Arizona State Lottery, A Component Unit of the State of Arizona

Financial Statements as of and for the Year Ended June 30, 2005, Supplemental Schedule for the Year Ended June 30, 2005, and Independent Auditors' Report

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

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Janet Napolitano
Governor

J. Art Macias, Jr.
Executive Director

February 28, 2006

Dear Arizona Lottery Commissioners:

The Arizona Lottery is pleased to submit its audited financial statements for the year ended June 30, 2005, as compiled by the Lottery Accounting Department and audited by Deloitte & Touche LLP. The Lottery is responsible for the accuracy and completeness of all data and disclosures in this report. To the best of our knowledge, the information presented is accurate and complete in all material respects and fairly depicts the financial position of the Arizona Lottery. This report includes a statement of net assets of the Arizona Lottery, the related statement of revenues, expenses and changes in Fund net assets, the statement of cash flows, footnotes related to the financial reports and the supplemental schedules of gross profit by game.

The audit of the Arizona Lottery was performed under the authority of A.R.S. § 5-505 and A.R.S. § 5-524, which require an annual audit of the Lottery.

The Arizona Lottery was created in 1980 when Arizona voters approved a ballot initiative adding Title 5, Chapter 5 to the Arizona Revised Statutes. The Lottery began selling instant "scratch-off" tickets in July 1981 and during its twenty-four years of operation has offered a variety of instant and on-line products. The Lottery operates as an agency of the State of Arizona and is reported as an enterprise fund within the state's Comprehensive Annual Financial Report. The fund is operated in a manner similar to a private business enterprise.

In fiscal year 2005, the Arizona Lottery had revenues of $397.6 million from Lottery ticket sales, 8.5% greater than last fiscal year, and an income before transfers of $117.0 million, 8.0% greater than last fiscal year. More than $220 million was paid to our players in prizes and our retail partners received $26.5 million for sales commissions. In its twenty-four years of operation, the Lottery has produced over $5.5 billion in Lottery ticket sales.

In fiscal year 2005, the Arizona Lottery made transfers to other State funds of $28.1 million for the Local Transportation Assistance Fund, $7.7 million for the County Assistance Fund, $20.0 million for the Heritage Fund, $3.0 million for the Economic Development Fund, $0.3 million

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for the Department of Gaming, $17.0 million for the Healthy Arizona Fund, and $37.8 million was transferred to the State General Fund for allocation by the state legislature. In addition, from the Lottery Prize Fund, over $2.6 million was transferred to the Court Appointed Special Advocate (CASA). In total, $116.4 million was transferred to other State Funds for FY 2005. In its twenty-four years of operation, the Lottery has returned over $1.8 billion to its beneficiaries.

Further financial results for fiscal year 2005 are detailed in Management's Discussion and Analysis, included in this report.

Sincerely,

J. Art Macias Jr.
Executive Director

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INDEPENDENT AUDITORS' REPORT

To the Commissioners of
Arizona State Lottery
Phoenix, Arizona

We have audited the accompanying statement of net assets of Arizona State Lottery (the "Lottery"), a component unit of the State of Arizona, as of June 30, 2005, and the related statements of revenues, expenses, and changes in fund net assets and of cash flows for the year then ended. 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 audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Governmental Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the respective financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the financial position of the Lottery as of June 30, 2005, and the changes in net assets and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying required supplementary information, management's discussion and analysis, is presented on pages 3 through 6 and is not a required part of the basic financial statements, but is supplementary accounting information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Lottery's management. 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 we do not express an opinion on it.

Our audit was conducted for the purpose of forming an opinion on the Lottery's basic financial statements. The accompanying schedule of gross profit by game is presented for purposes of additional analysis and is not a required part of the basic financial statements. This schedule is the responsibility of the Lottery's management. Such information has been subjected to the auditing procedures applied by us in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

In accordance with Government Auditing Standards, we have also issued our report dated February 28, 2006, on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance and other matters. The purpose of that report is to describe the scope of our 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 read in conjunction with this report in considering the results of our audit.

Deloitte & Touche LLP

February 28, 2006

ARIZONA STATE LOTTERY
A COMPONENT UNIT OF THE STATE OF ARIZONA
PROPRIETARY FUND—ENTERPRISE FUND

MANAGEMENT'S DISCUSSION AND ANALYSIS
YEAR ENDED JUNE 30, 2005

This discussion and analysis of the Lottery's financial statements is a required component of financial reporting under *Government Accounting Standards* and was prepared by Arizona Lottery Management. It provides an overview of financial activities for the year ended June 30, 2005, and should be read in conjunction with the Lottery's financial statements and notes to the financial statements.

This annual report consists of three types of financial statements and accompanying notes that provide explanations and details of accounting policies, account balances and activities. Account balances and activities are shown as of and for the year ended June 30, 2005, with comparative totals for June 30, 2004. The statement of net assets; the statement of revenues, expenses and changes in net assets; and the notes are presented using the accrual method of accounting. Under this method, financial transactions are recorded when earned or incurred regardless of when cash is received or disbursed. The statement of cash flows reflects cash receipts and disbursements during the same twelve-month periods.

The statement of net assets provides information about the assets and liabilities of the Lottery. Assets consist of cash, substantially all held by the State Treasurer, amounts owed to the Lottery from licensed Lottery retailers and other State agencies, ticket inventory and property. Liabilities represent amounts owed by the Lottery to vendors, to employees for wages and benefits, to prize winners and to other State funds. Net assets represent the portion of the Lottery's assets that are not encumbered by liabilities. It serves as an indicator of the net worth of the Lottery.

