



FINANCIAL AND COMPLIANCE AUDIT REPORT

**Kansas Lottery
Fiscal Year 2006**

**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
November 2006**

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

Senator Les Donovan, Chair
Senator Anthony Hensley
Senator Nick Jordan
Senator Derek Schmidt
Senator Chris Steineger

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

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LEGISLATURE OF KANSAS

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November 6, 2006

To: Members, Legislative Post Audit Committee

Senator Les Donovan, Chair
Senator Anthony Hensley
Senator Nick Jordan
Senator Derek Schmidt
Senator Chris Steineger

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

This report contains the findings and conclusions from the completed financial-compliance audit of the *Kansas Lottery* covering fiscal year 2006. 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.

Barbara J. Hinton
Legislative Post Auditor



Berberich Trahan & Co.

KANSAS LOTTERY

(A COMPONENT UNIT OF THE STATE OF KANSAS)

FINANCIAL AND COMPLIANCE AUDIT
YEARS ENDED JUNE 30, 2006 AND 2005

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

FINANCIAL AND COMPLIANCE AUDIT

Years Ended June 30, 2006 and 2005

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KANSAS LOTTERY
(A COMPONENT UNIT OF THE STATE OF KANSAS)
FINANCIAL AND COMPLIANCE AUDIT
YEARS ENDED JUNE 30, 2006 AND 2005

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

INTRODUCTION

Year Ended June 30, 2006

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, 2006.

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, 2006

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, 2006 and 2005, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the 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, 2006 and 2005 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, 2006 and 2005, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated September 15, 2006 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 10 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 15, 2006

MANAGEMENT'S DISCUSSION AND ANALYSIS YEARS ENDED JUNE 30, 2006 AND 2005

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, 2006 and 2005. 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 2006 Financial Highlights

- Lottery sales for FY 2006 were \$236,045,945 reflecting an increase of \$29,325,174 over those in FY 2005, and sales were the highest since the Lottery began selling tickets in November 1987. The Lottery continued to enjoy another good year of Instant scratch ticket sales in FY 2006. Instant sales were \$107,365,573 compared to \$93,275,467 in FY 2005. 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 2006. This, plus the Lottery's business partnerships with Cabela's, Kansas Speedway, GMC, Cobalt Boats, Wichita River Festival, the 3i Show and the Kansas State Fair in the promotion of special instant scratch games, resulted in a \$14,090,106 increase compared to FY 2005. Sales of barcoded pull-tab tickets that were introduced in October 2002 were \$7,036,654 an increase of \$2,648,324 over FY 2005. Total on-line sales were \$12,586,744 greater than the previous year. Powerball (a Multi-State Lottery (MUSL) game) sales were up \$9,825,741 as a result of having several large jackpots. The new Hot Lotto game was started March 12, 2006 (a MUSL game) with partial year sales of \$2,552,121. Super Kansas Cash sales remained stable with a decrease of \$133,197 over the FY 2005 figures. Keno and Pick 3 resulted in a combined total decrease of \$510,752. The 2by2 game realized sales of \$1,904,830 which was a decrease of \$263,988 from the previous year. The eScratch game is interactive with the Internet, and the sales were \$1,882,120, an increase of \$1,116,819 over FY 2005.
- For 2006 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 \$66,000,000 with no less than \$4,500,000 being transferred in any one month. The \$66,000,000 was eventually increased by \$288,000 to an amount of \$66,288,000 for FY 2006. As a result, regular transfers to the SGRF were \$66,288,000. Another \$717,113 was transferred to the SGRF from the special veterans' games. And lastly, Accounts and Reports transferred a total of \$83,496 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 \$67,088,609, which reflects a \$1,679,168 total increase 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 29.3% which is .7% less than FY 2005. Sales were 14% greater than FY 2005 with the operating income remained stable at the 30% level.

