



FINANCIAL AND COMPLIANCE AUDIT REPORT

**Kansas Lottery
Fiscal Year 2005**

**A Report to the Legislative Post Audit Committee
By Berberich Trahan & Co., a certified public accounting firm
under contract with the Legislative Division of Post Audit
State of Kansas
October 2005**

Legislative Post Audit Committee

Legislative Division of Post Audit

The Legislative Post Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$11 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of government agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U. S. Government Accountability Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. These audit standards have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

The Legislative Post Audit Committee is a bipartisan committee comprising five senators and five representatives. Of the Senate members, three are appointed by the President of the Senate and two are appointed by the Senate Minority Leader. Of the representatives, three are appointed by the Speaker of the House and two are appointed by the House Minority Leader.

As part of its audit responsibilities, the Division is charged with meeting the requirements of the Legislative Post Audit Act which address audits of financial matters. Those requirements call for two major types of audit work.

First, the Act requires an annual audit of the State's financial statements. Those statements, prepared by the Department of Administration's Division of Accounts and Reports, are audited by a certified public accounting firm under contract with the Legislative Division of Post Audit. The firm is selected by the Contract Audit Committee, which comprises three members of the Legislative Post Audit Committee (including the Chairman and Vice-Chairman), the Secretary of Administration, and the Legislative Post Auditor. This audit

work also meets the State's audit responsibilities under the federal Single Audit Act.

Second, the Act provides for a regular audit presence in every State agency by requiring that audit work be conducted at each agency at least once every three years. Audit work done in addition to the annual financial statement audit focuses on compliance with legal and procedural requirements and on the adequacy of the audited agency's internal control procedures. These compliance and control audits are conducted by the Division's staff under the direction of the Legislative Post Audit Committee.

LEGISLATIVE POST AUDIT COMMITTEE

Representative John Edmonds, Chair
Representative Tom Burroughs
Representative Peggy Mast
Representative Bill McCreary
Representative Tom Sawyer

Senator Les Donovan, Vice-Chair
Senator Anthony Hensley
Senator Nick Jordan
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Barbara J. Hinton, Legislative Post Auditor

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LEGISLATURE OF KANSAS

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October 5, 2005

To: Members, Legislative Post Audit Committee

Representative John Edmonds, Chair
Representative Tom Burroughs
Representative Peggy Mast
Representative Bill McCreary
Representative Tom Sawyer

Senator Les Donovan, Vice-Chair
Senator Anthony Hensley
Senator Nick Jordan
Senator Derek Schmidt
Senator Chris Steiner

This report contains the findings and conclusions from the completed financial-compliance audit of the Kansas Lottery covering fiscal year 2005. This audit was conducted by Berberich Trahan & Co., a certified public accounting firm under contract with the Legislative Division of Post Audit.

We would be happy to discuss this report with any legislative committees, individual legislators, or other State officials.

A large, stylized handwritten signature in black ink that reads "Barbara J. Hinton".

Barbara J. Hinton
Legislative Post Auditor



Berberich Trahan & Co., P.A.

Certified Public Accountants

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

FINANCIAL AND COMPLIANCE AUDIT

YEARS ENDED JUNE 30, 2005 AND 2004

with

INDEPENDENT AUDITORS' REPORT

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

FINANCIAL AND COMPLIANCE AUDIT

Years Ended June 30, 2005 and 2004

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KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)
FINANCIAL AND COMPLIANCE AUDIT
YEARS ENDED JUNE 30, 2005 AND 2004

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

INTRODUCTION

Year Ended June 30, 2005

The accompanying report represents the results of the financial and compliance audit of the operations of the Kansas Lottery (the Lottery) for the fiscal year ended June 30, 2005.

The Lottery was created as an independent component unit of the State of Kansas to operate lottery games. It is administered by the Executive Director and the five members of the Lottery Commission appointed by the Governor. The Lottery is an enterprise fund wherein the activities are financed and operated through user charges similar to a private business enterprise.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

SCHEDULE OF FINDINGS AND RECOMMENDATIONS

Year Ended June 30, 2005

A. SUMMARY OF AUDIT RESULTS

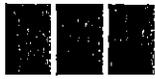
1. The auditors' report expresses an unqualified opinion on the financial statements of the Kansas Lottery.
2. No material weaknesses relating to the audit of the financial statements are reported in the report on internal control over financial reporting and on compliance and other matters based on an audit of financial statements performed in accordance with *Government Auditing Standards*.
3. No instances of noncompliance material to the financial statements of the Kansas Lottery were disclosed during the audit.

B. FINDINGS - FINANCIAL STATEMENT AUDIT

None.

C. PRIOR YEAR FINDINGS

None.



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INDEPENDENT AUDITORS' REPORT

Legislative Post Audit Committee
Kansas State Legislature:

We have audited the accompanying basic financial statements of the business-type activity of the Kansas Lottery (the Lottery), a component unit of the State of Kansas, as of and for the years ended June 30, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note 1, the financial statements of the Kansas Lottery are intended to present the financial position and the results of its operations and cash flows of the Lottery. They do not purport to, and do not present fairly, the financial position of the State of Kansas as of June 30, 2005 and 2004 and the changes in its financial position and cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the business-type activity of the Kansas Lottery, as of June 30, 2005 and 2004, 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 September 16, 2005 on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 1 through 9 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Berberich Trahan & Co., P.A.

September 16, 2005

MANAGEMENT'S DISCUSSION AND ANALYSIS FOR THE FISCAL YEARS ENDED JUNE 30, 2005 AND 2004

The following management's discussion and analysis (MD&A) of the Kansas Lottery's financial performance provides an overview of financial activities for the fiscal years ended June 30, 2005 and 2004. Please read it in conjunction with the Lottery's financial statements, which follow the MD&A. The financial statements reflect only activities of the Kansas Lottery, a component unit of the State of Kansas.

Fiscal Year 2005 Financial Highlights

- Lottery sales for FY 2005 were \$206,720,771 reflecting a decrease of \$17,736,395 over those in FY 2004 but were the second highest since the Lottery began selling tickets in November 1987. The Lottery enjoyed another good year of Instant scratch ticket sales in FY 2005. Sales were \$93,275,467 compared to \$87,483,053 in FY 2004. By continuing to print considerably more instant games but in smaller quantities, the Lottery was able to offer new games to players on a more frequent basis during FY 2005. This, plus the Lottery's business partnerships with Cabela's, Kansas Speedway, Midwest Ford, GMC, Cobalt Boats, Wichita River Festival, AMC Theatres, Harley Davidson, the 3i Show and the Kansas State Fair in the promotion of special instant scratch games, resulted in an \$5,792,414 increase compared to FY 2004. Sales of barcoded pull-tab tickets that were introduced in October 2002, were \$4,388,330, an increase of \$142,029 over FY 2004. Total on-line sales were \$23,670,838 less than the previous year. Powerball, (a Multi-State Lottery (MUSL) game), sales were down \$12,268,380 as a result of not having any large jackpots. Super Kansas Cash sales decreased by \$9,273,755 over the FY 2004 figures. This was the result of not having any sizable jackpots. Keno and Pick 3 resulted in a combined total decrease of \$2,756,144. The 2by2 game realized sales of \$2,168,818 and was comparable to the previous year. The eScratch game is interactive with the Internet, and was re-launched to provide better odds and increased prizes. Although the prizes are actually determined at the time of purchase of a ticket, the player may take the ticket home and play-it-out on his or her personal computer in the form of animated and entertaining games. The first full year's sales were \$765,301.
- For 2005 the legislature again waived the requirement of monthly transfers to the State Gaming Revenues Fund (SGRF) being based on an amount of approximately 30% of sales. Instead, it originally set a minimum amount of \$63,250,000 with no less than \$4,500,000 being transferred in any one month. The \$63,250,000 was eventually increased by \$290,000 to an amount of \$63,540,000 for FY 2005. As a result, regular transfers to the SGRF were \$63,540,000. Another \$701,164 was transferred to the SGRF from the special veterans' games. And lastly, Accounts and Reports transferred a total of \$1,168,277 to the State General Fund (SGF) for various administrative costs charged to the Lottery and mandatory budget reductions. The final amount transferred to both the SGRF and the SGF was \$65,409,441, which reflects a \$4,808,503 total decrease from the previous year. Transfers to the SGRF are capped at \$50 million. Overages become part of the State General Fund. Of the \$50 million, the first \$80,000 is earmarked for the Problem Gambling Grant Fund (PGGF), then 85% of the balance goes to the Economic

Development Initiatives Fund (EDIF), 10% to prison reconstruction, and 5% to juvenile detention facilities.

