

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

*Financial Statements as of and for the
Year Ended June 30, 2006, Supplemental
Schedule for the Year Ended June 30, 2006,
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

December 11, 2006

Dear Arizona Lottery Commissioners:

The Arizona Lottery is pleased to submit its audited financial statements for the year ended June 30, 2006, as prepared 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-five 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 2006, the Arizona Lottery had revenues of \$468.7 million from Lottery ticket sales, 17.9% greater than last fiscal year, and an income before transfers of \$141.2 million, 20.7% greater than last fiscal year. More than \$259 million was paid to our players in prizes and our retail partners received \$31.3 million for sales commissions. In its twenty-five years of operation, the Lottery has produced nearly \$6.0 billion in Lottery ticket sales.

In fiscal year 2006, the Arizona Lottery made transfers to other State funds of \$41.0 million for the Local Transportation Assistance Fund, \$7.7 million for the County Assistance Fund, \$20.0 million for the Heritage Fund, \$4.0 million for the Economic Development Fund, \$0.3 million

for the Department of Gaming, \$20.0 million for the Healthy Arizona Fund, and \$45.3 million was transferred to the State General Fund for allocation by the state legislature. In addition, from the Lottery Prize Fund, over \$2.8 million was transferred to the Court Appointed Special Advocate (CASA). In total, \$141.1 million was transferred to other State Funds for FY 2006. In its twenty-five years of operation, the Lottery has returned nearly \$2.0 billion to its beneficiaries.

Further financial results for fiscal year 2006 are detailed in Management's Discussion and Analysis, included in this report.

Sincerely,

A handwritten signature in black ink, appearing to read "J. Art Macias Jr.", written in a cursive style.

J. Art Macias Jr.
Executive Director

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, 2006, 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 *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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. Accordingly, we express no such opinion. 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, 2006, 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 December 11, 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

December 11, 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, 2006

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, 2006, and should be read in conjunction with the Lottery's financial statements and notes to the financial statements.

This annual report consists 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, 2006, with comparative totals for June 30, 2005. 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 period.

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, 2006 were the highest in the Lottery's twenty-five year history. As shown in the financial statements, sales increased 17.9% from the prior year, from \$397.6 million in Fiscal Year 2005 to \$468.7 million in the current year. The increases in ScratchersSM, Powerball[®], Fantasy 5TM, and Pick 3TM sales more than offset the decreases in The PickTM sales.

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

Product Sales	FY 2006	FY 2005	Difference	Percentage
Scratchers (including economic development)	\$249.8	\$219.7	\$30.1	13.7%
Powerball	157.9	106.5	51.4	48.3%
The Pick	43.1	54.8	-11.7	-21.4%
Fantasy 5	10.0	9.4	0.6	6.4%
Pick 3	7.9	7.2	0.7	9.7%
Total	\$468.7	\$397.6	\$71.1	17.9%

Total Revenues

Nonoperating revenues for the year ended June 30, 2006 were \$765,000 as compared to \$913,000 for the year ended June 30, 2005. Nonoperating revenue is comprised of interest earned on invested cash. The decrease of \$148,000 is primarily due to the reallocation of MUSL Prize Reserves that occurred in FY 2005. No reallocation occurred in FY 2006.

Total revenues were \$469.5 million for the year ended June 30, 2006 as compared to \$398.5 million for the year ended June 30, 2005. As mentioned above, the majority of the increase was due to the increase in sales revenues.

Major Expenses

\$308.6 million of the Lottery's total operating expenses of \$328.3 million for the year ended June 30, 2006 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, \$262.8 million of the Lottery's total operating expenses of \$281.5 million for the year ended June 30, 2005 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 2006	FY 2005	Difference	Percentage
Prize Expense	\$259.1	\$220.3	\$38.8	17.6%
Retailer Commissions	31.3	26.5	4.8	18.1%
On-line System Expenses	12.2	10.5	1.7	16.2%
Scratchers System and Distribution Expenses	1.9	1.7	.2	11.8%
Tickets Purchased	4.1	3.8	.3	7.9%
Total	\$308.6	\$262.8	\$45.8	17.4%

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 increase 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 fees directly increased with the higher level of on-line sales. The second element is the telecommunications costs associated with the Lottery retailer network which decreased \$59,800 this fiscal year.

The Lottery's contract with an outside vendor for Scratchers ticket distribution and accounting services resulted in increased costs of \$196,200 over last fiscal year because of higher Scratchers sales.

Of the \$19.7 million in Fiscal Year 2006 in other operating expenses, \$11.0 million was used for advertising and promotion and \$5.7 million was used to compensate Lottery employees. In comparison, of the \$18.7 million in Fiscal Year 2005 other operating expenses, \$10.5 million was used for advertising and promotion and \$5.4 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 \$141.1 million to other State Funds. The increase in product sales of \$71.1 million in this fiscal year resulted in an increase of \$24.7 million in the amount transferred to other State Funds. This year's transfers included \$17.0 million above the minimum transfers required in Lottery Statutes.