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 reflect the Lottery's financial position as of June 30, 2006 and 2005. 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, 2006 and 2005. 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, 2006, were the highest year since the Lottery's first sales began in November 1987. They were 14.2% or \$29,325,174 greater than the previous year, as indicated in the financial statements. FY 2006 sales were \$236,045,945 compared to \$206,720,771 in FY 2005. The increase in sales was made up of (1) Powerball having several large jackpots, resulting in a increase in sales of \$9,825,741 over FY 2005; (2) Super Kansas Cash was stable with a \$133,197 decrease in sales compared to the prior year; and (3) the instant scratch sales being \$14,090,106 higher than those in FY 2005, which was accomplished by keeping fresh games available to the public and partnering with Cabela's, Kansas Speedway, Kansas State Fair, and other businesses, in special games promotions. The eScratch game more than doubled in sales, and produced total sales of \$1,882,120 for the 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>2006</u>	<u>2005</u>	<u>Difference</u>	<u>Percentage</u>
Instant	\$ 107.3	\$ 93.2	\$ 14.1	15.13%
Pull-Tabs	7.0	4.4	2.6	59.09%
Powerball	54.4	44.5	9.9	22.25%
2by2	1.9	2.2	(0.3)	-13.64%
Super Kansas Cash	19.2	19.3	(0.1)	-0.52%
Keno	36.3	37.1	(0.8)	-2.16%
Pick 3	5.5	5.2	0.3	5.77%
eScratch	1.9	0.8	1.1	137.50%
Hot Lotto	2.5	-	2.5	
Total	\$ 236.0	\$ 206.7	\$ 29.3	14.18%

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 Cabela'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	\$ 206.7	\$ 224.5	\$ (17.8)	-7.9%

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, 2006, these revenues amounted to \$1,224,536 compared to \$1,349,932 for FY 2005, and \$999,416 for FY 2004.

Total revenues for FY 2006 were \$237,270,481 in comparison to \$208,070,703 for FY 2005, an increase of \$29,199,778 or 14%. As previously stated, the increase in revenues was the result of the sales increases of the on-line Powerball and Instant games.

Total revenues for FY 2005 were \$208,070,703 in comparison to \$225,456,582 for FY 2004, a decrease of 17,385,879 or 7.7%. The decrease in revenue was the result of the sales decreases on the on-line Powerball and Super Kansas Cash games.

Major Expenses

Approximately \$157.6 million of the Lottery's total operating expenses of \$167.6 million for FY 2006 were directly associated with lottery games. For FY 2005, the game-related expenses were \$136.1 million of a total \$145.5 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 2006 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 2006 and FY 2005. The expenses are shown in millions of dollars:

<u>Description</u>	<u>2006</u>	<u>2005</u>	<u>Difference</u>	<u>Percentage</u>
Game Prizes	\$ 131.0	\$ 112.5	\$ 18.5	16.4%
Retailer Commissions	13.6	12.1	1.5	12.4%
On-line Games Service Bureau	6.3	5.6	0.7	12.5%
Telecommunications Terminal Costs	2.1	2.1	-	0.0%
Instant Ticket Printing Costs	4.6	3.8	0.8	21.1%
Total	<u>\$ 157.6</u>	<u>\$ 136.1</u>	<u>\$ 21.5</u>	15.8%

The overall increase in Game Prizes was the result of the increase in sales compared to those in FY 2005. The Telecommunications Terminal Costs has remained the same. The On-line Games Service Bureau costs increased as a result of the greater on-line sales. Instant Ticket Printing Costs for FY 2006 increased as sales increased by 15%, and the strategy of ordering smaller quantities of each game was successful.

Of the \$10 million of FY 2006 operating expenses that were not game-related, \$4.3 million was for employees' salaries and wages, \$2.8 million was spent for games and promotional advertising, and other administrative expenses accounted for \$2.9 million. In FY 2005, these same expenses were \$4.2 million, \$2.6 million and \$2.6 million, respectively. The Lottery engaged in slightly more promotional advertising for fiscal year 2006 and continued the successful promotions with the business partnerships including Cabela's, Kansas Speedway, Midwest Ford, GMC, Kansas State Fair and other businesses in Kansas. Many of the promotions were second chance drawing giveaways that included products made in Kansas and a number of vehicle giveaways.

Approximately \$136.1 million of the Lottery's total operating expenses of \$145.5 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	\$ 112.5	\$ 120.8	\$ (8.3)	-6.9%
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	 \$ 136.1	 \$ 145.7	 \$ (9.6)	 6.6%

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, \$2.6 million was spent for games and promotional advertising, and other administrative expenses accounted for \$2.6 million. In FY 2004, these same expenses were \$3.8 million, \$3.2 million and \$2.1 million, respectively. The Lottery engaged in 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.