A summary of the financial results of operations for the twelve-month periods is presented in the statement of revenues, expenses and changes in Fund net assets. Operating revenues include sales of Lottery tickets, retailer licensing fees and commissions earned on the sales of Lottery tickets at Lottery offices, and special events. Direct costs and administrative expenses comprise the operating expenses section of this statement. Direct costs are variable expenses that fluctuate with the level of sales. Marketing and overhead costs are included in the administrative expenses category.

Nonoperating revenues consist of interest earned on prize fund cash investments from the State Treasurer and interest credited to the Multi-State Lottery Association ("MUSL") unreserved account. The Transfers category includes transfers to other State Funds as required by Lottery statutes.

The statement of cash flows includes cash receipts and disbursements from operating, noncapital financing and investment earnings. This statement also includes a reconciliation of operating income presented on the accrual basis of accounting to net cash provided by operating activities.

The notes to the financial statements present information on accounting policies, transfers and statutory requirements, commitments, contingencies and retirement benefits. These notes are an integral part of the financial statements.

Sales Activities

Revenues from the sale of Lottery products for the fiscal year ended June 30, 2005 were the highest in the Lottery's twenty-four year history. As shown in the financial statements, sales increased 8.5% from the prior year, from $366.6 million in Fiscal Year 2004 to $397.6 million in the current year. The increases in Scratchers℠, The Pick™ and Pick 3™ sales more than offset the decreases in Powerball® and Fantasy 5™ sales.

The following table compares Lottery product sales between fiscal years. Sales are presented in millions of dollars.

Product Sales	FY 2005	FY 2004	Difference	Percentage
Scratchers	$219.7	$183.3	$36.4	19.9%
Powerball	106.5	132.8	-26.3	-19.8%
The Pick	54.8	34.0	20.8	61.2%
Fantasy 5	9.4	9.7	- .3	-3.0%
Pick 3	7.2	6.8	.4	5.9%
Total	$397.6	$366.6	$31.0	8.5%

Total Revenues

Nonoperating revenues for the year ended June 30, 2005 were $913,000 as compared to $335,000 for the year ended June 30, 2004. Nonoperating revenue is comprised of interest earned on invested cash. The increase of $578,000 is due to interest rates that substantially higher in Fiscal Year 2005.

Total revenues were $398.5 million for the year ended June 30, 2005 as compared to $367.1 million for the year ended June 30, 2004. As mentioned above, the majority of the increase was due to the increase in sales revenues.

Major Expenses

$262.8 million of the Lottery's total operating expenses of $281.5 million for the year ended June 30, 2005 were incurred in direct support of the sales of Lottery games. These expenses include prize expense, retailer commissions and incentives, purchases of Scratchers tickets, telecommunication network costs, compensation to the vendor for Scratchers ticket distribution and compensation to the vendor who maintains and supports the on-line gaming system.

In comparison, $241.4 million of the Lottery's total operating expenses of $258.7 million for the year ended June 30, 2004 were game-related expenses.

The following table compares the game-related expenses between fiscal years. All expenses are presented in millions of dollars.

Game Related Expenses	FY 2005	FY 2004	Difference	Percentage
Prize Expense	$220.3	$200.3	$20.0	10.0%
Retailer Commissions	26.5	24.5	2.0	8.2%
On-line System Expenses	10.5	11.5	-1.0	-8.7%
Scratchers System and Distribution Expenses	1.7	1.5	.2	13.3%
Tickets Purchased	3.8	3.6	.2	5.6%
Total	$262.8	$241.4	$21.4	8.9%

The increase in prize expense, retailer commissions and tickets purchased is reflective of the increase in product sales. See the product sales schedule above. The decrease in on-line system expenses is made up of two elements. On-line vendor fees are based on a contracted percentage of on-line sales and increase with the higher level of on-line sales. In September of this fiscal year, the contracted percentage rate decreased from 4.99% to 4.50% causing the on-line expenses to decrease. The second element is the telecommunications costs associated with the Lottery retailer network which increased $55,300 this fiscal year. The Lottery's contract with an outside vendor for Scratchers ticket distribution and accounting services resulted in increased costs of $213,300 over last fiscal year.

Of the $18.7 million in Fiscal Year 2005 in other operating expenses, $10.5 million was used for advertising and promotion and $5.4 million was used to compensate Lottery employees. In comparison, of the $17.3 million in Fiscal Year 2004 other operating expenses, $9.6 million was used for advertising and promotion and $5.2 million was used to compensate Lottery employees.

Transfers to Other State Funds

Note 3 to the financial statements details the amounts transferred to other State Funds. The Lottery transferred $116.4 million to other State Funds. The increase in product sales of $31.0 million in this fiscal year resulted in an increase of $8.6 million in the amount transferred to other State Funds. This year's transfers included $12.2 million above the minimum transfers required in Lottery Statutes.

Other Financial Information

The Lottery's total assets at June 30, 2005 were $69.1 million. Assets consisted of cash held substantially by the State Treasurer of $50.2 million, receivables from Lottery retailers for the sale of Lottery products of $6.4 million, Scratchers ticket inventory of $2.3 million, net investment in fixed assets of $3.4 million and a deposit with MUSL of $6.7 million.