- Operating income as a percent of total operating revenues was 30.0% which is 1.3% less than FY 2004. This is a result of sales having decreased by 7.9% while total operating expenses had a corresponding decrease of 6.0%.

Using this Financial Report

This report consists of a series of financial statements and reflects the self-supporting activities of the Kansas Lottery. The Balance Sheets provide information about the Lottery's assets and liabilities and reflects the Lottery's financial position as of June 30, 2005 and 2004. The Statements of Revenues, Expenses and Changes in Net Assets report the activity of selling lottery tickets and the related expenses for the 12-month periods ended June 30, 2005 and 2004. And lastly, the Statements of Cash Flows reflect the cash inflows and outflows attributed to the sales of lottery tickets for the same 12-month periods.

Game Revenues

Revenues from the sale of lottery tickets for the fiscal year ended June 30, 2005, were the second highest year since the Lottery's first sales began in 1988. They were 7.9% or \$17,736,395 less than the previous year, as indicated in the financial statements. FY 2005 sales were \$206,720,771 compared to \$224,457,166 in FY 2004. The decrease in sales was made up of (1) Powerball not having any large jackpots, resulting in a decrease in sales of \$12,268,380 over FY 2004; (2) Super Kansas Cash also did not have sizeable jackpots which resulted in a \$9,273,755 decrease in sales compared to the prior year; and (3) the instant scratch sales being \$5,792,414 higher than those in FY 2004, which was accomplished by keeping fresh games available to the public and partnering with Cabella's, Kansas Speedway, Kansas State Fair, and other businesses, in special games promotions. The new eScratch game was re-launched with improved odds and higher payouts and produced total sales of \$765,301 for the first full year of sales.

Presented in millions of dollars, the following table compares Lottery sales by game type between fiscal years:

<u>Type of Game</u>	<u>2005</u>	<u>2004</u>	<u>Difference</u>	<u>Percentage</u>
Instant	\$ 93.2	\$ 87.5	\$ 5.7	6.5%
Pull-Tabs	4.4	4.3	0.1	2.3%
Powerball	44.5	56.8	(12.3)	-21.7%
2by2	2.2	2.1	0.1	4.8%
Super Kansas Cash	19.3	28.6	(9.3)	-32.5%
Keno	37.1	39.7	(2.6)	-6.5%
Pick 3	5.2	5.3	(0.1)	-1.9%
eScratch	0.8	0.2	0.6	300.0%
Total	<u>\$ 206.7</u>	<u>\$ 224.5</u>	<u>\$ (17.8)</u>	-7.9%

Revenues from the sale of lottery tickets for the fiscal year ended June 30, 2004 were the highest since the Lottery's first sales began in 1988. They were 10.6% or \$21,514,292 higher than the previous year, as indicated in the financial statements. FY 2004 sales were \$224,457,166 compared to \$202,942,874 in FY 2003. This was the culmination of (1) Powerball having three fairly large jackpots, resulting in a sales increase of \$4,048,109 over FY 2003; (2) Super Kansas Cash also having three sizable jackpots which produced a \$9,382,395 increase in sales compared to the prior year; and (3) instant scratch sales being \$8,060,279 higher than those in FY 2003, which was accomplished by keeping fresh games available to the public and partnering with Cabela's, Kansas Speedway, Dodge City Steak Co. and other businesses, in special games promotions. The new eScratch game was launched on May 3rd and produced total sales of \$192,273 for the two months of May-June 2004.

Presented in millions of dollars, the following table compares Lottery sales by game type between fiscal years:

<u>Type of Game</u>	<u>2004</u>	<u>2003</u>	<u>Difference</u>	<u>Percentage</u>
Instant	\$ 87.5	\$ 79.4	\$ 8.1	10.2%
Pull-Tabs	4.3	4.8	(0.5)	-10.4%
Powerball	56.8	52.7	4.1	7.8%
2by2	2.1	2.2	(0.1)	-4.5%
Super Kansas Cash	28.6	19.2	9.4	49.0%
Keno	39.7	39.0	0.7	1.8%
Pick 3	5.3	5.6	(0.3)	5.4%
eScratch	0.2	-	0.2	100.0%
Total	<u>\$ 224.5</u>	<u>\$ 202.9</u>	<u>\$ 21.6</u>	10.6%

Total Revenues

Other operating revenues consist of \$150 per retailer application fees and a \$10 per week per retailer lottery terminal satellite communication reimbursement charge. For the fiscal year ended June 30, 2005, these revenues amounted to \$1,051,436 compared to \$999,416 for the FY 2004 and \$996,799 for FY 2003.

Total revenues for FY 2005 were \$207,772,207 in comparison to \$225,456,582 for FY 2004, a decrease of \$17,684,375 or 7.8%. As previously stated, the decrease in revenues was the result of the sales decreases of the on-line Powerball and Super Kansas Cash games.

Total revenues for FY 2004 were \$225,456,582 in comparison to \$203,939,673 for FY 2003, an increase of \$21,516,909 or 10.6%. The increase in revenues was the result of the sales increases of the on-line Powerball and Super Kansas Cash games and instant scratch tickets.

Major Expenses

Approximately \$136.0 million of the Lottery's total operating expenses of \$145.4 million for FY 2005 were directly associated with lottery games. For FY 2004, the game-related expenses were \$145.7 million of a total \$154.8 million. These expenses include game prizes, retailer commissions, on-line game service bureau fees, telecommunications costs for on-line terminal satellite connections to retailer locations, and the cost of printing instant tickets. The satellite communication system provides telecommunications for approximately 1,900 retailers' terminals. This system continued to perform well throughout FY 2005 and has eliminated communication downtime from various causes such as storms, cables cut as a result of construction or street repair projects, etc.

The following table compares the game-related expenses between FY 2005 and FY 2004. The expenses are shown in millions of dollars:

<u>Description</u>	<u>2005</u>	<u>2004</u>	<u>Difference</u>	<u>Percentage</u>
Game Prizes	\$ 112.4	\$ 120.8	\$ (8.4)	-7.0%
Retailer Commissions	12.1	12.9	(0.8)	-6.2%
On-line Games Service Bureau	5.6	6.8	(1.2)	-17.6%
Telecommunications Terminal Costs	2.1	2.0	0.1	5.0%
Instant Ticket Printing Costs	3.8	3.2	0.6	18.8%
Total	<u>\$ 136.0</u>	<u>\$ 145.7</u>	<u>\$ (9.7)</u>	-6.7%

The overall decrease in Game Prizes was the result of the decrease in sales compared to those in FY 2004. The increase in the Telecommunications Terminal Costs is the result of the growth of an additional 100 retailers. The On-line Games Service Bureau costs decreased as a result of the lower on-line sales. Instant Ticket Printing Costs for FY 2005 increased as sales increased by 6.5%, and the strategy of ordering smaller quantities of each game was successful.