Other Financial Information

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

	2006	2005	2004
Current and other assets	\$ 19.6	\$ 15.2	\$ 18.5
Capital assets	0.3	0.2	0.5
Total assets	19.9	15.4	19.0
Current liabilities	12.3	10.4	11.3
Net assets			
Invested in capital assets	0.3	0.2	0.5
Unrestricted	7.3	4.8	7.2
Total net assets	\$ 7.6	\$ 5.0	\$ 7.7

Total assets of the Lottery for the fiscal year ended June 30, 2006, were \$19.9 million. They consisted of cash for operations and prizes of \$10.0 million, accounts receivable from Lottery retailers for lottery tickets sales activity of \$7.2 million, a MUSL restricted accounts receivable of \$.7 million, instant ticket inventory totaling \$1.7 million, and property and equipment net of depreciation amounting to \$0.3 million.

Comparable figures at June 30, 2005 were \$15.4 million in total assets consisting of \$5.1 million in cash for operations and prizes, \$8.4 million in accounts receivable from retailers, a MUSL restricted accounts receivable of \$.5 million, \$1.2 million in instant ticket inventory, and \$0.2 million in net property and equipment.

At June 30, 2004, the Lottery had \$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.

Total liabilities of the Lottery at June 30, 2006 were \$12.3 million and were comprised of accounts payable and accrued liabilities of \$1.2 million, transfers due to the State of Kansas of \$5.8 million, and prize liability of \$5.3 million.

For the 2005 fiscal year end, total liabilities were \$10.4 million, of which, \$1.2 million was in accounts payable and accrued liabilities, \$4.8 million was due to the State of Kansas, and \$4.4 million was for prize liability.

At June 30, 2004, total liabilities were \$11.3, 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.

The change in net assets between FY 2006 and FY 2005 was an increase of \$2.6 million. Primarily as a result of the overall increase in sales revenues of \$29.3 million, unrestricted net assets increased by \$2.5 million.

The change in net assets between FY 2005 and FY 2004 was a decrease of \$2.7 million, primarily as a result of the overall decrease of sales revenues of \$17.7 million.

Transfers to the State Gaming Revenues Fund (SGRF) and State General Fund (SGF)

For FY 2006 the legislature again waived the percentage of sales SGRF requirement for a minimum transfer of \$66,000,000 originally with a minimum monthly transfer of \$4,500,000. Final regular transfers to the SGRF were \$66,288,000. The special veterans' games contributed another \$717,113. Accounts and Reports transferred \$83,496 to the State General Fund. The final amounts transferred to both the SGRF and the SGF was \$67,088,609, which reflects a \$1,679,168 increase from FY 2005.

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 amounts 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 required 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 another \$835,250 to the SGF.

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

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, 2006, the budget submitted consisted of the redo of the fiscal year ending June 30, 2007, and a first-time submission for the fiscal year ending June 30, 2008.

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 2006, the approved no-limit cost of sales budget was \$12,652,269 and the final unlimited administration budget amount was \$9,699,044. On a cash basis, actual expenses were \$13,812,886 and \$9,369,983, respectively.

