities are reflected in MUSL's financial statements and, therefore, are not reflected in the Nebraska Lottery's financial statements.

7. Significant Compliance Requirements

Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004 requires until January 1, 2008 a portion of the dollar amount of the lottery tickets, which have been sold, on an annualized basis to be transferred to the beneficiary funds, except that the dollar amount transferred shall not be less than the dollar amount transferred to the funds in fiscal year 2003. Of the money remaining after the payment of prizes and operating expenses, the first five hundred thousand dollars shall be transferred to the Compulsive Gamblers Assistance Fund. Thereafter, twenty-four and three-fourths percent shall be transferred to the Education Innovation Fund, twenty-four and three-fourths percent shall be transferred to the Nebraska Scholarship Fund, forty-nine and one-half percent shall be transferred to the Nebraska Environmental Trust Fund, and one percent shall be transferred to the Compulsive Gamblers Assistance Fund.

NEBRASKA LOTTERY

NOTES TO THE FINANCIAL STATEMENTS

(Continued)

7. Significant Compliance Requirements (Concluded)

Due to the passing of Constitutional Amendment 4, from January 1, 2005 and forward, of the money remaining after the payment of prizes and operating expenses, the first five hundred thousand dollars shall be transferred to the Compulsive Gamblers Assistance Fund. Thereafter, twenty-two and one-fourth percent shall be transferred to the Education Innovation Fund, twenty-two and one-fourth percent shall be transferred to the Nebraska Scholarship Fund, forty-four and one-half percent shall be transferred to the Environmental Trust Fund, ten percent shall be transferred to the State Fair Support and Improvement Cash Fund, and one percent shall be transferred to the Compulsive Gamblers Assistance Fund.

The funds transferred to the Education Innovation Fund, for fiscal years 2004 and 2005, shall be allocated to the General Fund after operating expenses for the Excellence in Education Council are deducted.

The Nebraska Lottery develops game structures to comply with the minimum prize provision of its enabling legislation, which requires a minimum of forty percent must be paid in prizes. Prizes are redeemable for 180 days after game end or applicable on-line drawing.

The Nebraska Lottery compares the social security number of each winner that has a per wager prize in excess of \$500 against a list of social security numbers having an outstanding State tax liability or delinquent child support payments. Any delinquent payments are withheld from winnings and forwarded to the appropriate State agency. During the fiscal year the Nebraska Lottery collected \$3,918 in delinquent State taxes and \$5,815 in delinquent child support payments.

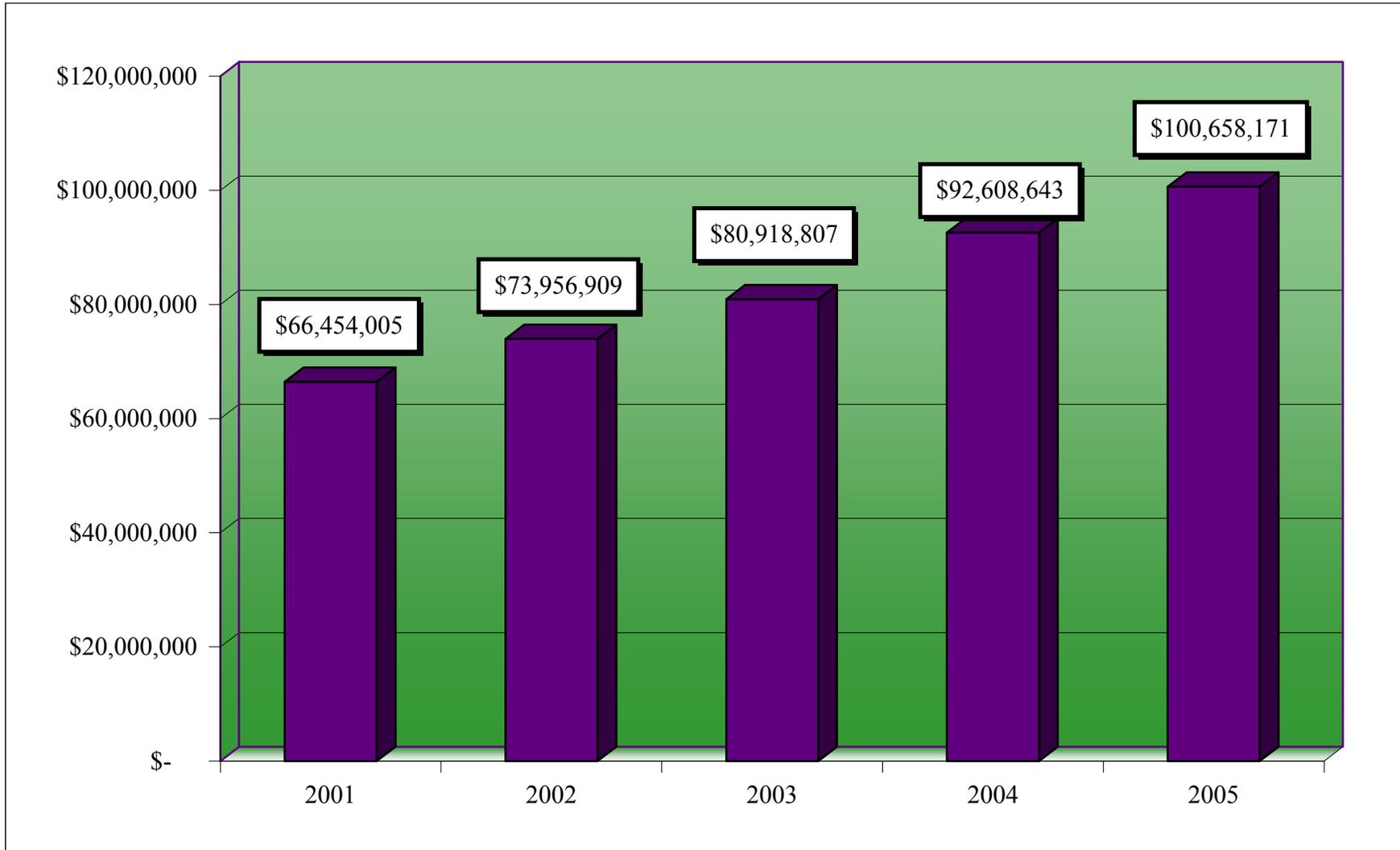
As required under its enabling legislation, transfers of \$22,195,478 were made to other funds during the fiscal year. In addition to the above transfers, a transfer of \$5,000,000 was made by the State Treasurer from the State Lottery Operation Trust Fund to the General Fund on July 15, 2004, as required by Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004.