Other Financial Information

The Lottery's total assets at June 30, 2006 were \$74.0 million. Assets consisted of cash held substantially by the State Treasurer of \$56.6 million, receivables from Lottery retailers for the sale of Lottery products of \$3.5 million, Scratchers ticket inventory of \$2.9 million, net investment in fixed assets of \$3.7 million and a deposit with MUSL of \$7.3 million.

Comparable figures at June 30, 2005 were \$69.1 million in total assets, including \$50.2 million in cash held by the State Treasurer, \$6.4 million in receivables from retailers, \$2.3 million in Scratchers ticket inventory, net investment in fixed assets of \$3.4 million and a MUSL deposit of \$6.7 million.

Total liabilities at June 30, 2006 were \$62.7 million, consisting of \$2.9 million in accounts payable and accrued expenses, prize liabilities of \$34.9 million and amounts due to other State Funds of \$25.0 million. All of the Lottery's liabilities were current liabilities.

The Lottery's total liabilities at June 30, 2005 were \$57.9 million, which consisted of \$3.1 million of accounts payable and accrued expenses, prize liabilities of \$30.1 million and amounts due to other State Funds of \$24.7 million. All liabilities were current liabilities.

Total net assets at June 30, 2006 were \$11.3 million, an increase of \$0.1 million or 1.0% over total net assets at June 30, 2005. \$7.6 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 2007 and 2006 were set in the regular legislative session of 2005. 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 \$60.2 million at the beginning of the year and increased to \$72.5 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 2006 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, 2006
(With comparative totals for June 30, 2005)**

	2006	2005
ASSETS		
CURRENT ASSETS:		
Cash—substantially all held by the State Treasurer	\$ 56,615,737	\$ 50,193,176
Accounts receivable, net of allowance for doubtful accounts of \$155,000	3,489,195	6,387,620
Scratch ticket inventory	<u>2,897,235</u>	<u>2,327,466</u>
Total current assets	<u>63,002,167</u>	<u>58,908,262</u>
CAPITAL ASSETS:		
Land	937,830	937,830
Land improvements	330,865	330,865
Buildings	3,299,667	3,299,667
Furniture, fixtures, and equipment	4,074,410	3,904,092
Construction in progress	171,859	
Less accumulated depreciation	<u>(5,142,216)</u>	<u>(5,032,724)</u>
Total capital assets	<u>3,672,415</u>	<u>3,439,730</u>
OTHER ASSETS—Deposit—Powerball	<u>7,315,835</u>	<u>6,729,549</u>
TOTAL	<u>73,990,417</u>	<u>69,077,541</u>
LIABILITIES		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	2,862,236	3,095,229
Prize liability	34,855,944	30,068,491
Due to other state funds	<u>24,980,485</u>	<u>24,693,534</u>
TOTAL	<u>62,698,665</u>	<u>57,857,254</u>
NET ASSETS		
INVESTED IN CAPITAL ASSETS	3,672,415	3,439,730
UNRESTRICTED	<u>7,619,337</u>	<u>7,780,557</u>
TOTAL	<u>\$ 11,291,752</u>	<u>\$ 11,220,287</u>

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, 2006
(With comparative totals for the year ended June 30, 2005)**

	2006	2005
OPERATING REVENUES:		
Ticket sales:		
Scratchers	\$ 234,854,290	\$ 208,284,696
Economic development	14,975,015	11,367,497
Powerball	157,891,886	106,477,985
The Pick	43,064,318	54,817,647
Fantasy 5	9,988,384	9,428,373
Pick 3	<u>7,922,934</u>	<u>7,184,747</u>
Total ticket sales	468,696,827	397,560,945
Other operating revenue	<u>81,408</u>	<u>45,854</u>
Total operating revenues	<u>468,778,235</u>	<u>397,606,799</u>
OPERATING EXPENSES:		
Direct costs:		
Prize expense	259,093,779	220,297,791
Retailer commissions and incentives	31,275,665	26,505,430
On-line system expenses	12,187,053	10,530,451
Scratcher system and distribution expenses	1,923,011	1,726,770
Tickets purchased	<u>4,092,461</u>	<u>3,758,966</u>
Total direct costs	308,571,969	262,819,408
Advertising and promotion	10,986,062	10,512,525
Wages and related expenses	5,656,855	5,409,808
Contract services	316,568	300,007
Depreciation	214,706	189,719
Administrative expenses	<u>2,601,547</u>	<u>2,259,165</u>
Total operating expenses	<u>328,347,707</u>	<u>281,490,632</u>
OPERATING INCOME	140,430,528	116,116,167
NONOPERATING REVENUES	<u>764,556</u>	<u>913,367</u>
INCOME BEFORE TRANSFERS	141,195,084	117,029,534
TRANSFERS TO OTHER STATE FUNDS	<u>141,123,619</u>	<u>116,392,918</u>
CHANGE IN FUND NET ASSETS	71,465	636,616
FUND NET ASSETS—Beginning of year	<u>11,220,287</u>	<u>10,583,671</u>
FUND NET ASSETS—End of year	<u>\$ 11,291,752</u>	<u>\$ 11,220,287</u>