Fiscal Year 2007 Budget

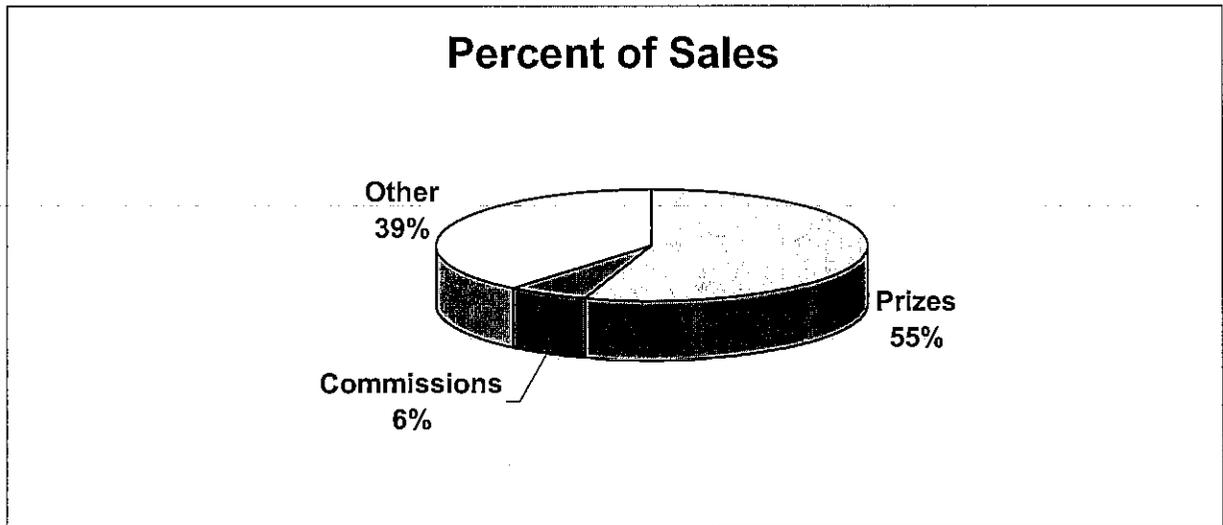
For FY 2007, the 2006 legislature has, once again, waived the previously required transfer rate based on a percentage of ticket sales in favor of a set minimum amount. This decision will afford the Lottery additional operating flexibility, and should result in increased ticket sales, with a budget estimated at \$12.6 million more than those in FY 2006. The sales for FY 2007 are being projected at a greater amount than the FY 2006 results because of the continued smaller games and higher priced games. Also the auto-ship program is getting the games out to the retailers on a timely basis by monitoring the retailers' ticket inventories and automatically replacing instant ticket stock as needed. Continuing the partnerships and sponsorships with Kansas based businesses has enhanced second chance drawings. The legislature has approved the Lottery to transfer to the SGRF a minimum of \$67,000,000 including the net proceeds of the instant scratch games designated to benefit veterans' causes. The revised FY 2007 budget has increased the transfer amount to the SGRF to \$70 million. Overall, the Lottery has set a revised sales goal of \$247.5 million for FY 2007. Administrative expenses for FY 2007 have been revised in the budget to \$10.4 million from the approved amount of \$9.4. Payroll consists of \$4.6 million, the Lottery is required to budget for payroll as if all positions were filled, and all approved pay increases are included. The contractual services of \$4.9 million are a major part of the Administrative budget, and commodities have a budgeted amount of \$.7 million. Capital outlay has a budget of \$.3 million which includes the cost for replacing ten high mileage vehicles.

Contacting the Lottery's Financial Management

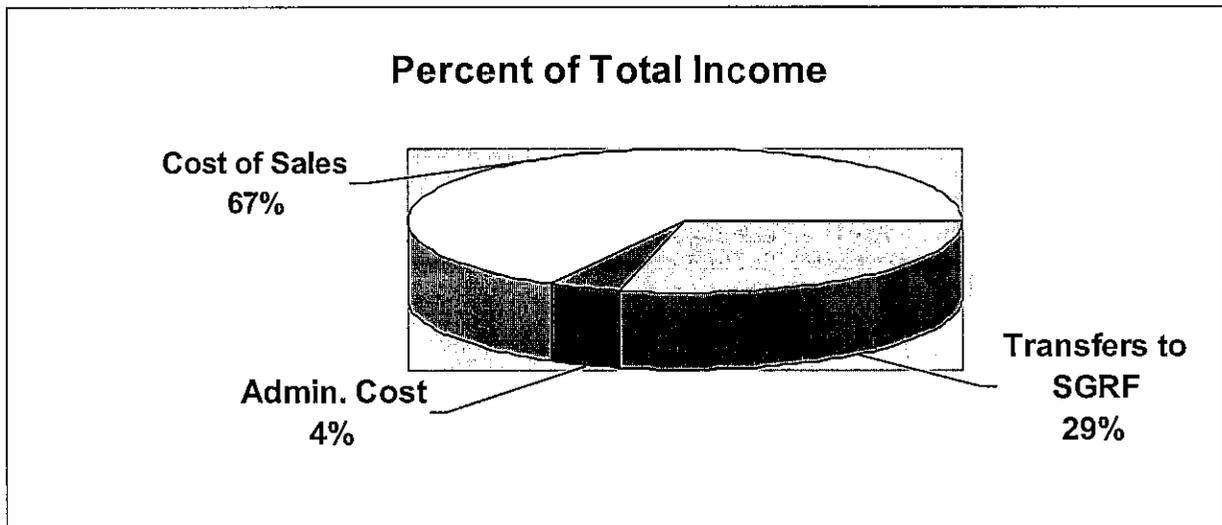
This management's discussion and analysis report is designed to provide Kansas citizens, Kansas government officials, players, retailers and other interested parties with a general overview of the Lottery's financial activity for the fiscal years ended June 30, 2006 and 2005 and to demonstrate the Lottery's accountability for the monies it received from its lottery ticket sales activity. Questions or comments about this report may be addressed to Carolyn Brock, Director of Finance or Wayne Regnier, 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, 2006