Operating Transfers In/Out will not balance and Due To/From Other Funds will not balance, within the Nebraska Lottery's financial statements, as the Nebraska Lottery only represents part of the State's primary government.

8. Net Assets

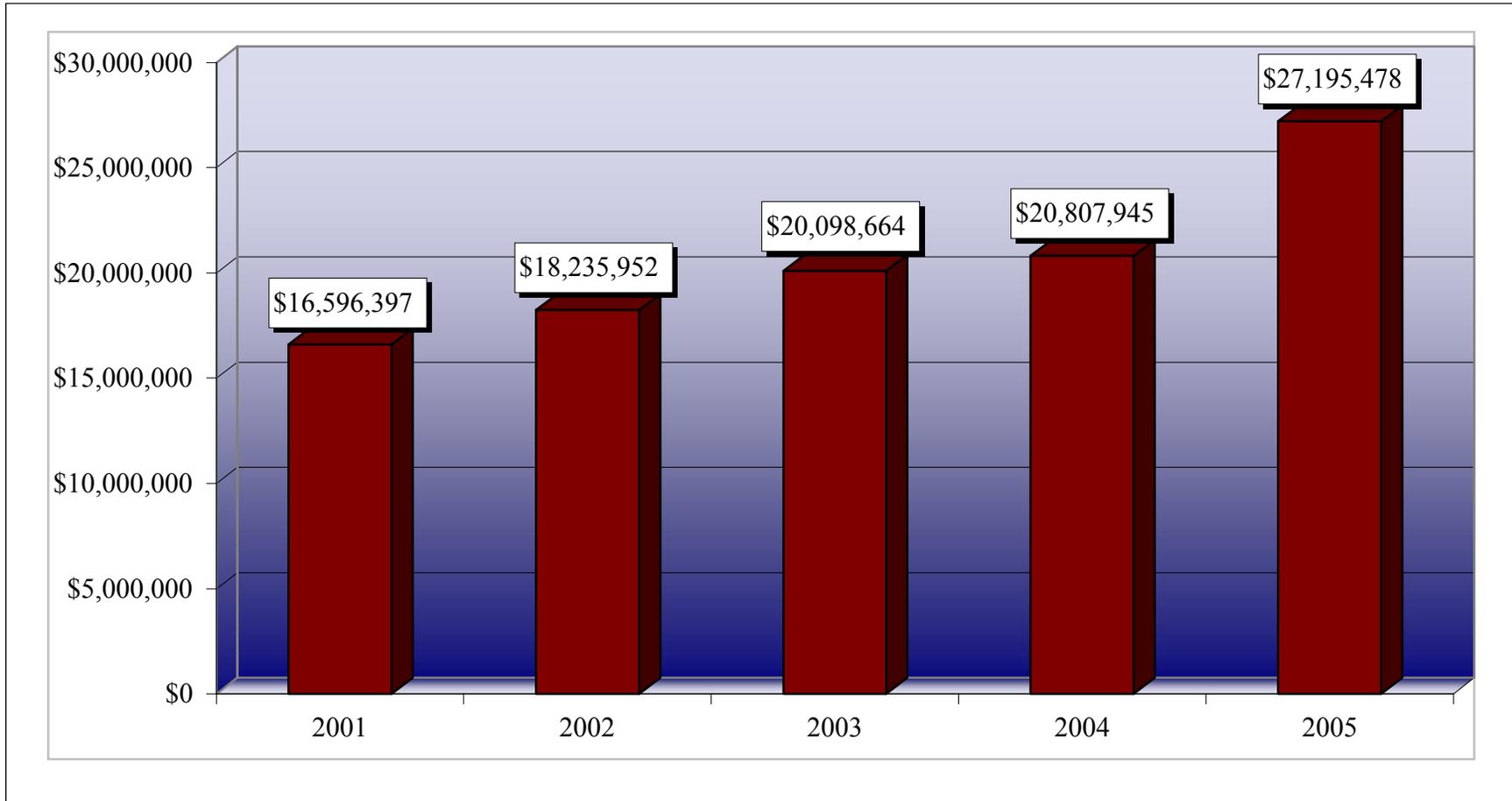
The Nebraska Lottery's unrestricted net assets represent funds not legally restricted for any specific purpose. The funds, however, may only be used to fund additional prize pay-outs, transfers to the beneficiary funds or additional operating expenses of the Nebraska Lottery. It is management's intention to use the unrestricted net assets to fund additional prize pay-outs, retailer incentives, and other game enhancements.