Comparable figures at June 30, 2004 were $56.5 million in total assets, including $39.0 million in cash held by the State Treasurer, $5.2 million in receivables from retailers, $1.6 million in Scratchers ticket inventory, net investment in fixed assets of $3.5 million and MUSL deposit of $7.2 million.

Total liabilities at June 30, 2005 were $57.9 million, consisting of $3.1 million in accounts payable and accrued expenses, prize liabilities of $30.1 million and amounts due to other State Funds of $24.7 million. All of the Lottery's liabilities were current liabilities.

The Lottery's total liabilities at June 30, 2004 were $45.9 million, which consisted of $2.4 million of accounts payable and accrued expenses, prize liabilities of $29.4 million and amounts due to other State Funds of $14.1 million. All liabilities were current liabilities.

Total net assets at June 30, 2005 were $11.2 million, an increase of $0.6 million or 6.0% over total net assets at June 30, 2004. $7.8 million of the Lottery's total net assets are unrestricted.

BUDGETARY HIGHLIGHTS

The Lottery's budget is set by the legislative appropriations process on a biennial basis. The budgets for Fiscal Years 2005 and 2004 were set in the regular legislative session of 2003. The Lottery's budget for Fiscal Year 2005 included a mandatory transfer to the State General Fund of $2.5 million. The Lottery's appropriation for sales-related expenditures is based on approved percentages of projected revenues and is allowed to increase for these items without a supplemental appropriations request if actual revenues exceed projected revenues. The appropriation does not include an amount for prizes because Lottery statutes set this amount at "not less than fifty percent of the total annual revenues accruing from the sale of Lottery tickets or shares."

The Lottery's appropriation was $49.6 million at the beginning of the year and increased to $63.8 million as actual revenues exceeded projections.

CONTACTING THE LOTTERY'S FINANCIAL MANAGEMENT

This management's discussion and analysis ("MD&A") is designed to provide Arizona citizens, Arizona government officials, our players, retailers and other interested parties with an overview of the Lottery's financial activity for Fiscal Year 2005 and to demonstrate the Lottery's accountability for the money it received from the sale of Lottery products.

If you have questions about the MD&A or need additional information, contact the Arizona Lottery's Director of Audit and Accounting, 4740 East University, Phoenix, Arizona 85034.

J. Art Macias, Jr.
Executive Director

William B. Kaehler
Director of Audit & Accounting

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA
PROPRIETARY FUND—ENTERPRISE FUND

STATEMENT OF NET ASSETS
AS OF JUNE 30, 2005
(With comparative totals for June 30, 2004)

	2005	2004
ASSETS		
CURRENT ASSETS:		
Cash—substantially all held by the State Treasurer	$50,193,176	$39,042,684
Accounts receivable, net of allowance for doubtful accounts of $155,000 in 2005 and 2004	6,387,620	5,223,509
Scratch ticket inventory	2,327,466	1,555,149
Total current assets	58,908,262	45,821,342
CAPITAL ASSETS:		
Land	937,830	937,830
Land improvements	330,865	330,865
Buildings	3,299,667	3,158,251
Furniture, fixtures, and equipment	3,904,092	3,848,577
Construction in progress		94,370
Less accumulated depreciation	(5,032,724)	(4,889,227)
Total capital assets	3,439,730	3,480,666
OTHER ASSETS—Deposit—Powerball	6,729,549	7,208,027
TOTAL	69,077,541	56,510,035
LIABILITIES		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	3,095,229	2,401,422
Prize liability	30,068,491	29,378,369
Due to other state funds	24,693,534	14,146,573
TOTAL	57,857,254	45,926,364
NET ASSETS		
INVESTED IN CAPITAL ASSETS	3,439,730	3,480,666
UNRESTRICTED	7,780,557	7,103,005
TOTAL	$11,220,287	$10,583,671

See notes to financial statements.

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA
PROPRIETARY FUND—ENTERPRISE FUND

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN FUND NET ASSETS
FOR THE YEAR ENDED JUNE 30, 2005
(With comparative totals for the year ended June 30, 2004)

	2005	2004
OPERATING REVENUES:		
Ticket sales:		
Scratchers	$208,284,696	$172,861,514
Economic development	11,367,497	10,392,547
Powerball	106,477,985	132,776,171
The Pick	54,817,647	34,028,254
Fantasy 5	9,428,373	9,669,338
Pick 3	7,184,747	6,854,281
Total ticket sales	397,560,945	366,582,105
Other operating revenue	45,854	135,018
Total operating revenues	397,606,799	366,717,123
OPERATING EXPENSES:		
Direct costs:		
Prize expense	220,297,791	200,302,437
Retailer commissions and incentives	26,505,430	24,501,412
On-line system expenses	10,530,451	11,482,112
Scratcher system and distribution expenses	1,726,770	1,513,464
Tickets purchased	3,758,966	3,643,963
Total direct costs	262,819,408	241,443,388
Advertising and promotion	10,512,525	9,632,149
Wages and related expenses	5,409,808	5,226,991
Contract services	300,007	384,896
Depreciation	189,719	176,107
Administrative expenses	2,259,165	1,876,589
Total operating expenses	281,490,632	258,740,120
OPERATING INCOME	116,116,167	107,977,003
NONOPERATING REVENUES	913,367	334,961
INCOME BEFORE TRANSFERS	117,029,534	108,311,964
TRANSFERS TO OTHER STATE FUNDS	116,392,918	107,757,710
CHANGE IN FUND NET ASSETS	636,616	554,254
FUND NET ASSETS—Beginning of year	10,583,671	10,029,417
FUND NET ASSETS—End of year	$ 11,220,287	$ 10,583,671

See notes to financial statements.