Of the \$9.4 million of FY 2005 operating expenses that were not game-related, \$4.2 million was for employees' salaries and wages, \$2.7 million was spent for games and promotional advertising, and other administrative expenses accounted for \$2.5 million. In FY 2004, these same expenses were \$3.8 million, \$3.2 million and \$2.1 million, respectively. The Lottery engaged in a slightly lesser amount of promotional advertising for fiscal year 2005 and concentrated on advertising the promotions resulting from its business partnerships with Cabela's, Kansas Speedway, Midwest Ford, GMC, Kansas State Fair and other businesses in Kansas. A few of the promotions were second chance drawing giveaways that included products made in Kansas and a number of vehicle giveaways.

Approximately \$145.7 million of the Lottery's total operating expenses of \$154.8 million for FY 2004 were directly associated with lottery games. For FY 2003, the game-related expenses were \$131.2 million of a total \$140.1 million. These expenses include game prizes, retailer commissions, on-line game service bureau fees, telecommunications costs for on-line terminal satellite connections to retailer locations, and the cost of printing instant tickets. In January of 2003, the Lottery's on-line service vendor, GTech, completed installation of a satellite communication system for approximately 1,800

retailers' terminals. This system continued to perform well throughout FY 2004 and has eliminated communication downtime from various causes such as storms, cables cut as a result of construction or street repair projects, etc. And of significant importance, it is considerably less costly than the phone line system used in the past. Telecommunications expenses were down again for FY 2004 and were \$631,551 less than those for FY 2003.

The following table compares the game-related expenses between FY 2004 and FY 2003. The expenses are shown in millions of dollars:

<u>Description</u>	<u>2004</u>	<u>2003</u>	<u>Difference</u>	<u>Percentage</u>
Game Prizes	\$ 120.8	\$ 107.7	\$ 13.1	12.2%
Retailer Commissions	12.9	11.7	1.2	10.3%
On-line Games Service Bureau	6.8	6.0	0.8	13.3%
Telecommunications Terminal Costs	2.0	2.7	(0.7)	-25.9%
Instant Ticket Printing Costs	3.2	3.1	0.1	3.2%
Total	<u>\$ 145.7</u>	<u>\$ 131.2</u>	<u>\$ 14.5</u>	11.1%

The overall increase in Game Prizes was the result of the tremendous increase in sales compared to those in FY 2003. The decrease in the Telecommunications Terminal Costs category is the result of enjoying a full fiscal year of the satellite communications system installed by GTech in 2003. The On-line Games Service Bureau costs increased as a result of substantially higher On-line Sales. Specifically, Telecommunications Terminal Costs decreased by 23.7% and the On-Line Games Service Bureau costs increased by 12.5%. Instant Ticket Printing Costs for FY 2004 were only 1.2% greater than those in FY 2003.

Of the \$9.1 million of FY 2004 operating expenses that were not game-related, \$3.8 million was for employees' salaries and wages, \$3.2 million was spent for games and promotional advertising, and other administrative expenses accounted for \$2.1 million. In FY 2003, these same expenses were \$3.6 million, \$3.0 million and \$2.3 million, respectively. The Lottery engaged in a slightly lesser amount of promotional advertising for fiscal year 2004 and concentrated advertising the promotions resulting from its business partnerships with Cabela's, Kansas Speedway, Dodge City Steak Co., Kansas State Fair and other businesses in Kansas. A few of the promotions were second chance drawing giveaways that included a shopping spree at Cabela's and a number of vehicle giveaways.

Other Financial Information

The following table presents the Lottery's assets, liabilities, and net assets (shown in millions of dollars):

	2005	2004	2003
Current and other assets	\$ 14.7	\$ 18.5	\$ 17.8
Capital assets	0.2	0.5	0.3
Total assets	<u>14.9</u>	<u>19.0</u>	<u>18.1</u>
Current liabilities	<u>10.4</u>	<u>11.3</u>	<u>11.2</u>
Net assets:			
Invested in capital assets	0.2	0.5	0.3
Unrestricted	4.3	7.2	6.6
Total net assets	<u>\$ 4.5</u>	<u>\$ 7.7</u>	<u>\$ 6.9</u>

Total assets of the Lottery for the fiscal year ended June 30, 2005 were \$14.9 million. They consisted of cash for operations and prizes of \$5.1 million, accounts receivable from Lottery retailers for lottery tickets sales activity of \$8.4 million, instant ticket inventory totaling \$1.2 million, and property and equipment net of depreciation amounting to \$0.2 million.

Comparable figures at June 30, 2004 were \$19.0 million in total assets consisting of \$9.3 million in cash for operations and prizes, \$7.3 million in accounts receivable from retailers, \$1.9 million in instant ticket inventory, and \$0.5 million in net property and equipment.

At June 30, 2003, the Lottery had \$18.1 million in total assets consisting of \$9.1 million in cash for operations and prizes, \$7.4 million in accounts receivable from retailers, \$1.3 million in instant ticket inventory, and \$0.3 million in net property and equipment.

Total liabilities of the Lottery at June 30, 2005 were \$10.4 million and were comprised of accounts payable and accrued liabilities of \$1.2 million, transfers due to the State of Kansas of \$4.8 million, and prize liability of \$4.4 million.

For the 2004 fiscal year end, total liabilities were \$11.3 million, of which \$1.5 million was in accounts payable and accrued liabilities, \$5.5 million was due to the State of Kansas, and \$4.3 million was for prize liability.

At June 30, 2003, total liabilities were \$11.2 million, of which \$1.4 million was in accounts payable and accrued liabilities, \$4.9 million was due to the State of Kansas, and \$4.9 million was for prize liability.

The change in net assets between FY 2005 and FY 2004 was a decrease of \$3.2 million. Primarily as a result of the overall decrease in sales revenues of \$17.7 million, unrestricted net assets decreased by \$2.9 million.

The change in net assets between FY 2004 and FY 2003 was an increase of \$.8 million, primarily as a result of the overall increase in sales revenues.

Transfers to the State Gaming Revenue Fund and State General Fund

For FY 2005 the legislature waived the percentage of sales SGRF requirement for a minimum transfer of \$63,540,000 originally with a minimum monthly transfer of \$4,500,000. Final regular transfers to the SGRF were \$63,540,000. The special veterans' games contributed another \$701,164. Accounts and Reports transferred \$1,168,277 to the State General Fund. The final amount transferred to both the SGRF and the SGF was \$65,409,441, which reflects a \$4,808,000 decrease from FY 2004.

For FY 2004 the legislature waived the percentage of sales SGRF requirement for a minimum transfer of \$62,773,000 originally with a minimum monthly transfer of \$4,500,000. The \$62,773,000 was increased in subsequent Session laws to \$66,573,000. Final regular transfers to the SGRF were \$66,750,000. The special veterans' games contributed another \$632,694. Also, the legislature authorized the Director of Accounts and Reports to transfer \$2,000,000 from the Lottery operating fund directly to the Economic Development Initiatives Fund. And lastly, Accounts and Reports transferred \$835,250 to the State General Fund. The final amounts transferred to both the SGRF and the SGF was \$70,217,944, which reflects a \$7,717,944 total increase from FY '03.