NEBRASKA LOTTERY
LOTTERY TICKET SALES
For the Fiscal Years 2001 through 2005



Note: These sales are shown on an accrual basis.

NEBRASKA LOTTERY
TOTAL OPERATING TRANSFERS
For the Fiscal Years 2001 through 2005



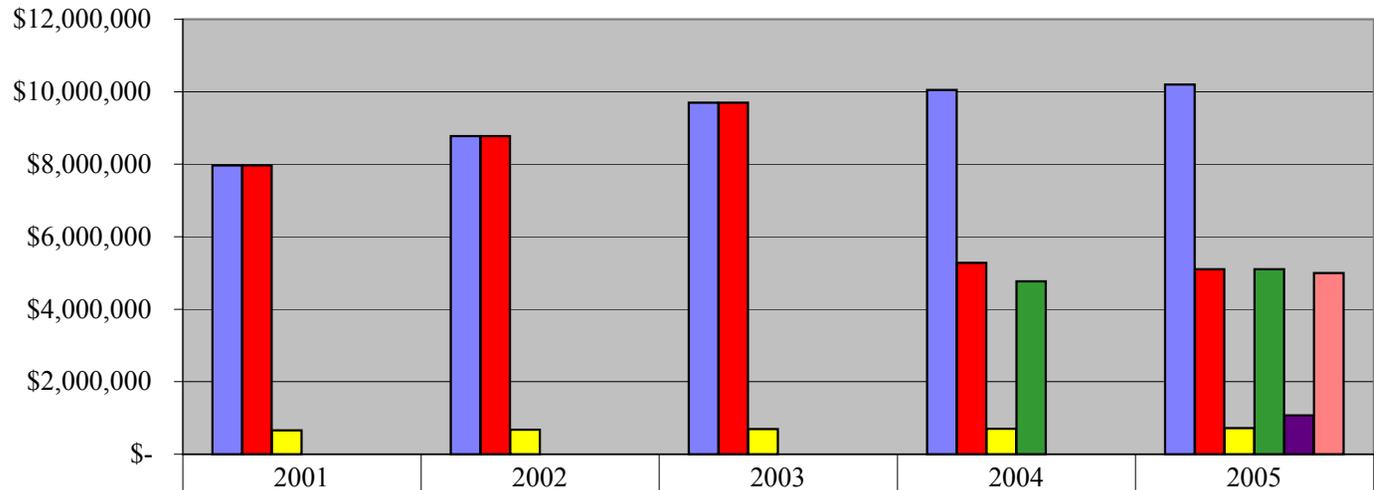
Note: The Total Operating Transfers include transfers to the Environmental Trust Fund, the Education Innovation Fund, the Nebraska Scholarship Fund (as of October 1, 2003), the Compulsive Gamblers Fund, and the State Fair Support and Improvement Cash Fund (as of January 1, 2005). The Fiscal Year 2005 Operating Transfers amount includes an additional \$5,000,000 transfer made from the State Lottery Operation Trust Fund to the General Fund in July 2004, as required by Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004. These are shown on a cash basis

NEBRASKA LOTTERY
SCHEDULE OF CUMULATIVE OPERATING TRANSFERS

| State Fiscal Year | Transfer Amount |
|----------------------------|-----------------|
| 1994 | \$ 10,931,811 |
| 1995 | 19,308,170 |
| 1996 | 20,486,304 |
| 1997 | 23,363,387 |
| 1998 | 18,740,463 |
| 1999 | 17,581,026 |
| 2000 | 17,887,538 |
| 2001 | 16,596,397 |
| 2002 | 18,235,952 |
| 2003 | 20,098,664 |
| 2004 | 20,807,945 |
| 2005 | 27,195,478 |
| Total Cumulative Transfers | \$ 231,233,135 |