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA
PROPRIETARY FUND—ENTERPRISE FUND

STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED JUNE 30, 2005
(With comparative totals for the year ended June 30, 2004)

	2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from retailers—net of commission and incentives	$217,648,757	$214,565,617
Cash from other sources	17,135,947	10,401,307
Cash payments for prizes and related taxes	(83,993,721)	(79,311,966)
Cash payments to suppliers of goods or services	(28,541,906)	(30,469,128)
Cash payments to employees	(5,459,892)	(5,202,046)
Net cash provided by operating activities	116,789,185	109,983,784
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES—Cash payments to beneficiaries per Lottery Statutes	(105,845,957)	(105,893,583)
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES—Payments for acquisition of capital assets	(153,682)	(153,428)
CASH FLOWS FROM INVESTING ACTIVITIES—Receipts of interest	360,946	168,446
NET INCREASE IN CASH	11,150,492	4,105,219
CASH—Beginning of year	39,042,684	34,937,465
CASH—End of year	$ 50,193,176	$ 39,042,684
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	$116,116,167	$107,977,003
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	189,719	176,107
Loss on disposal of equipment	4,899	
Changes in assets and liabilities:		
Accounts receivable and due from other State agencies	(611,690)	1,372,320
Ticket inventory	(772,317)	(306,768)
Deposit—Powerball	478,478	(184,604)
Accounts payable and accrued expenses	693,807	(1,652,972)
Prizes and withholdings payable	690,122	2,602,698
Total adjustments	673,018	2,006,781
NET CASH PROVIDED BY OPERATING ACTIVITIES	$116,789,185	$109,983,784

See notes to financial statements.

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

NOTES TO FINANCIAL STATEMENTS
AS OF AND FOR THE YEAR ENDED JUNE 30, 2005

1. DESCRIPTION OF OPERATIONS

The Arizona State Lottery (the "Lottery") was created by enactment of Title 5, Chapter 5 to the Arizona Revised Statutes, which was an initiative measure approved by the voters of the State of Arizona in 1980. The Lottery commenced operations in 1981. The Lottery is a component unit of the State of Arizona (the "State"). The accompanying financial statements present information as to the transactions of the Lottery.

For the period July 1, 2004 through June 30, 2005, the Lottery held 82 instant games (games 257, 300, 357, 360–361, 371, 374, 377–383, 385-386, 389–391, 393–395, 397–449, 452–453, 455–456, 460, and 464), four of which were Economic Development games (games 377, 393, 412, and 436). During 2005, the Lottery continued the "Pick 3," "Fantasy 5," "The Pick," and "Powerball" on-line games. As required, the Lottery has a deposit with "Powerball," a multistate on-line lottery game, of $6,729,549.

2. SIGNIFICANT ACCOUNTING POLICIES

The Lottery prepares its financial statements in accordance with accounting principles generally accepted in the United States of America.

State Lottery Fund—The State Lottery Fund (the "Fund"), which is an Enterprise Fund of the State of Arizona, accounts for revenues received from the sale of lottery tickets and the receipt of license fees. The Fund is operated in a manner similar to a private business enterprise where the governing body has decided that periodic determination of revenues earned, expenses incurred, and net income is appropriate for capital maintenance, management control, accountability, or other purposes. Activities accounted for in the proprietary fund follow all applicable Government Accounting Standards Board ("GASB") pronouncements as well as applicable Financial Accounting Standards Board ("FASB") pronouncements issued on or before November 30, 1989. The Fund accounts for prize payments, operational expenses, including consulting, promotional and advertising expenses, and transfers of monies to other State funds. Receipts from each type of lottery game are to be allocated as follows:

- Not less than 50% of the total annual revenue from lottery ticket sales is apportioned for the payment of prizes to the holders of winning tickets for the period July 1, 2004 to June 30, 2005.

- During the period of July 1, 2004 to June 30, 2005, not less than 29% of receipts for "Fantasy 5," "Pick 3," and "The Pick," not less than 31.6% of receipts for "Powerball," and not less than 21.5% of receipts for instant games must be apportioned for transfer to a designated State fund.

- Expenditures related to promotional or advertising services are restricted to not more than 4.0% of the total annual gross revenues of the Lottery. Legislative appropriation further restricted advertising expenditures to 2.7% of the gross revenues during fiscal years 2005 and 2004. All other receipts can be used by the Lottery for operations or transferred to other State funds.

In addition, State statute requires that 30% of all unclaimed prizes be transferred to the Court Appointed Special Advocate Account, a fund within the State's General Fund.

Ticket Sales and Revenue Recognition—Revenue is recognized and the related direct expenses of ticket sales are accrued based upon the known relationship of the amount of ticket sales to the amount of prizes for each game. This method of measuring revenue is necessary in order to properly match revenues and expenses.