Although most Lottery transfers are made to the SGRF, there is a \$50 million cap of that fund; therefore, any transfers in excess of \$50 million are subsequently transferred to the State General Fund (SGF). Of the \$50 million in the SGRF, the first \$80,000 is transferred to the Problem Gambling Grant Fund (PGGF). Then, of the balance remaining, 85% is transferred to the Economic Development Initiatives Fund (EDIF), 10% to the Correctional Institutions Building Fund (CIBF), and 5% to the Juvenile Detention Facilities Fund (JDFF). It should be noted that the Lottery has no control over or involvement in the transfers going out of the SGRF.

Budgetary Process and Highlights

As stated in the opening paragraph of this document, the Lottery is a component unit of the State of Kansas, and is a fully self-supporting entity and receives no monies from the State General Fund. The Lottery is required to annually submit by September 15th its budget to the Division of the Budget (DOB). The budget is prepared on a cash basis that revamps the current year based on expenditure limitations approved by the legislature during the previous legislative session, and submits a proposed budget for the next year that is considered the budget year. For example, after receiving the required approval of the Kansas Lottery Commission, on September 15, 2004, the budget submitted consisted of the redo of the fiscal year ending June 30, 2005, and a first-time submission for the fiscal year ending June 30, 2006.

The Lottery has in the past operated with both limited and unlimited expenditures, however the 2005 Legislature removed the limit on all types of expenditures. Administrative type expenditures are payroll, rents, utilities, travel, audit services, various types of office and professional supplies, capital outlay, etc., and does include advertising expense. Other unlimited expenditures consist of sales driven expenses or cost of sales expenses such as telecommunication costs for satellite connections to the lottery terminals in retailer locations, instant scratch ticket printing costs, fees paid to the on-line vendor, and auto-ship freight and supplies.

In November of each year, the Division of the Budget (DOB) returns to the Lottery the DOB's recommendations that usually include some changes. The Lottery may appeal to the DOB and the Governor if it deems necessary. The final DOB recommendations are sent to the Governor for his/her submission to the newly convened legislature in January. The budget then goes through a lengthy legislative process and may have changed by the time it is finally approved in April.

For FY 2005, the approved no-limit cost of sales budget was \$12,479,440 and the final limited administration budget amount was \$9,456,553. On a cash basis, actual expenses were \$11,127,401 and \$8,934,328, respectively.

Fiscal Year 2006 Budget

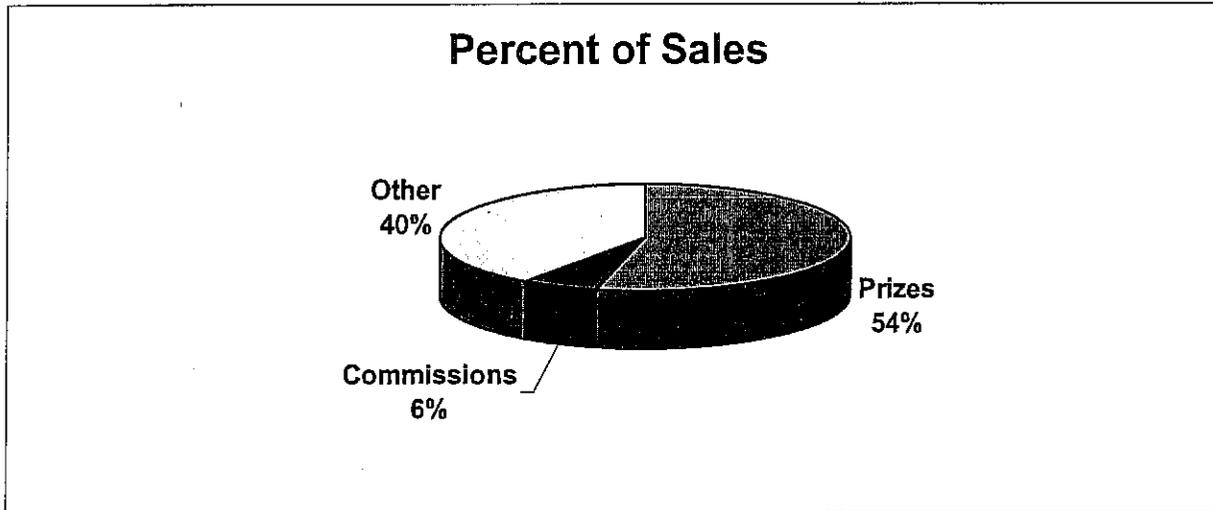
For FY 2006, the 2005 legislature has, once again, waived the previously required transfer rate based on a percentage of ticket sales in favor of a set minimum amount. This decision will afford the Lottery additional operating flexibility, and should result in ticket sales similar to those for FY 2004, but an estimated \$16.0 million more than those in FY 2005. The reason why sales for FY 2006 are being projected at a greater amount than the FY 2005 results is because there were no high jackpots during FY 2005, which decreased sales to \$206.7 million. Also the implementation in July 2005 of the new auto-ship program is intended to increase sales. This program monitors the retailers' ticket inventories and automatically replaces instant ticket stock as needed. The legislature is requiring the Lottery to transfer to the SGRF a minimum of \$66,000,000 plus the net proceeds of two instant scratch games designated to benefit veterans' causes. Overall, the Lottery has set a sales goal of \$223.0 million for FY 2006. Administrative expenses for FY 2006 have been increased in the budget to \$9,699,044. \$472,130 of the projected increase is for payroll, since the Lottery is now required to budget for payroll as if all positions were filled, the 2.5 percent pay increase, and the 27th pay period. The 27th pay period happens every eleventh year. The contractual services reflect a decrease of \$225,343, and commodities has a planned decrease of \$6,297. Capital outlay has a small increase of \$90,462 for the replacement of high mileage vehicles and security alarm systems.

Contacting the Lottery's Financial Management

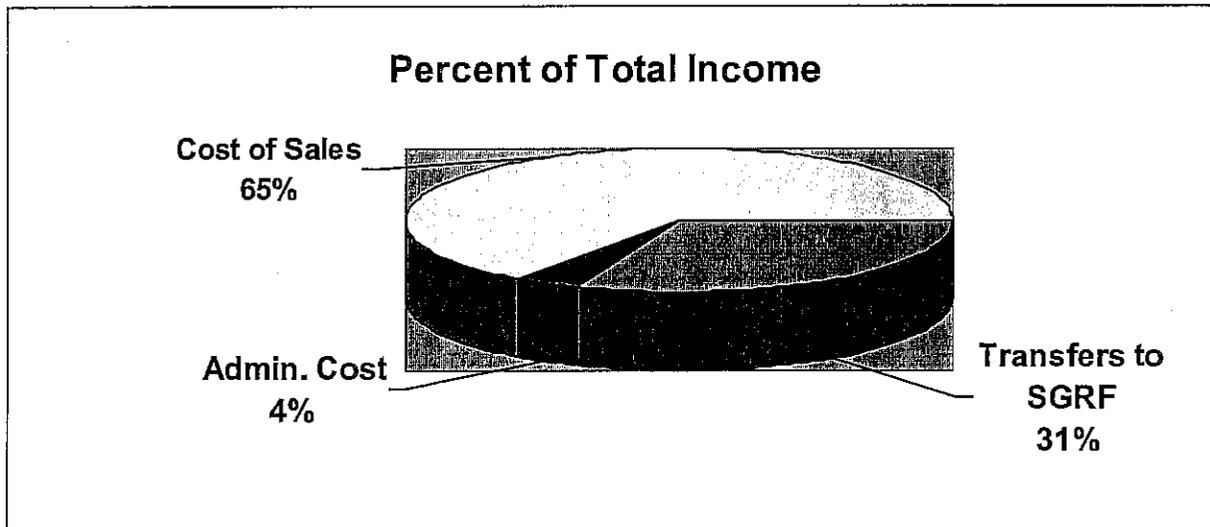
This management discussion and analysis report is designed to provide Kansas citizens, Kansas government officials, players, retailers and other interested parties with a general overview of the Lottery's financial activity for the fiscal year ended June 30, 2005 and to demonstrate the Lottery's accountability for the monies it received from its lottery ticket sales activity. Questions or comments about this report may be addressed to Carolyn Brock, the Kansas Lottery's Director of Finance or Wayne Regnier, the Lottery's Fiscal Manager at 128 N. Kansas Avenue, Topeka, Ks. 66603.