Note: Total Cumulative Transfers includes transfers to the Solid Waste Landfill Closure Fund (final allocation made in July 1997), the Environmental Trust Fund, the Education Innovation Fund, the Nebraska Scholarship Fund (beginning October 1, 2003), the Compulsive Gamblers Assistance Fund, and the State Fair Support and Improvement Cash Fund (beginning January 1, 2005). These transfers are shown on a cash basis except for an adjustment of \$2,342,407 increasing the Fiscal Year 2000 transfer amount and decreasing the Fiscal Year 2001 transfer amount to better reflect the transfer in the year it relates to. The 2005 transfer amount includes a \$5,000,000 transfer from the State Lottery Operation Trust Fund to the General Fund in July 2004, as required by Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004.

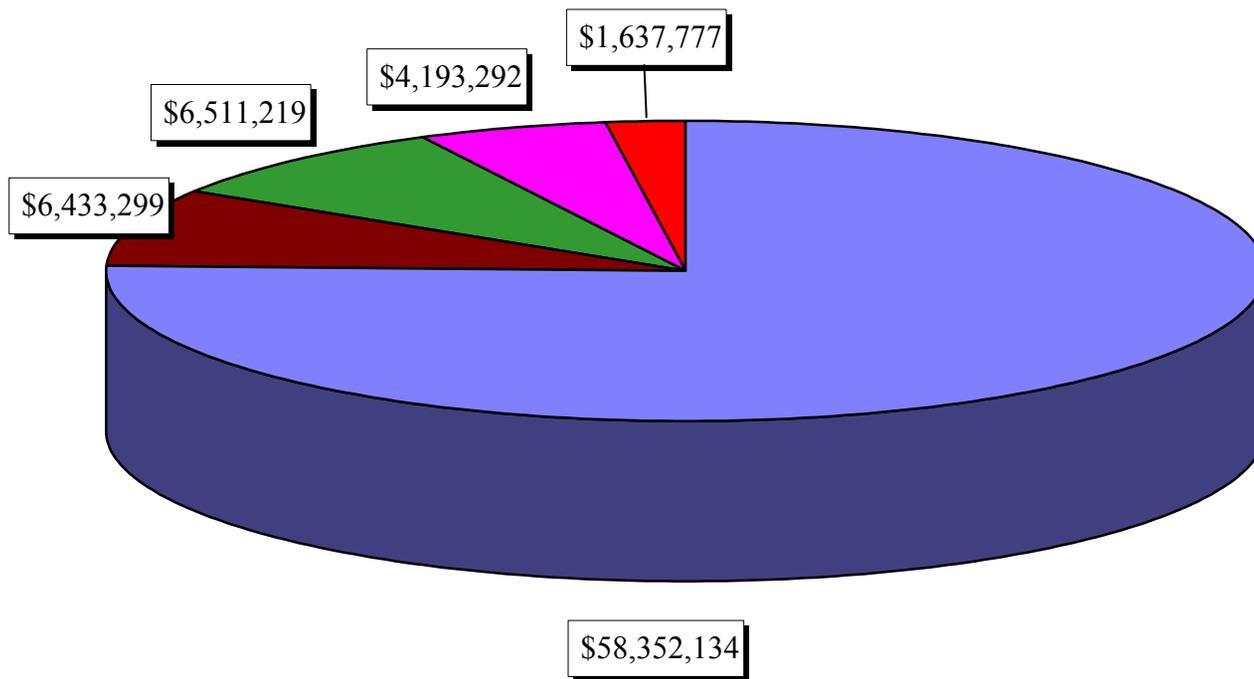
**NEBRASKA LOTTERY
OPERATING TRANSFERS**
For the Fiscal Years 2001 through 2005



| | 2001 | 2002 | 2003 | 2004 | 2005 |
|--|-------------|-------------|-------------|--------------|--------------|
| ■ Environmental Trust Fund | \$7,967,716 | \$8,779,296 | \$9,701,339 | \$10,052,433 | \$10,201,368 |
| ■ Education Innovation Fund | \$7,967,717 | \$8,779,296 | \$9,701,339 | \$5,283,669 | \$5,100,683 |
| ■ Compulsive Gamblers Assistance Fund | \$660,964 | \$677,360 | \$695,986 | \$703,079 | \$716,956 |
| ■ Nebraska Scholarship Fund | \$- | \$- | \$- | \$4,768,764 | \$5,100,683 |
| ■ State Fair Support and Improvement Cash Fund | \$- | \$- | \$- | \$- | \$1,075,788 |
| ■ General Fund | \$- | \$- | \$- | \$- | \$5,000,000 |