Property and Equipment—Property and equipment of the Fund, which consists principally of buildings, land, land improvements, and office furniture and equipment are stated at historical cost. Expenditures for normal repairs and maintenance are charged to operations as incurred, whereas expenditures for major renewals, replacements, and betterments are capitalized and depreciated. Depreciation is provided for as follows:

	Method	Estimated Useful Life
Buildings	Straight-line	40 years
Land improvements	Straight-line	20 years
Furniture, fixtures, and computer equipment	Straight-line	5–7 years

Investment Income—Investment income from all investments is recognized in the Fund. An amount equal to the calculated amount of earnings on the State Lottery Prize Fund cash balances is transferred to the Prize Fund.

Ticket Inventory—Ticket inventory is stated at cost, which represents the amount incurred by the Lottery for purchasing the tickets.

Cash—Substantially all the Lottery's cash is held by the State Treasurer for pooled investment purposes. Statutes require the State Treasurer to invest these pooled funds in obligations of the U.S. government and are recorded at fair value.

Compensated Absences—Vacation leave vests with the employee as it is earned. Employees may carry forward only the amount of vacation benefits equal to the maximum allowable accumulated credits for the preceding calendar year. Accordingly, at June 30, 2005, the Fund's accounts payable balance includes an accrual of vacation pay and related benefits of approximately $311,100. Upon termination or retirement, an employee will be compensated for accumulated leave up to a maximum of 240 hours, dependent upon accumulated time and the individual's benefits associated with their rank as defined by State personnel rule #R2-5-403. Payment will be based on the individual's rate of pay at termination or retirement. Upon death, the same benefits shall be paid to the employee's beneficiary.

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 these estimates.

3. TRANSFERS AND STATUTORY REQUIREMENTS

The Lottery made the following transfers during the year ended June 30, 2005, as required by Arizona Revised Statutes ("ARS") Section 5-505.

Transfers to the State of Arizona:	
County Assistance Fund	$ 7,650,000
Court Appointed Special Advocate Account	2,648,918
Department of Gaming	300,000
General Fund	37,750,900
Healthy Arizona Fund	17,000,000
Heritage Fund	20,000,000
Local Transportation Assistance Fund	28,084,700
Economic Development Commission Fund	2,958,400
Total transfers to other State of Arizona funds	$ 116,392,918

These transactions met the minimum percentage requirements imposed upon the Lottery by statute.

4. CAPITAL ASSETS

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

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets:				
Land	$ 937,830	$ -	$ -	$ 937,830
Land improvements	330,865			330,865
Buildings	3,158,251	141,416		3,299,667
Furniture, fixtures, and equipment	3,848,577	106,636	(51,121)	3,904,092
Construction in progress	94,370	(94,370)		
Total capital assets	8,369,893	153,682	(51,121)	8,472,454
Less accumulated depreciation for:				
Land improvements	(280,267)	(27,181)		(307,448)
Buildings	(1,105,975)	(63,880)		(1,169,855)
Furniture, fixtures, and equipment	(3,502,985)	(98,658)	46,222	(3,555,421)
Total accumulated depreciation	(4,889,227)	(189,719)	46,222	(5,032,724)
Total capital assets—net	$ 3,480,666	$ (36,037)	$ (4,899)	$ 3,439,730

5. PRIZE LIABILITY

Prize liability activity for the year ended June 30, 2005, was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Prize liability	$ 29,378,369	$ 223,036,122	$ (222,346,000)	$ 30,068,491

6. COMMITMENTS

The Lottery enters into various contracts for goods and services during the normal course of its business. All contacts and purchasing activity are subject to the Arizona State Procurement Code and the rules of the Arizona State Procurement Office. All contracts have incorporated into them the "Standard Terms and Conditions" as required by the Arizona State Procurement Office. These terms and conditions in all the contracts allow for cancellation for lack of funding in the current fiscal year or next fiscal year. The contract may also be terminated for the Lottery's convenience at any time with no penalty when it is in the best interest of the State.

Net rental expense for the years ended June 30, 2005 and 2004, was $65,311 and $59,225, respectively.

Effective September 2, 1999, the Lottery entered into a five-year contract with G-Tech Services, Inc. for computer processing services at a base contract rate of 4.9854% of on-line sales. The Lottery has exercised an option to extend the contract through August 31, 2006, and as of September 1, 2005, the base contract rate was reduced to 4.50% for the remainder of the contract term. Subsequent to the year ending June 30, 2005, the Lottery entered into a new five-year contract, effective September 1, 2006, with this vendor at a base contract rate of 3.5455% of on-line sales.

7. CONTINGENCIES

Annuities are purchased for all prizes over $400,000 for which winners will receive the jackpot in annual installments for The Pick on-line game. These annuities are purchased from qualifying insurance companies, which have the highest ratings from among A.M. Best Company, Standard & Poor's, Moody, Duff & Phelps, or Weiss. The Lottery remains contingently liable on all annuities. Aggregate future payments to prize winners on existing annuities totaled approximately $196,281,000 at June 30, 2005. Approximately $140,626,000 of the total aggregate future payments at June 30, 2005, relate to annuities purchased from five separate insurance companies, of which approximately $57,771,000 relates to a single insurance company.

In 1994, an insurance company from which the Lottery purchased annuities during the period 1983 through 1989 was placed under State supervision. At June 30, 2005, remaining aggregate minimum future payments on such purchased annuities approximated $2,728,000. In 1997, an insurance company from which the Lottery purchased annuities in 1986 was placed under State supervision. At June 30, 2005, remaining aggregate minimum future payments on such purchased annuities approximated $279,000. As of February 28, 2006, both insurance companies were current in their required annuity payments. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the operations or financial position of the Lottery.