See graphs of financial highlights on the following page.

KANSAS LOTTERY
GRAPHS OF FINANCIAL HIGHLIGHTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005



To depict compliance with the 45% prize payment statute and the retailers' commissions rules.



To depict expenditures as a percentage of total income.

The Cost of Sales category includes prizes, commissions, service bureau, terminal phone/satellite lines, auto-ship, and instant ticket printing.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

BALANCE SHEETS

June 30, 2005 and 2004

	2005	2004
<u>ASSETS</u>		
Current assets:		
Cash:		
Operating fund	\$ 3,783,410	\$ 8,864,194
Prize payment fund	1,347,033	458,230
Accounts receivable, net of allowance for doubtful accounts of \$ 308,108 and \$ 272,698 at 2005 and 2004, respectively	2,173,013	2,157,313
Accounts receivable - unbilled	6,194,691	5,189,555
Instant ticket game inventory	1,149,683	1,866,924
Total current assets	14,647,830	18,536,216
Capital assets:		
Property and equipment	4,033,426	4,020,073
Less accumulated depreciation	3,790,989	3,550,026
Total capital assets	242,437	470,047
Total assets	\$ 14,890,267	\$ 19,006,263
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,183,705	\$ 1,513,771
Due to State Gaming Revenue fund	4,790,000	3,500,000
Due to State Economic Development Initiatives fund	-	2,000,000
Prize liability	4,370,866	4,315,733
Total current liabilities	10,344,571	11,329,504
Net assets:		
Invested in capital assets	242,437	470,047
Unrestricted	4,303,259	7,206,712
Total net assets	4,545,696	7,676,759
Total liabilities and net assets	\$ 14,890,267	\$ 19,006,263

See accompanying notes to financial statements.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

Years Ended June 30, 2005 and 2004

	2005	2004
Operating revenues:		
Net game revenues	\$ 200,200,044	\$ 218,994,477
Net unsettled revenues	6,520,727	5,462,689
Retailer fees and miscellaneous income	84,746	57,502
Phone reimbursements	966,690	941,914
	207,772,207	225,456,582
Operating expenses:		
Game prizes	112,554,879	120,775,874
Retailer commissions	12,086,279	12,926,131
Advertising	2,591,238	3,171,750
Cost of instant tickets	3,843,235	3,149,143
Depreciation	243,213	226,227
Professional services	171,436	65,158
On-line games service bureau	5,591,900	6,769,205
Salaries and benefits	4,202,998	3,836,268
Telecommunications	2,108,586	2,029,323
Other administrative expense	2,101,996	1,828,944
	145,495,760	154,778,023
Operating income	62,276,447	70,678,559
Nonoperating revenues (expenses):		
Payments to State of Kansas	(65,409,441)	(70,217,944)
Gain on sale of capital assets	1,931	-
	(65,407,510)	(70,217,944)
Income (loss) before contributions	(3,131,063)	460,615
Contribution of capital assets from State Motor Pool	-	327,079
Change in net assets	(3,131,063)	787,694
Net assets, beginning of year	7,676,759	6,889,065
Net assets, end of year	\$ 4,545,696	\$ 7,676,759

See accompanying notes to financial statements.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

STATEMENTS OF CASH FLOWS

Years Ended June 30, 2005 and 2004

	2005	2004
Cash flows from operating activities:		
Cash received from sales and reimbursements	\$ 206,751,371	\$ 225,523,640
Cash paid for prizes, commissions, and other expenses	(140,653,050)	(151,859,736)
Cash paid to employees	(4,157,189)	(3,759,940)
Net cash provided by operating activities	61,941,132	69,903,964
Cash flows from noncapital financing activities:		
Payments to State Gaming Revenue fund	(64,951,164)	(68,732,694)
Payments to State General fund	(1,168,277)	(835,250)
Net cash used by noncapital financing activities	(66,119,441)	(69,567,944)
Cash flows from capital and related financing activities:		
Proceeds from sale of capital assets	10,087	-
Purchase of capital assets	(23,759)	(76,236)
Net cash used by capital and related financing activities	(13,672)	(76,236)
Net increase (decrease) in cash	(4,191,981)	259,784
Cash, beginning of year	9,322,424	9,062,640
Cash, end of year	\$ 5,130,443	\$ 9,322,424
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 62,276,447	\$ 70,678,559
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	243,213	226,227
Changes in operating assets and liabilities:		
Accounts receivable	(1,020,836)	67,058
Instant ticket game inventory	717,241	(550,395)
Accounts payable and accrued liabilities	(330,066)	78,254
Prize liability	55,133	(595,739)
Net cash provided by operating activities	\$ 61,941,132	\$ 69,903,964
SUPPLEMENTAL DISCLOSURE OF NON-CASH CAPITAL AND RELATED FINANCING ACTIVITIES:		
Contribution of capital assets at net book value from State Motor Pool	\$ -	\$ 327,079

See accompanying notes to financial statements.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS

June 30, 2005 and 2004

1 - Summary of Significant Accounting Policies

Reporting Entity

In November 1986, a constitutional amendment was approved by the Kansas voters authorizing a State Lottery. During the 1987 Legislative session, the State Legislature adopted the Lottery Act (the Act), and created the Kansas Lottery (the Lottery) as an independent component unit of the State of Kansas to operate lottery games. The 2001 Legislative session continued the Lottery until June 30, 2008. The Kansas Lottery Act abolishes the Lottery on July 1, 2008, unless the Legislature reaches an affirmative vote to continue the Lottery during the 2007 Legislative session.

The Lottery was organized on March 19, 1987 and commenced administrative operations on May 21, 1987 but was strictly in the developmental stage through fiscal year 1987. Instant win ticket games began November 12, 1987. On February 2, 1988, the Lottery began participating in Lotto America, a multi-state on-line game now called Powerball. Additional games offered by the Lottery include Kansas Cash, Keno, Pick 3, 2 by 2, Pull Tabs and eScratch.

The Lottery operates under the direction of the Executive Director of the Lottery and a five-member Lottery Commission appointed by the Governor. The Commission advises the Executive Director and reviews and approves Lottery games, rules, and regulations.

Basis of Presentation

The Lottery is accounted for as an enterprise fund. Enterprise funds are used to account for activities that are financed and operated in a manner similar to private business enterprises where the intent is that the costs of providing goods and services to the general public on a continuing basis are to be financed through user charges or where the periodic determination of net income is considered appropriate. Private-sector standards of accounting and financial reporting issued prior to December 1, 1989 generally are followed by the Lottery to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. The Lottery has elected not to follow subsequent private-sector guidance.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

1 - Summary of Significant Accounting Policies (Continued)

Basis of Accounting

The financial statements of the Lottery have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP) as applied to government units. The Governmental Accounting Standards Board (GASB) is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

Basis of accounting refers to when revenues, expenses and the related assets and liabilities are recognized in the accounts and reported in the financial statements. Measurement focus refers to what is being measured. The financial statements are prepared on the accrual basis of accounting and on an economic resources measurement focus in accordance with GAAP.