Note: Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004 requires until October 1, 2003, at least twenty-five percent and beginning October 1, 2003, and until January 1, 2008, a portion of the dollar amount of the lottery tickets, which have been sold, on an annualized basis to be transferred to the beneficiary funds, except that the dollar amount transferred shall not be less than the dollar amount transferred to the funds in fiscal year 2003. Of the money remaining after the payment of prizes and operating expenses; the first five hundred thousand dollars shall be transferred to the Compulsive Gamblers Assistance Fund. Thereafter, twenty-four and three-fourths percent shall be transferred to the Education Innovation Fund, twenty-four and three-fourths percent shall be transferred to the Nebraska Scholarship Fund, forty-nine and one-half percent shall be transferred to the Nebraska Environmental Trust Fund, and one percent shall be transferred to the Compulsive Gamblers Assistance Fund. Due to the passing of Constitutional Amendment 4, from January 1, 2005 and forward, of the money remaining after the payment of prizes and operating expenses; the first five hundred thousand dollars shall be transferred to the Compulsive Gamblers Assistance Fund. Thereafter, twenty-two and one-fourth percent shall be transferred to the Education Innovation Fund, twenty-two and one-fourth percent shall be transferred to the Nebraska Scholarship Fund, forty-four and one-half percent shall be transferred to the Environmental Trust Fund, ten percent shall be transferred to the State Fair Support and Improvement Cash Fund, and one percent shall be transferred to the Compulsive Gamblers Assistance Fund. In addition to the above transfers, a transfer of \$5,000,000 was made by the State Treasurer from the State Lottery Operation Trust Fund to the General Fund on July 15, 2004, as required by Neb. Rev. Stat. Section 9-812 R.S.Supp., 2004.

**NEBRASKA LOTTERY
OPERATING EXPENSES**
For the Fiscal Year Ended June 30, 2005



Total Operating Expenses \$77,127,721

■ Prize Expense
 ■ Retailer Commissions
 ■ Contractual Services
 ■ Marketing
 ■ Lottery Operations

Breakdown of Expenses

Prize Expense:

| | |
|-----------------------|----------------------|
| Instant Prize Expense | \$ 37,585,212 |
| On-Line Prize Expense | 22,423,977 |
| Unclaimed Prizes | <u>(1,657,055)</u> |
| Total | \$ 58,352,134 |

Retailer Commissions:

| | |
|------------------------|---------------------|
| Instant Commissions | \$ 3,852,008 |
| On-line Commissions | 2,424,022 |
| Misc. Retailer Expense | <u>157,269</u> |
| Total | \$ 6,433,299 |

Contractual Services:

| | |
|-------------------|---------------------|
| Gtech | \$ 4,875,454 |
| Intralot | 1,088,229 |
| Other Contractors | <u>547,536</u> |
| Total | \$ 6,511,219 |

Marketing Expense:

| | |
|---------------------|---------------------|
| Advertising Expense | \$ 3,196,623 |
| Promotions Expense | <u>996,669</u> |
| Total | \$ 4,193,292 |

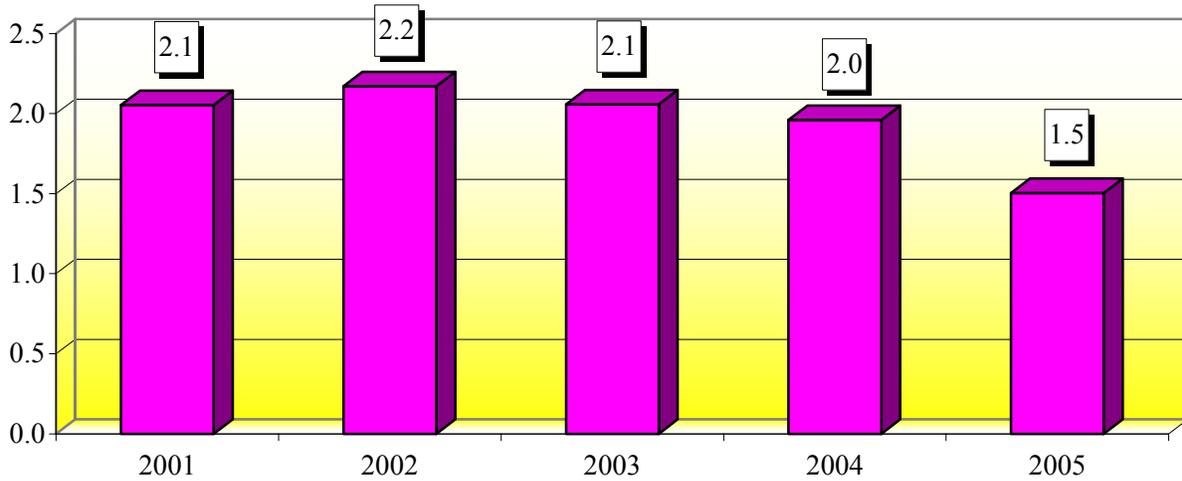
Lottery Operations:

| | |
|-------------------------|---------------------|
| Payroll Expense | \$ 1,264,991 |
| Other Operating Expense | <u>372,786</u> |
| Total | \$ 1,637,777 |