The Lottery is involved in various legal proceedings, which arose in the normal course of business. Management of the Lottery does not believe that the ultimate resolution of these matters will have a material effect on the financial position, results of operations, or cash flows of the Lottery.

8. RETIREMENT PLAN

Permanent, full-time employees of the Lottery are covered by the Arizona State Retirement Plan (the "Plan"), a retirement plan administered by the Arizona State Retirement System ("ASRS"), which is a multiple employer, cost-sharing pension plan. The Comprehensive Annual Financial Report of the ASRS can be obtained by accessing www.asrs.state.az.us. The Plan was established by the State to provide benefits for employees of the State and employees of participating political subdivisions and school districts. The Plan became effective on July 1, 1971. By actuarial computation, employee

member contributions to the Plan were fixed at 5.20%, 5.20%, and 2.00% of their compensation for the years ended June 30, 2005, 2004, and 2003, respectively, with the contributions made through payroll deduction. Employee contributions vest immediately. Total contributions to the Plan for the years ended June 30, 2005, 2004, and 2003 by the Lottery's covered employees were $214,819, $206,574, and $85,146, respectively.

Matching employer member contributions were actuarially determined and fixed at 5.20%, 5.20%, and 2.00% of the compensation of all employee members for the years ended June 30, 2005, 2004, and 2003, respectively. Total matching contributions to the Plan for the years ended June 30, 2005, 2004, and 2003 by the Lottery were $214,819, $206,574, and $85,146, respectively. In the event the Plan's actuary determines that additional contributions are needed in order to amortize an unfunded accrued liability, every employer member will be required to contribute the revised contribution percentage that is set by the Plan.

All full-time employees of the Lottery are required to become members of the Plan. The Lottery's total payroll for employees covered by this Plan for the years ended June 30, 2005, 2004, and 2003 was $4,163,347, $4,056,215, and $4,288,181, respectively. Contributions to the Plan by the Lottery for its covered employees become fully vested immediately after membership in the Plan. All required employer contributions were made to the Plan within 30 days after June 30, 2005.

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SUPPLEMENTAL SCHEDULE

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

SUPPLEMENTAL SCHEDULE OF GROSS PROFIT BY GAME
FOR GAMES EXPIRING DURING THE YEAR ENDED JUNE 30, 2005

	Game 257		Game 300		Game 357	
TICKET SALES	$ 100,674,662	100.00 %	$ 59,524,672	100.00 %	$ 1,391,485	100.00 %
DIRECT EXPENSES:						
Commissions	6,543,854	6.50	3,869,103	6.50	90,447	6.50
Prizes—low tier	44,905,932	44.60	32,959,103	55.37	695,743	50.00
Prizes—high tier	15,034,450	14.93	2,392,850	4.02	79,650	5.72
Total prizes	59,940,382	59.53	35,351,953	59.39	775,393	55.72
Ticket purchases	1,499,277	1.49	942,422	1.58	36,200	2.60
Advertising	16,979	0.02				
Total direct expenses	68,000,492	67.54	40,163,478	67.47	902,040	64.83
GROSS PROFIT BY GAME	$ 32,674,170	32.46	$ 19,361,194	32.53	$ 489,445	35.17

	Game 366		Game 370		Game 372	
TICKET SALES	$ 4,095,085	100.00 %	$ 1,373,363	100.00 %	$ 1,453,683	100.00 %
DIRECT EXPENSES:						
Commissions	266,182	6.50	89,269	6.50	94,490	6.50
Prizes—low tier	2,047,543	50.00	727,882	53.00	712,305	49.00
Prizes—high tier	584,350	14.27	37,199	2.71	98,350	6.77
Total prizes	2,631,893	64.27	765,081	55.71	810,655	55.77
Ticket purchases	70,634	1.72	36,268	2.64	47,144	3.24
Advertising	181,066					
Total direct expenses	3,149,775	76.92	890,618	64.85	952,289	65.51
GROSS PROFIT BY GAME	$ 945,310	23.08	$ 482,745	35.15	$ 501,394	34.49

	Game 374		Game 375		Game 376	
TICKET SALES	$ 3,123,438	100.00 %	$ 1,678,814	100.00 %	$ 1,589,361	100.00 %
DIRECT EXPENSES:						
Commissions	203,023	6.50	109,124	6.50	103,310	6.50
Prizes—low tier	1,436,781	46.00	889,772	53.00	842,361	53.00
Prizes—high tier	429,000	13.73	58,992	3.51	53,190	3.35
Total prizes	1,865,781	59.73	948,764	56.51	895,551	56.35
Ticket purchases	54,676	1.75	38,821	2.31	36,114	2.27
Advertising						
Total direct expenses	2,123,480	67.99	1,096,709	65.33	1,034,975	65.12
GROSS PROFIT BY GAME	$ 999,958	32.01	$ 582,105	34.67	$ 554,386	34.88

(Continued)