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, 2006 and 2005

	2006	2005
<u>ASSETS</u>		
Current assets:		
Cash:		
Operating fund	\$ 9,152,091	\$ 3,783,410
Prize payment fund	810,138	1,347,033
Accounts receivable, net of allowance for doubtful accounts of \$ 363,498 and \$ 308,108 at 2006 and 2005, respectively	18,404	2,173,013
Accounts receivable - unbilled	7,246,972	6,194,691
Other receivable	671,460	499,955
Instant ticket game inventory	1,680,915	1,149,683
Total current assets	19,579,980	15,147,785
Capital assets:		
Property and equipment	4,202,909	4,033,426
Less accumulated depreciation	3,923,062	3,790,989
Total capital assets	279,847	242,437
Total assets	\$ 19,859,827	\$ 15,390,222
<u>LIABILITIES AND NET ASSETS</u>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 1,239,324	\$ 1,183,705
Due to State Gaming Revenue fund	5,755,113	4,790,000
Prize liability	5,246,216	4,370,866
Total current liabilities	12,240,653	10,344,571
Net assets:		
Invested in capital assets	279,847	242,437
Unrestricted	7,339,327	4,803,214
Total net assets	7,619,174	5,045,651
Total liabilities and net assets	\$ 19,859,827	\$ 15,390,222

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, 2006 and 2005

	2006	2005
Operating revenues:		
Net game revenues	\$ 228,946,577	\$ 200,711,702
Net unsettled revenues	7,099,368	6,009,069
Retailer fees and miscellaneous income	240,186	383,242
Phone reimbursements	984,350	966,690
	237,270,481	208,070,703
Operating expenses:		
Game prizes	131,004,556	112,554,879
Retailer commissions	13,641,678	12,086,279
Advertising	2,834,603	2,591,238
Cost of instant tickets	4,600,652	3,843,235
Depreciation	176,412	243,213
Professional services	76,681	171,436
On-line games service bureau	6,339,882	5,591,900
Salaries and benefits	4,313,167	4,202,998
Telecommunications	2,078,525	2,108,586
Other administrative expense	2,556,377	2,101,996
	167,622,533	145,495,760
Operating income	69,647,948	62,574,943
Nonoperating revenues (expenses):		
Payments to State of Kansas	(67,088,609)	(65,409,441)
Gain on sale of capital assets	14,184	1,931
	(67,074,425)	(65,407,510)
Change in net assets	2,573,523	(2,832,567)
Net assets, beginning of year as previously stated	5,045,651	7,676,759
Prior period adjustment	-	201,459
Net assets, beginning of year as restated	5,045,651	7,878,218
Net assets, end of year	\$ 7,619,174	\$ 5,045,651

See accompanying notes to financial statements.