NEBRASKA LOTTERY

CURRENT RATIO

For the Fiscal Year 2001 through 2005

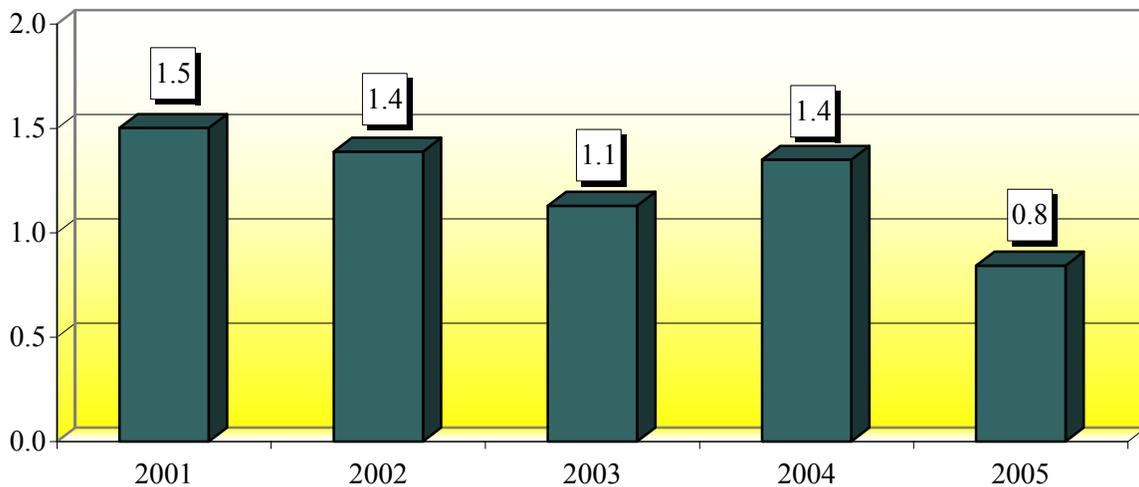


| | 2001 | 2002 | 2003 | 2004 | 2005 |
|---------------------|---------------|---------------|---------------|---------------|--------------|
| Current Assets | \$ 10,824,233 | \$ 11,054,752 | \$ 12,535,367 | \$ 11,635,452 | \$ 9,401,348 |
| Current Liabilities | \$ 5,271,746 | \$ 5,091,837 | \$ 6,089,747 | \$ 5,936,040 | \$ 6,249,164 |

Note: The Current Ratio is an assessment of Lottery's current assets in excess of current liabilities.

QUICK RATIO

For the Fiscal Years 2001 through 2005



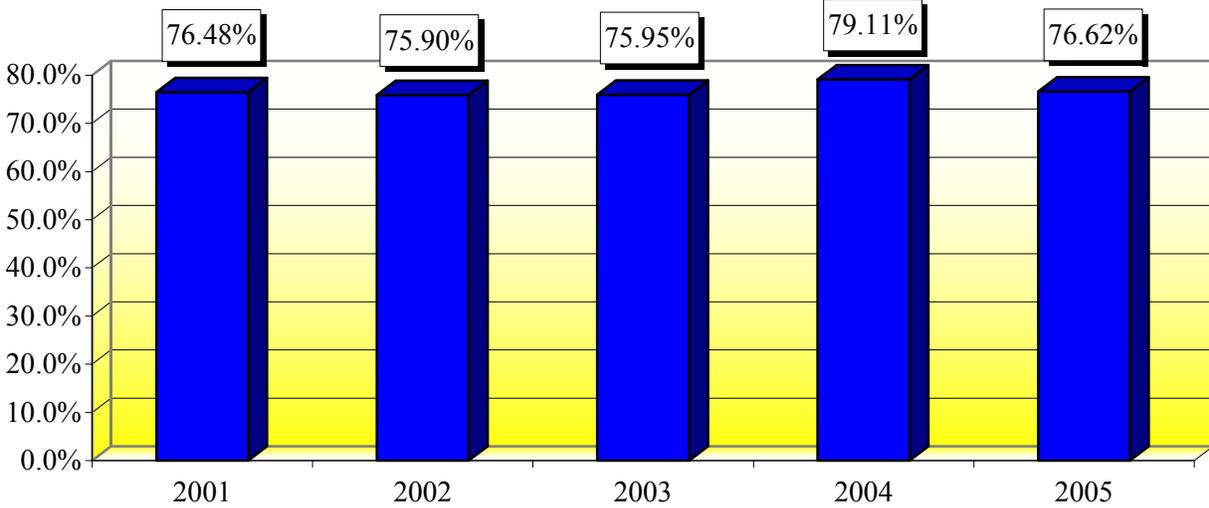
| | 2001 | 2002 | 2003 | 2004 | 2005 |
|-------------------------|--------------|--------------|--------------|--------------|--------------|
| Cash & Cash Equivalents | \$ 7,920,826 | \$ 7,070,423 | \$ 6,878,514 | \$ 8,014,088 | \$ 5,267,568 |
| Current Liabilities | \$ 5,271,746 | \$ 5,091,837 | \$ 6,089,747 | \$ 5,936,040 | \$ 6,249,164 |

Note: The Quick Ratio is an assessment of the Nebraska Lottery's cash in excess of current liabilities.