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

SUPPLEMENTAL SCHEDULE OF GROSS PROFIT BY GAME
FOR GAMES EXPIRING DURING THE YEAR ENDED JUNE 30, 2005

	Game 377		Game 378		Game 379	
TICKET SALES	$ 6,587,883	100.00 %	$ 5,640,690	100.00 %	$ 2,764,516	100.00 %
DIRECT EXPENSES:						
Commissions	428,215	6.50	366,645	6.50	179,693	6.50
Prizes—low tier	2,305,759	35.00	2,820,345	50.00	1,354,613	49.00
Prizes—high tier	2,071,247	31.44	715,250	12.68	296,650	10.73
Total prizes	4,377,006	66.44	3,535,595	62.68	1,651,263	59.73
Ticket purchases	88,213	1.34	60,135	1.07	65,707	2.38
Advertising	18,438	0.28	61,195			
Total direct expenses	4,911,872	74.56	4,023,570	71.33	1,896,663	68.61
GROSS PROFIT BY GAME	$ 1,676,011	25.44	$ 1,617,120	28.67	$ 867,853	31.39

	Game 380		Game 381		Game 382	
TICKET SALES	$ 2,854,024	100.00 %	$ 11,142,570	100.00 %	$ 1,682,134	100.00 %
DIRECT EXPENSES:						
Commissions	185,511	6.50	724,267	6.50	109,341	6.50
Prizes—low tier	1,427,012	50.00	3,815,216	34.24	841,067	50.00
Prizes—high tier	268,600	9.41	2,866,550	25.73	98,800	5.87
Total prizes	1,695,612	59.41	6,681,766	59.97	939,867	55.87
Ticket purchases	63,576	2.23	74,514	0.66	36,416	2.16
Advertising			40,647			
Total direct expenses	1,944,699	68.14	7,521,194	67.50	1,085,624	64.54
GROSS PROFIT BY GAME	$ 909,325	31.86	$ 3,621,376	32.50	$ 596,510	35.46

	Game 384		Game 385		Game 386	
TICKET SALES	$ 1,212,367	100.00 %	$ 2,347,698	100.00 %	$ 3,453,795	100.00 %
DIRECT EXPENSES:						
Commissions	78,805	6.50	152,601	6.50	224,500	6.50
Prizes—low tier	581,936	48.00	1,079,942	46.00	1,726,898	50.00
Prizes—high tier	91,650	7.56	321,075	13.68	515,620	14.93
Total prizes	673,586	55.56	1,401,017	59.68	2,242,518	64.93
Ticket purchases	37,287	3.08	45,404	1.93	88,515	2.56
Advertising						
Total direct expenses	789,678	65.14	1,599,022	68.11	2,555,533	73.99
GROSS PROFIT BY GAME	$ 422,689	34.86	$ 748,676	31.89	$ 898,262	26.01

(Continued)

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

SUPPLEMENTAL SCHEDULE OF GROSS PROFIT BY GAME
FOR GAMES EXPIRING DURING THE YEAR ENDED JUNE 30, 2005

	Game 387		Game 388		Game 389	
TICKET SALES	$ 1,403,500	100.00 %	$ 1,173,865	100.00 %	$ 1,726,556	100.00 %
DIRECT EXPENSES:						
Commissions	91,228	6.50	76,303	6.50	112,226	6.50
Prizes—low tier	659,645	47.00	575,194	49.00	897,809	52.00
Prizes—high tier	185,300	13.20	76,550	6.52	83,000	4.81
Total prizes	844,945	60.20	651,744	55.52	980,809	56.81
Ticket purchases	37,012	2.64	37,260	3.17	35,966	2.08
Advertising						
Total direct expenses	973,185	69.34	765,307	65.20	1,129,001	65.39
GROSS PROFIT BY GAME	$ 430,315	30.66	$ 408,558	34.80	$ 597,555	34.61

	Game 391		Game 392		Game 393	
TICKET SALES	$ 3,007,566	100.00 %	$ 1,617,473	100.00 %	$ 5,164,625	100.00 %
DIRECT EXPENSES:						
Commissions	195,491	6.50	105,138	6.50	335,701	6.50
Prizes—low tier	1,383,480	46.00	824,911	51.00	2,065,850	40.00
Prizes—high tier	407,900	13.56	87,900	5.43	1,202,450	23.28
Total prizes	1,791,380	59.56	912,811	56.43	3,268,300	63.28
Ticket purchases	46,031	1.53	39,825	2.46	65,941	1.28
Advertising					4,688	0.09
Total direct expenses	2,032,902	67.59	1,057,774	65.40	3,674,630	71.15
GROSS PROFIT BY GAME	$ 974,664	32.41	$ 559,699	34.60	$ 1,489,995	28.85

	Game 394		Game 395		Game 396	
TICKET SALES	$ 11,223,550	100.00 %	$ 2,936,314	100.00 %	$ 1,689,233	100.00 %
DIRECT EXPENSES:						
Commissions	729,531	6.50	190,860	6.50	109,801	6.50
Prizes—low tier	4,489,420	40.00	1,556,246	53.00	827,724	49.00
Prizes—high tier	2,783,950	24.80	217,150	7.40	125,730	7.44
Total prizes	7,273,370	64.80	1,773,396	60.40	953,454	56.44
Ticket purchases	70,949	0.63	101,217	3.45	36,416	2.16
Advertising	134,897	1.20	7,484	0.25		0.00
Total direct expenses	8,208,747	73.14	2,072,957	70.60	1,099,671	65.10
GROSS PROFIT BY GAME	$ 3,014,803	26.86	$ 863,357	29.40	$ 589,562	34.90