The Lottery distinguishes operating revenue and expenses from nonoperating items. The principal revenue of the Lottery is primarily comprised of sales from instant and on-line tickets. Operating expenses mainly consist of payments to prize winners, commissions to retailer agents and payments to vendors and employees.

Revenue Recognition

Lottery games are sold to the public by contracted retailers. The Lottery utilizes an on-line instant ticket validation system. This system utilizes a bar code system to activate, track and validate instant win tickets which are consigned to retailers. The activated and unsettled instant win ticket packets are reflected in revenues in the current period and are carried on the balance sheet as accounts receivable - unbilled. Consigned instant win ticket packets at the retailer that have not been activated are reflected on the financial statements in ticket inventory at original cost.

Certain instant ticket games include tickets which entitle the holder to exchange the ticket for another ticket ("free tickets"). Such tickets are deemed to be replacements and, therefore, are not included in sales.

Instant pull tab game revenue is recognized when the games are delivered to the retailers. The instant pull tab games are accounted for in the same manner as instant games. Pull tabs are purchased without a right of return.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

1 - Summary of Significant Accounting Policies (Continued)

Revenue Recognition (Continued)

On-line game revenue is recognized in the period in which tickets are sold.

Retailer Commissions

Retailers receive a commission of five percent of ticket sales, which is recognized as expense when sales are recorded. In addition to the five percent commission on sales, retailers receive a one percent cashing bonus for redeeming prizes that are less than \$ 600, an additional one percent for redeeming Keno prizes and a bonus of one percent on instant and on-line tickets they sell that win over \$ 600, with a minimum of \$ 10 and a maximum of \$ 100 for each prize.

Retailers also receive a bonus of \$ 10,000 for selling a winning Powerball jackpot ticket and a \$ 1,000 bonus for selling a winning Kansas Cash jackpot ticket or a winning \$ 100,000 Powerball ticket.

Retailer Fees

Licensed retailers are charged a one-time fee for the right to sell lottery tickets. Fees are recorded as income when received by the Lottery.

Accounts Receivable

Accounts receivable represent amounts to be collected from retailers and are shown net of an allowance for doubtful accounts. The allowance for doubtful accounts is based on an analysis of accounts receivable, which considers the age of the accounts and current economic conditions. Generally accounts greater than 60 days old are included in the allowance for doubtful accounts.

Ticket Inventory

Instant ticket game inventory consists of tickets stored in the main and regional warehouses, trunk stock of District Managers and consigned and inactivated tickets at the retailer. Inventories are carried at cost based on the specific identification method. Tickets are charged to cost of sales when activated by a licensed retailer. Unsold tickets are charged to cost of sales at the end of each instant ticket game.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

1 - Summary of Significant Accounting Policies (Continued)

Capital Assets

Capital assets, which include property and equipment, are defined by the State of Kansas as assets with an initial, individual cost of more than \$ 5,000. Such assets are recorded at historical cost. The costs of normal maintenance and repairs that do not add to the value of the asset or materially extend assets' lives are not capitalized. Depreciation is computed on the straight-line basis using estimated useful lives of three to five years.

Prize Liability

The Act states "as nearly as practical, an amount equal to not less than 45 percent of the total sales of lottery tickets or shares, computed on an annual basis, shall be allocated for payment of Lottery prizes." This amount is recognized and accrued as a prize liability. Actual prizes paid are treated as a reduction of the prize liability.

Prize expense for instant ticket games is recorded based on the predetermined prize structure for each game. Since instant prize tickets are randomly distributed throughout the tickets, there will be differences between amounts accrued and the amounts actually paid if all tickets for a game have not yet been sold.

Prizes which are not claimed within 180 days after the termination of each game are removed from the prize pool, and future prizes will be increased accordingly through special prize promotions.

Prize expense for on-line games is recorded based on ticket sales. Prizes which are not claimed within one year after the drawing remain in the prize pool, and future prizes will be increased accordingly through special prize promotions.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

1 - Summary of Significant Accounting Policies (Continued)

Compensated Absences

Under the terms of the Lottery's personnel policy, employees are granted vacation and sick leave in varying amounts based upon length of service. In the event of termination or separation, an employee is generally paid for accumulated vacation up to 144 hours for service less than five years; 176 hours for service between five and ten years; 208 hours for service between ten and fifteen years; and 240 hours if service exceeds fifteen years [K.A.R. 1-9-4]. Accordingly, it is the Lottery's policy to record vacation pay as an expense as it is earned. The amount of earned but unused accumulated vacation is included as an accrued liability in the accompanying financial statements.

Retiring employees are paid a portion of their accumulated sick leave in excess of 100 or more days, depending upon the total number of accumulated days and years of service. The minimum payable is 30 days, and the maximum is limited to 60 days. The amount of earned but unused accumulated sick leave is paid from the State Leave Payment Reserve fund to which the Lottery makes monthly contributions.

Budget

The Lottery prepares an annual budget of expenses which is approved by the State Legislature of Kansas. Any changes in the budget must also be approved by the State Legislature. Such budgets are adopted on a cash plus encumbrance basis, which differs from accounting principles generally accepted in the United States of America. Encumbrances represent commitments relating to unperformed contracts for goods or services. All budgeted, unencumbered funds lapse at fiscal year-end.

Statement of Cash Flows

For purposes of the statement of cash flows, cash includes cash on hand and in banks and amounts deposited with the Treasurer of the State of Kansas.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

1 - Summary of Significant Accounting Policies (Continued)

Use of Estimates

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

Pending Governmental Accounting Standards Board Statements

At December 31, 2004, the Governmental Accounting Standards Board (GASB) had issued several statements not yet implemented by the Lottery. The statements that might impact the Lottery are as follows:

GASB Statement No. 43, "Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans", was issued in April 2004. The objective of this statement is to establish uniform financial reporting standards for other postemployment benefit plans (OPEB plans). The term "other postemployment benefits" refers to postemployment benefits other than pension benefits and includes [a] postemployment healthcare benefits and, [b] other types of postemployment benefits (i.e., life insurance) if provided separately from a pension plan. This statement provides standards for measurement, recognition, and display of the assets, liabilities, and, where applicable, net assets and changes in net assets of such funds and for related disclosures. The provisions of this statement are effective for periods beginning after December 15, 2005.

GASB Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions", was issued in June 2004. This statement establishes standards for the measurement, recognition and display of other postemployment benefits (OPEB) expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The term "other postemployment benefits" refers to postemployment benefits other than pension benefits and includes [a] postemployment healthcare benefits and, [b] other types of postemployment benefits (i.e., life insurance) if provided separately from a pension plan. The provisions of this statement are effective for periods beginning after December 15, 2006.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

2 - Cash

Cash, other than petty cash and imprest funds, is part of the common cash pool in the State Treasury. The Pooled Money Investment Board invests funds of the common cash pool in excess of that necessary to meet current obligations. Collateral is required for deposits made by the common cash pool that are not covered by federal deposit insurance. The fair value of the collateral must equal 100 percent of the uninsured deposit and is held by the State Treasurer or an independent third party in the State Treasurer's name. At least monthly, the State Treasurer determines that the fair value of the collateral is adequate. Earnings on investments are retained by the State of Kansas. At June 30, 2005 and 2004, the Lottery's share in the State's common cash pool was \$ 4,976,065 and \$ 9,177,195 respectively.