NEBRASKA LOTTERY

PERCENTAGE OF OPERATING EXPENSES TO REVENUES

For the Fiscal Year 2001 through 2005

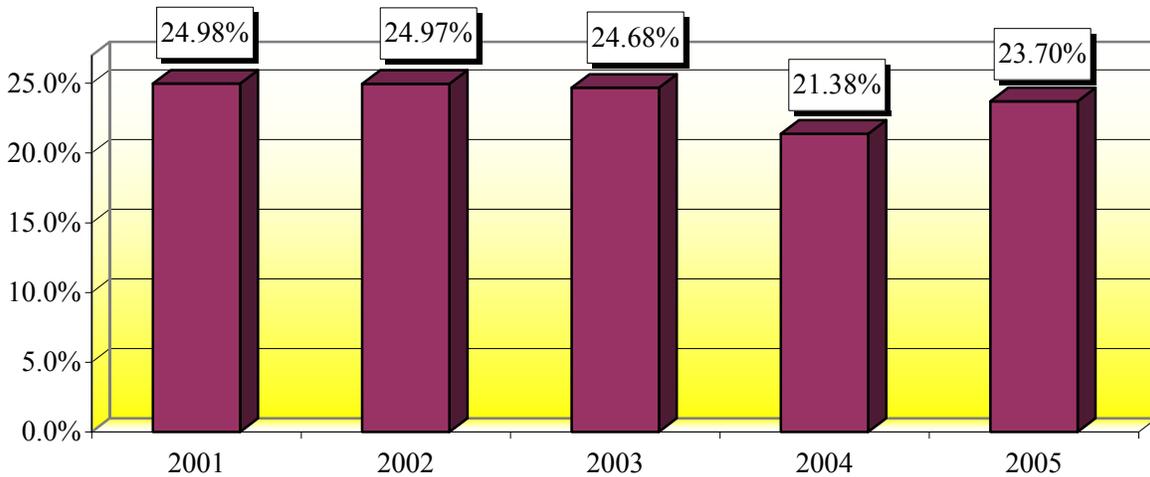


| | 2001 | 2002 | 2003 | 2004 | 2005 |
|-------------------------|---------------|---------------|---------------|---------------|----------------|
| Total Operating Expense | \$ 50,823,823 | \$ 56,133,115 | \$ 61,455,786 | \$ 73,264,372 | \$ 77,127,721 |
| Total Operating Revenue | \$ 66,454,005 | \$ 73,956,909 | \$ 80,918,807 | \$ 92,608,643 | \$ 100,658,171 |

Note: The graph represents the percentage of operating expenses to revenues.