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

STATEMENTS OF CASH FLOWS

Years Ended June 30, 2006 and 2005

	2006	2005
Cash flows from operating activities:		
Cash received from sales and reimbursements	\$ 238,201,304	\$ 206,751,371
Cash paid for prizes, commissions, and other expenses	(162,607,150)	(140,653,050)
Cash paid to employees	(4,439,234)	(4,157,189)
Net cash provided by operating activities	71,154,920	61,941,132
Cash flows from noncapital financing activities:		
Payments to State Gaming Revenue fund	(66,040,000)	(64,951,164)
Payments to State General fund	(83,496)	(1,168,277)
Net cash used by noncapital financing activities	(66,123,496)	(66,119,441)
Cash flows from capital and related financing activities:		
Proceeds from sale of capital assets	19,280	10,087
Purchase of capital assets	(218,918)	(23,759)
Net cash used by capital and related financing activities	(199,638)	(13,672)
Net increase (decrease) in cash	4,831,786	(4,191,981)
Cash, beginning of year	5,130,443	9,322,424
Cash, end of year	\$ 9,962,229	\$ 5,130,443
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 69,647,948	\$ 62,574,943
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	176,412	243,213
Changes in operating assets and liabilities:		
Accounts receivable	1,102,328	(1,020,836)
Other receivable	(171,505)	(298,496)
Instant ticket game inventory	(531,232)	717,241
Accounts payable and accrued liabilities	55,619	(330,066)
Prize liability	875,350	55,133
Net cash provided by operating activities	\$ 71,154,920	\$ 61,941,132

See accompanying notes to financial statements.

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

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

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, Hot Lotto, eScratch, and Pull Tabs.

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 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.

Prior Period Adjustment

Beginning net assets at June 30, 2005 were restated to reflect the addition of the MUSL unreserved account as an other receivable. The effect of this restatement is an increase of \$ 201,459 to beginning net assets, an increase of \$ 499,955 to 2005 other receivable, and an increase of \$ 298,496 to 2005 retailer fees and miscellaneous income. There was no effect on 2006 revenue or expenses as a result of this adjustment.

Pending Governmental Accounting Standards Board Statements

At June 30, 2006, 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, 2006.

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

NOTES TO FINANCIAL STATEMENTS
(Continued)

1 - Summary of Significant Accounting Policies (Continued)

Pending Governmental Accounting Standards Board Statements (Continued)

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, 2007.

Reclassification

Certain prior year balances have been reclassified to conform to the current year presentation.

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, 2006 and 2005, the Lottery's share in the State's common cash pool was \$ 9,790,456 and \$ 4,976,065 respectively.

The Lottery maintains its imprest fund cash in one commercial bank. The amount on deposit at June 30, 2006 and 2005 exceeded the insurance limits of the Federal Deposit Insurance Corporation by approximately \$ 16,000 and \$ 26,000, 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, 2006 and 2005:

Fiscal Year 2006:	Beginning Balance	Increases	Decreases	Ending Balance
Data processing equipment	\$ 2,693,377	\$ 57,701	\$ -	\$ 2,751,078
Office furniture, fixtures, and equipment	812,420	-	-	812,420
Vehicles and other	527,629	161,217	49,435	639,411
	<u>\$ 4,033,426</u>	<u>\$ 218,918</u>	<u>\$ 49,435</u>	<u>\$ 4,202,909</u>
Accumulated depreciation	<u>\$(3,790,989)</u>	<u>\$(176,412)</u>	<u>\$(44,339)</u>	<u>\$(3,923,062)</u>
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>

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:

2007	\$ 472,135
2008	472,135
2009	4,600
	<u>\$ 948,870</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 \$ 475,582 and \$ 461,637 under operating leases for the years ended June 30, 2006 and 2005, 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.

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, 2006 and 2005 are \$ 24,455,000 and \$ 34,789,000, 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 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, 2006 and 2005, the prize reserve account had a balance of \$ 75,178,923 and \$ 73,049,064, respectively, of which the Lottery's contribution was \$ 1,810,500 and \$ 1,946,500, respectively. The set prize reserve at June 30, 2006 and 2005 had a balance of \$ 24,941,590 and \$ 24,999,967, respectively, of which the Lottery's contribution was \$ 532,500 and \$ 572,500, 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, 2006 and 2005, the prize reserve account had a balance of \$ 280,972 and \$ 224,929, respectively, of which the Lottery's contribution was \$ 122,318 and \$ 110,443, respectively.

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

NOTES TO FINANCIAL STATEMENTS
(Continued)

5 - Contingencies (Continued)

MUSL Prize Reserves (Continued)

The Hot Lotto 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, 2006, the prize reserve account had a balance of \$ 1,616,069, of which the Lottery's contribution was \$ 204,613.

The Lottery has contributed to an account with MUSL which is used to pay certain operating expenses incurred by member lotteries for the Powerball game. With certain restrictions, the balances in this account are refundable to the member lotteries upon termination of the member's agreement with MUSL or upon the disbanding of MUSL. At June 30, 2006 and 2005, the Lottery's portion of the balance of this account was \$ 671,460 and \$ 499,955, respectively, and is reported as a receivable.