The Lottery maintains its imprest fund cash in one commercial bank. The amount on deposit at June 30, 2005 and 2004 exceeded the insurance limits of the Federal Deposit Insurance Corporation by approximately \$ 26,000 and \$ 38,000, respectively.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

3 - Capital Assets

Property and equipment consisted of the following at June 30, 2005 and 2004:

Fiscal Year 2005:	Beginning Balance	Increases	Decreases	Ending Balance
Data processing equipment	\$ 2,688,118	\$ 5,259	\$ -	\$ 2,693,377
Office furniture, fixtures, and equipment	793,920	18,500	-	812,420
Vehicles and other	538,035	-	10,406	527,629
	<u>\$ 4,020,073</u>	<u>\$ 23,759</u>	<u>\$ 10,406</u>	<u>\$ 4,033,426</u>
Accumulated depreciation	<u>\$(3,550,026)</u>	<u>\$(243,213)</u>	<u>\$(2,250)</u>	<u>\$(3,790,989)</u>
Fiscal Year 2004:	Beginning Balance	Increases	Decreases	Ending Balance
Data processing equipment	\$ 2,639,832	\$ 48,286	\$ -	\$ 2,688,118
Office furniture, fixtures, and equipment	775,420	18,500	-	793,920
Vehicles and other	201,506	336,529	-	538,035
	<u>\$ 3,616,758</u>	<u>\$ 403,315</u>	<u>\$ -</u>	<u>\$ 4,020,073</u>
Accumulated depreciation	<u>\$(3,323,799)</u>	<u>\$(226,227)</u>	<u>\$ -</u>	<u>\$(3,550,026)</u>

4 - Commitments

The Lottery leases office and warehouse space in both Topeka and Great Bend under operating leases from unrelated parties. Minimum future lease payments by fiscal year are as follows:

2006	\$ 461,592
2007	461,592
2008	461,592
2009	4,600
	<u>\$ 1,389,376</u>

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

4 - Commitments (Continued)

It is anticipated that as leases expire they will be replaced with new leases.

The Lottery incurred office, warehouse and miscellaneous rental expense of approximately \$ 461,637 and \$ 399,800 under operating leases for the years ended June 30, 2005 and 2004, respectively.

The Lottery has contracted with a service bureau which provides computer services for on-line games and instant-win validation. The duration of the current contract is through June 30, 2008. Future fees, calculated on cumulative net on-line sales (gross, less cancels, coupons, free tickets and rejected tickets) through June 30, 2008, are 5.12 percent, with no fee for validation of instant win games through June 30, 2008.

5 - Contingencies

Zero Coupon Bonds

Powerball prizes awarded to the grand prize winner are payable in annual installments over 20 years. Prizes awarded to grand prize winners after November 2, 1997 are payable in annual installments over 25 years. The first payment is made by the Lottery within weeks of the drawing. Treasury zero coupon bonds that provide payments corresponding to the Lottery's obligation to these winners are purchased by the Multi-State Lottery (MUSL). MUSL holds these bonds in an account for the Lottery, cashes the bonds when due, and wires the money to the Lottery on or before the anniversary date of the winner. The investments and related prize liabilities for winners of these games are excluded from these financial statements.

Prior to 1998, the MUSL had purchased zero coupon bonds for the Lottery to fund future installment payments aggregating \$ 224,979,000. The total purchase price of these bonds was \$ 117,288,823. During fiscal year 2001, a cash out option was offered to these prize winners as a result of Congressional changes in the United States Internal Revenue Code of 1986, as amended, specifically Section 451(h). These cash out options were taken by six prize winners in the amount of approximately \$ 43,500,000. Total future installments outstanding at June 30, 2005 and 2004 are \$ 34,789,000 and \$ 39,825,000, respectively.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

5 - Contingencies (Continued)

MUSL Prize Reserves

The Lottery is a member of the MUSL, which consists of 29 state and district lotteries. MUSL operates the Powerball game, a semiweekly 5 out of 53 plus 1 out of 42 lotto game. The grand prize is determined on a parimutuel basis, payable over a set number of years. A cash option became available on November 2, 1997. The remaining prizes are set cash prizes. Each MUSL member sells Powerball tickets through its retailers and makes weekly wire transfers to the MUSL. The weekly transfer amount consists of 50 percent of weekly sales less actual set cash prizes paid by the Lottery. The prize pool for all Powerball prize categories consists of 50 percent of each drawing period's sales, until the grand prize is funded to the annuitized amount guaranteed by the MUSL. When the grand prize fund reaches the guaranteed annuitized amount, then 48 percent of sales becomes part of the prize pool and 2 percent of sales is placed in the prize reserve fund. The MUSL has placed a \$ 75,000,000 cap on the prize reserve account and a \$ 25,000,000 cap on the set prize reserve account. Once the prize reserve accounts exceed the designated caps, the excess will become part of the prize pool. The prize reserve account serves as a contingency reserve fund to protect the MUSL in case of unforeseen, but valid liabilities for grand prize claims or for set prizes. The unreserved account serves as a MUSL operations and Powerball promotions expense account.

The Powerball prize reserve and set prize reserve account monies are refundable to MUSL members if the MUSL disbands or if a member withdraws from MUSL. Members leaving MUSL must wait one year before receiving their refund. At June 30, 2005 and 2004, the prize reserve account had a balance of \$ 73,049,064 and \$ 68,267,775, respectively, of which the Lottery's contribution was \$ 1,946,500 and \$ 2,209,353, respectively. The set prize reserve at June 30, 2005 and 2004 had a balance of \$ 24,999,967 and \$ 25,582,357, respectively, of which the Lottery's contribution was \$ 572,500 and \$ 649,810, respectively. The unreserved account at June 30, 2005 and 2004 had a balance of \$ 11,961,734 and \$ 9,737,349, respectively, of which the Lottery's contribution was \$ 499,955 and \$ 201,459, respectively.

The 2 by 2 prize reserve monies are refundable to MUSL members if the MUSL disbands or if a member withdraws from MUSL. Members leaving MUSL must wait one year before receiving their refund. At June 30, 2005 and 2004, the prize reserve account had a balance of \$ 224,929 and \$ 148,507, respectively, of which the Lottery's contribution was \$ 110,443 and \$ 75,469, respectively.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

5 - Contingencies (Continued)

Win for Life

The Lottery purchases annuity contracts from insurance companies in the name of the Win for Life game jackpot prize winners. In the event an insurance company defaults on its payments, the Kansas Life and Health Insurance Guarantee Association (KLHIGA) will make the payments. The KLHIGA was statutorily created, as set forth in K.S.A. 40-3008, subsection (o), to provide coverage in the event an insurance company defaults. The Lottery remains contingently liable for the payment of the lifetime prizes in the event the insurance companies and the KLHIGA fail to meet their obligation.

Annuity contracts have been purchased for lifetime prize payments. The approximate remaining prize payments are \$ 571,500. Prize payments are due in varying amounts through September 2048 or the life of the individuals.

Litigation

There may, at times, be claims and/or lawsuits to which the Lottery is a party. The Lottery management and legal counsel anticipate that the potential claims against the Lottery would not materially affect the financial position of the Lottery.

6 - Risk Management

The Lottery's risk management activities for workers' compensation and unemployment are recorded in the State Workers' Compensation Self-Insurance Fund and the Employment Security Fund, funds of the State of Kansas. The Lottery contributes to these funds based upon annual assessed rates.

Employees are offered various health insurance coverage programs of the State. The Lottery's contribution toward single member coverage ranges from 85 percent to 97 percent, based on salary level and tobacco usage of the employee.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

6 - Risk Management (Continued)

State agencies are not allowed to purchase or carry insurance on any property owned by the State or its agencies, except as expressly and specifically authorized by statute. Currently, none of the exceptions apply to property of the Lottery. The State has had no problem in resolving losses in the past through utilization of resources available at the time the loss occurred. The Lottery retains liability for property and equipment damage.