NET INCOME BEFORE TRANSFERS COMPARED TO OPERATING REVENUE

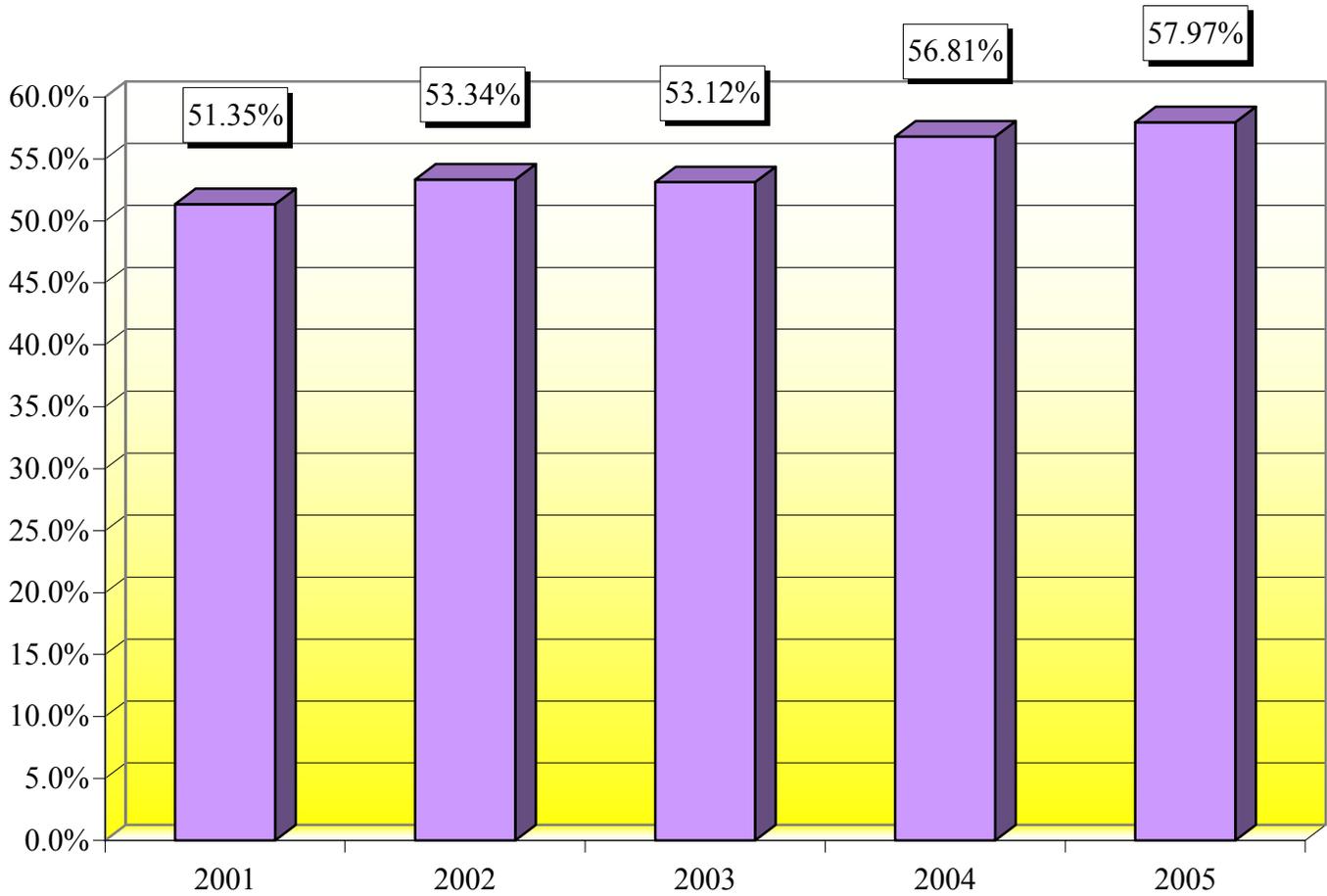
For the Fiscal Years 2001 through 2005



| | 2001 | 2002 | 2003 | 2004 | 2005 |
|-----------------------------|---------------|---------------|---------------|---------------|----------------|
| Net Income Before Transfers | \$ 16,600,216 | \$ 18,464,048 | \$ 19,968,899 | \$ 19,796,914 | \$ 23,860,515 |
| Total Operating Revenue | \$ 66,454,005 | \$ 73,956,909 | \$ 80,918,807 | \$ 92,608,643 | \$ 100,658,171 |

Note: The graph represents the percentage of net income before operating transfers compared to total operating revenue.

NEBRASKA LOTTERY
PRIZE PERCENTAGE OF SALES PAID OUT
 For the Fiscal Years 2001 through 2005



| | 2001 | 2002 | 2003 | 2004 | 2005 |
|-------------------------|---------------|---------------|---------------|---------------|----------------|
| Prize Expense | \$ 34,123,676 | \$ 39,449,981 | \$ 42,984,053 | \$ 52,607,966 | \$ 58,352,134 |
| Total Operating Revenue | \$ 66,454,005 | \$ 73,956,909 | \$ 80,918,807 | \$ 92,608,643 | \$ 100,658,171 |

Note: The graph represents the percentage of net sales paid out in prizes.

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Kate Witek
State Auditor
Kate.Witek@apa.ne.gov

NEBRASKA LOTTERY REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

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Mary Jane Egr Edson
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Nebraska Department of Revenue, Lottery Division
Lincoln, Nebraska

We have audited the financial statements of the Nebraska Lottery for the fiscal year ended June 30, 2005, and have issued our report thereon dated October 3, 2005. 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 examination, we considered the Nebraska Lottery's internal control over financial reporting in order to determine our 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. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider to be a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Nebraska Lottery's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. A reportable condition is described in the Comments Section of the report as Comment Number 3 (Reconciliation of Bank Records to the Nebraska Information System by DAS).

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 examined may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe the reportable condition described above is not a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Nebraska 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 examination, 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*.

We also noted certain additional items that we reported to management of the Nebraska Lottery in the Comments Section of this report as Comment Number 1 (Information Systems Internal Control Review) and Comment Number 2 (Meal Expenses).

This report is intended solely for the information and use of the Nebraska Lottery and the appropriate Federal and regulatory agencies. However, this report is a matter of public record and its distribution is not limited.

Handwritten signature of Timothy J. Channer CPA in black ink.

Assistant Deputy Auditor

October 3, 2005