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 \$ 553,500. 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.

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

NOTES TO FINANCIAL STATEMENTS
(Continued)

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.

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.

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

NOTES TO FINANCIAL STATEMENTS
(Continued)

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, 2006 and 2005, the State Legislature set a minimum amount of transfers to the fund of \$ 66,288,000 and \$ 63,540,000, respectively. In addition, for the years ended June 30, 2006 and 2005, mandated transfers were made to the fund of \$ 717,113 and \$ 701,164, respectively, from proceeds of special veterans' games and mandated transfers of \$ 83,496 and \$ 1,168,277, respectively, were made to the State General Fund. Total transfers to the State of Kansas of \$ 67,088,609 and \$ 65,409,441 were made for the years ended June 30, 2006 and 2005, respectively, of which \$ 5,755,113 and \$ 4,790,000 were unpaid as of June 30, 2006 and 2005, respectively.

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 2006 and 2005 are 5.27 and 4.87 percent, respectively. The Lottery contributions to KPERS for the years ending June 30, 2006, 2005 and 2004, were approximately \$ 203,000, \$ 166,000 and \$ 129,000, 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, 2006										
	Power-					Kansas					Hot
	Pull	Power-	2 by 2	Cash	Keno	eScratch	Pick 3	Lotto	Total		
Instant	Tabs	ball									
Sales, net	\$ 107,365,573	\$ 7,036,654	\$ 54,355,367	\$ 1,904,830	\$ 19,176,934	\$ 36,304,626	\$ 5,467,720	\$ 2,552,121	\$ 236,045,945		
Prizes, net	(63,509,658)	(4,404,945)	(27,720,060)	(971,463)	(9,780,236)	(19,568,193)	(2,788,537)	(1,301,582)	(131,004,556)		
Retailer commissions	(6,517,394)	(426,421)	(2,851,354)	(103,051)	(1,037,470)	(2,170,290)	(295,804)	(138,071)	(13,641,678)		
Gross margin	\$ 37,338,521	\$ 2,205,288	\$ 23,783,953	\$ 830,316	\$ 8,359,228	\$ 14,566,143	\$ 2,383,379	\$ 1,112,468	\$ 91,399,711		

	Year Ended June 30, 2005										
	Power-					Kansas					Hot
	Pull	Power-	2 by 2	Cash	Keno	eScratch	Pick 3	Lotto	Total		
Instant	Tabs	ball									
Sales, net	\$ 93,275,467	\$ 4,388,330	\$ 44,529,626	\$ 2,168,818	\$ 19,310,131	\$ 37,113,506	\$ 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)	(2,533,100)	-	(112,554,879)		
Retailer commissions	(5,766,559)	(245,746)	(2,460,476)	(121,454)	(1,081,367)	(2,078,356)	(289,464)	-	(12,086,279)		
Gross margin	\$ 32,703,554	\$ 1,572,149	\$ 20,609,776	\$ 962,955	\$ 8,959,901	\$ 14,622,722	\$ 2,347,028	\$ -	\$ 82,079,613		

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. The operating and cost of sales (COS) expenses are currently on a no-limit basis, with the exception of Kansas Incentive Program (KSIP) and official hospitality line items.

The operating fund currently has a no-limit appropriation. The no-limit allows the budget to be prepared to reflect the operating and COS requirements of increasing sales and doing business as a lottery. The prize fund has had a no-limit appropriation for several years allowing the flexibility needed for paying winners' claims. Each year the current year budget is revised and the next year's budget is prepared. The completed budget document is submitted to the Department of Budget, and must have the approval of the Governor and Legislature.

At June 30, 2006, there were only two separate line items budgeted: KSIP appropriations and official hospitality. Actual expenses on a budgetary basis were \$ 235,038 for KSIP appropriations out of the budgeted amount of \$ 331,267. Actual expenses on a budgetary basis for official hospitality were \$ 1,677 out of the budgeted amount of \$ 5,000 on a budgetary basis for the year ended June 30, 2006.



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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, 2006, and have issued our report thereon dated September 15, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the 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 15, 2006

RSM McGladrey Network
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