(Continued)

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

SUPPLEMENTAL SCHEDULE OF GROSS PROFIT BY GAME
FOR GAMES EXPIRING DURING THE YEAR ENDED JUNE 30, 2005

	Game 397		Game 398		Game 399	
TICKET SALES	$ 3,403,424	100.00 %	$ 1,240,959	100.00 %	$ 1,685,370	100.00 %
DIRECT EXPENSES:						
Commissions	221,223	6.50	80,663	6.50	109,550	6.50
Prizes—low tier	1,633,644	48.00	645,299	52.00	842,686	50.00
Prizes—high tier	394,500	11.59	47,550	3.83	97,750	5.80
Total prizes	2,028,144	59.59	692,849	55.83	940,436	55.80
Ticket purchases	86,751	2.55	37,287	3.00	36,175	2.15
Advertising						
Total direct expenses	2,336,118	68.64	810,799	65.34	1,086,161	64.45
GROSS PROFIT BY GAME	$ 1,067,306	31.36	$ 430,160	34.66	$ 599,209	35.55

	Game 402		Game 405		Game 406	
TICKET SALES	$ 2,136,314	100.00 %	$ 3,428,902	100.00 %	$ 1,661,301	100.00 %
DIRECT EXPENSES:						
Commissions	138,861	6.50	222,879	6.50	107,985	6.50
Prizes—low tier	1,068,157	50.00	1,474,428	43.00	863,876	52.00
Prizes—high tier	199,350	9.33	582,470	16.99	68,800	4.14
Total prizes	1,267,507	59.33	2,056,898	59.99	932,676	56.14
Ticket purchases	50,071	2.34	58,005	1.69	36,268	2.18
Advertising			172	0.01		
Total direct expenses	1,456,439	68.18	2,337,954	68.18	1,076,929	64.82
GROSS PROFIT BY GAME	$ 679,875	31.82	$ 1,090,948	31.82	$ 584,372	35.18

	Game 410		Game 411		Game 426	
TICKET SALES	$ 1,695,016	100.00 %	$ 1,155,498	100.00 %	$ 1,098,202	100.00 %
DIRECT EXPENSES:						
Commissions	110,176	6.50	75,109	6.50 %	71,384	6.50
Prizes—low tier	762,758	45.00	600,859	52.00 %	549,101	50.00
Prizes—high tier	240,801	14.21	44,250	3.83 %	69,120	6.29
Total prizes	1,003,559	59.21	645,109	55.83 %	618,221	56.29
Ticket purchases	41,093	2.42	37,234	3.22 %	36,962	3.37
Advertising						
Total direct expenses	1,154,828	68.13	757,452	65.55 %	726,567	66.16
GROSS PROFIT BY GAME	$ 540,188	31.87	$ 398,046	34.45 %	$ 371,635	33.84

(Continued)

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

SUPPLEMENTAL SCHEDULE OF GROSS PROFIT BY GAME
FOR GAMES EXPIRING DURING THE YEAR ENDED JUNE 30, 2005

	Game 427		Game 428	
TICKET SALES	$ 1,126,412	100.00 %	$ 1,658,642	100.00 %
DIRECT EXPENSES:				
Commissions	73,218	6.50	107,812	6.50
Prizes—low tier	585,734	52.00	829,321	50.00
Prizes—high tier	67,800	6.02	166,852	10.06
Total prizes	653,534	58.02	996,173	60.06
Ticket purchases	34,870	3.10	36,958	2.23
Advertising		0.00	123,104	7.42
Total direct expenses	761,622	67.61	1,264,047	76.21
GROSS PROFIT BY GAME	$ 364,790	32.39	$ 394,595	23.79

(Continued)

ARIZONA STATE LOTTERY,
A COMPONENT UNIT OF THE STATE OF ARIZONA

SUPPLEMENTAL SCHEDULE OF GROSS PROFIT BY GAME
FOR GAMES EXPIRING DURING THE YEAR ENDED JUNE 30, 2005

	Pick Drawings (1/1/04–12/31/04)		Fantasy 5 Drawings (1/1/04–12/31/04)		Powerball Drawings (1/1/04–12/31/04)	
TICKET SALES	$ 45,925,520	100.00 %	$ 9,611,836	100.00 %	$ 110,590,804	100.00 %
DIRECT EXPENSES:						
Commissions	2,985,188	0.07	624,795	6.50	7,188,433	6.50
Total prizes	23,479,128	0.51	4,565,621	51.12	55,295,402	50.00
Advertising	2,409,622	0.05		5.25	856,202	0.77
Total direct expenses	28,873,938	0.63	5,190,416	62.87	63,340,037	57.27
GROSS PROFIT BY GAME	$ 17,051,582	0.37	$ 4,421,420	37.13	$ 47,250,767	42.73

	Pick 3 Drawings (1/1/04–12/31/04)	
TICKET SALES	$ 6,966,364	100.00 %
DIRECT EXPENSES:		
Commissions	452,830	6.50
Total prizes	3,483,182	50.00
Advertising	156,171	2.24
Total direct expenses	4,092,183	58.74
GROSS PROFIT BY GAME	$ 2,874,181	41.26

NOTE: After the announced completion of ticket sales for each game, customers have a 180-day period in which to redeem their winning tickets. The above gross profit information includes games in which the 180-day grace period expired during the fiscal year ended June 30, 2005.

(Concluded)