Tort claims involving Lottery employees are subject to the Kansas Tort Claims Act (K.S.A. 75-6101, *et seq.*).

Employees' faithful performance is covered by commercial insurance. There has been no significant reduction in insurance coverage. Settlements have not exceeded insurance coverage in the past three years.

7 - Payments to the State of Kansas

Pursuant to the Act, the Director of Accounts and Reports of the State of Kansas shall transfer monies in the Lottery operating fund to the State Gaming Revenue fund (the fund), at least monthly, in an amount equal to the monies in such fund in excess of those needed for payment of Lottery expenses, payment of compensation to retailers and transfers to the prize payment fund as certified by the Executive Director of the Lottery. For the years ended June 30, 2005 and 2004, the State Legislature set a minimum amount of transfers to the fund of \$ 63,540,000 and \$ 62,773,000, respectively. Minimum transfers for the year ended June 30, 2004 were increased in subsequent Session Laws to \$ 66,573,000. In addition, for the year ended June 30, 2005, mandated transfers were made to the fund of \$ 701,164 from proceeds of special veterans' games and mandated transfers of \$ 1,168,277 were made to the State General Fund. Total transfers to the State of Kansas of \$ 65,409,441 and \$ 70,217,944 were made for the years ended June 30, 2005 and 2004, respectively, of which \$ 4,790,000 and \$ 5,500,000 were unpaid as of June 30, 2005 and 2004, respectively.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

8 - Pension Plan

Plan description. The Lottery participates in the Kansas Public Employees Retirement System (KPERS), a cost-sharing, multiple-employer defined benefit pension plan as provided by K.S.A. 74-4901, *et seq.* KPERS provides retirement benefits, life insurance, disability income benefits, and death benefits. Kansas law establishes and amends benefit provisions. KPERS issues a publicly available financial report that includes financial statements and required supplementary information. That report may be obtained by writing to KPERS (611 South Kansas Avenue, Suite 100; Topeka, Kansas 66603-3803) or by calling 1-800-228-0366.

Funding policy. K.S.A. 74-4919 establishes the KPERS member-employee contribution rate at four percent of covered salary. Eligible employees are considered full-time with one year of service. The employer collects and remits member-employee contributions according to the provisions of Section 414(h) of the Internal Revenue Code. State law provides that the employer contribution rate be determined annually based on the results of an annual actuarial valuation. KPERS is funded on an actuarial reserve basis. State law sets a limitation on annual increases in the contribution rates for KPERS employers. The employer rates established by statute for calendar years 2005 and 2004 are 4.87 and 4.58 percent, respectively. The Lottery contributions to KPERS for the years ending June 30, 2005, 2004 and 2003, were approximately \$ 166,000, \$ 129,000 and \$ 118,000, respectively, equal to 100% of the statutorily required contributions for each year.

KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)

NOTES TO FINANCIAL STATEMENTS
(Continued)

9 - Operating Segment Information

Operating segment information by game is as follows:

	Year Ended June 30, 2005								
	Instant	Pull Tabs	Power- ball	2 by 2	Cash	Keno	eScratch	Pick 3	Total
Sales, net	\$ 93,275,467	\$ 4,388,330	\$ 44,529,626	\$ 2,168,818	\$ 19,310,131	\$ 37,113,506	\$ 765,301	\$ 5,169,592	\$ 206,720,771
Prizes, net	(54,805,354)	(2,570,435)	(21,459,374)	(1,084,409)	(9,268,863)	(20,412,428)	(420,916)	(2,533,100)	(112,554,879)
Retailer commissions	(5,766,559)	(245,746)	(2,460,476)	(121,454)	(1,081,367)	(2,078,356)	(42,857)	(289,464)	(12,086,279)
Gross margin	\$ 32,703,554	\$ 1,572,149	\$ 20,609,776	\$ 962,955	\$ 8,959,901	\$ 14,622,722	\$ 301,528	\$ 2,347,028	\$ 82,079,613

	Year Ended June 30, 2004								
	Instant	Pull Tabs	Power- ball	2 by 2	Cash	Keno	eScratch	Pick 3	Total
Sales, net	\$ 87,483,053	\$ 4,246,301	\$ 56,798,006	\$ 2,114,405	\$ 28,583,886	\$ 39,739,114	\$ 192,273	\$ 5,300,128	\$ 224,457,166
Prizes, net	(49,340,668)	(2,844,172)	(28,045,460)	(1,087,438)	(14,112,665)	(22,565,360)	(110,772)	(2,671,339)	(120,775,874)
Retailer commissions	(5,302,277)	(274,736)	(3,134,270)	(118,389)	(1,586,291)	(2,205,362)	(10,670)	(294,136)	(12,926,131)
Gross margin	\$ 32,840,108	\$ 1,127,393	\$ 25,618,276	\$ 908,578	\$ 12,884,930	\$ 14,970,392	\$ 70,831	\$ 2,334,653	\$ 90,755,161

KANSAS LOTTERY
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NOTES TO FINANCIAL STATEMENTS
(Continued)

10 - Budget and Actual Comparison

As discussed in Note 1, the Lottery prepares an annual budget of expenses on a cash plus encumbrance basis. Expenses may not exceed budgeted amounts for total operating expenses or certain line items.

At June 30, 2005, there were only two separate line items budgeted: Kansas Incentive Program (KSIP) appropriations and official hospitality. Actual expenses on a budgetary basis were \$ 132,161 for KSIP appropriations out of the budgeted amount of \$ 338,073. Actual expenses on a budgetary basis for official hospitality were \$ 2,505 out of the budgeted amount of \$ 5,000 on a budgetary basis for the year ended June 30, 2005.

The following table presents a comparison of the legally adopted budget with actual data on a budgetary basis for years ended June 30, 2005 and 2004:

	2005	2004
Operating expenses excluding expenses for game prizes, retailer commissions, on-line games service bureau and on-line communications and ticket printing		
Actual, budget basis	\$ 8,934,328	\$ 8,505,770
Budget	\$ 9,456,553	\$ 9,064,498

Significant differences in actual expenses on a budget basis compared to actual expenses on a GAAP basis include game prizes, retailer commissions, on-line games service bureau, on-line communications expenses, and ticket printing, which are nonbudgeted expenses.



Berberich Trahan & Co., P.A.

Certified Public Accountants

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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*

Legislative Post Audit Committee
Kansas State Legislature:

We have audited the financial statements of the Kansas Lottery, a component unit of the State of Kansas, as of and for the year ended June 30, 2005, and have issued our report thereon dated September 16, 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 audit, we considered the Kansas Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

Compliance and Other Matters

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

This report is intended solely for the information and use of management and the Legislative Post Audit Committee of the Kansas State Legislature and is not intended to be and should not be used by anyone other than those specified parties.

Berberich Trahan & Co., P.A.

September 16, 2005



KANSAS LOTTERY

ED VAN PETTEN, EXECUTIVE DIRECTOR

KATHLEEN SEBELIUS, GOVERNOR

October 3, 2005

Ms. Karen L. Keehn, CPA
Shareholder
Berberich Trahan & Co., P.A.
3630 SW Burlingame Rod
Topeka, KS 66611-2050

Dear Ms. Keehn:

We have reviewed your draft of the Financial and Compliance Audit Report for the Kansas Lottery for the fiscal year ended June 30, 2005 and we concur with the results of the audit.

We are very pleased that there were no "findings" to be reported.

As in the past, we certainly appreciate the professional manner in which you and your staff worked with our staff in the audit preparation.

Sincerely,

A handwritten signature in black ink, appearing to read "Ed Van Petten".

Ed Van Petten
Executive Director