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, 2006
(With comparative totals for the year ended June 30, 2005)**

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Cash received from retailers—net of commission and incentives	\$267,416,157	\$217,648,757
Cash from other sources	13,151,549	17,135,947
Cash payments for prizes and related taxes	(94,667,102)	(83,993,721)
Cash payments to suppliers of goods or services	(32,971,691)	(28,541,906)
Cash payments to employees	<u>(5,554,550)</u>	<u>(5,459,892)</u>
Net cash provided by operating activities	147,374,363	116,789,185
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES—Cash payments to beneficiaries per Lottery Statutes	(140,836,668)	(105,845,957)
CASH FLOWS FROM CAPITAL FINANCING ACTIVITIES—Payments for acquisition of capital assets	(412,853)	(153,682)
CASH FLOWS FROM INVESTING ACTIVITIES—Receipts of interest	<u>297,719</u>	<u>360,946</u>
NET INCREASE IN CASH	6,422,561	11,150,492
CASH—Beginning of year	<u>50,193,176</u>	<u>39,042,684</u>
CASH—End of year	<u>\$ 56,615,737</u>	<u>\$ 50,193,176</u>
RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Operating income	<u>\$140,430,528</u>	<u>\$116,116,167</u>
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	214,706	189,719
Loss on disposal of equipment	3,158	4,899
Changes in assets and liabilities:		
Accounts receivable and due from other State agencies	3,365,262	(611,690)
Ticket inventory	(569,769)	(772,317)
Deposit—Powerball	(586,286)	478,478
Accounts payable and accrued expenses	(270,689)	693,807
Prizes and withholdings payable	<u>4,787,453</u>	<u>690,122</u>
Total adjustments	<u>6,943,835</u>	<u>673,018</u>
NET CASH PROVIDED BY OPERATING ACTIVITIES	<u>\$147,374,363</u>	<u>\$116,789,185</u>

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, 2006

1. DESCRIPTION OF OPERATIONS

The Arizona State Lottery (the "Lottery") was created by enactment of Title 5, Chapter 5 to the Arizona Revised Statutes ("ARS"), 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, 2005 through June 30, 2006, the Lottery held 94 instant games (games 360-361, 371, 383, 390, 400-401, 403-404, 407-409, 412-425, 429-475, 477-490, 492-495, 497-498, and 507), four of which were Economic Development games (games 412, 431, 436, and 459). During 2006, 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 \$7,315,835.

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, 2005 to June 30, 2006.
- During the period of July 1, 2005 to June 30, 2006, 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 during 2006 to 2.7% of the gross revenues or \$11 million, whichever is less. All other receipts can be used by the Lottery for operations, subject to legislative appropriation, 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, which includes invested cash held by the State Treasurer and invested prize reserves held by the Multi-State Lottery Association.

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, 2006, the Fund’s accounts payable balance includes an accrual of vacation pay and related benefits of approximately \$362,900. 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, 2006, as required by ARS Section 5-505.

Transfers to the State of Arizona:	
County Assistance Fund	\$ 7,650,000
Court Appointed Special Advocate Account	2,870,019
Department of Gaming	300,000
General Fund	45,323,800
Healthy Arizona Fund	19,975,000
Heritage Fund	20,000,000
Local Transportation Assistance Fund	41,000,000
Economic Development Commission Fund	<u>4,004,800</u>
Total transfers to other State of Arizona funds	<u>\$ 141,123,619</u>

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, 2006, was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Capital assets:				
Land	\$ 937,830	\$ -	\$ -	\$ 937,830
Land improvements	330,865			330,865
Buildings	3,299,667			3,299,667
Furniture, fixtures, and equipment	3,904,092	278,690	(108,372)	4,074,410
Construction in progress		<u>171,859</u>		<u>171,859</u>
Total capital assets	<u>8,472,454</u>	<u>450,549</u>	<u>(108,372)</u>	<u>8,814,631</u>
Less accumulated depreciation for:				
Land improvements	(307,448)	(16,538)	10,439	(313,547)
Buildings	(1,169,855)	(67,559)	(44,172)	(1,281,586)
Furniture, fixtures, and equipment	<u>(3,555,421)</u>	<u>(130,609)</u>	<u>138,947</u>	<u>(3,547,083)</u>
Total accumulated depreciation	<u>(5,032,724)</u>	<u>(214,706)</u>	<u>105,214</u>	<u>(5,142,216)</u>
Total capital assets—net	<u>\$ 3,439,730</u>	<u>\$ 235,843</u>	<u>\$ (3,158)</u>	<u>\$ 3,672,415</u>

5. PRIZE LIABILITY

Prize liability activity for the year ended June 30, 2006, was as follows:

	Beginning Balance	Increases	Decreases	Ending Balance
Prize liability	<u>\$ 30,068,491</u>	<u>\$ 262,098,401</u>	<u>\$ (257,310,948)</u>	<u>\$ 34,855,944</u>

6. COMMITMENTS

The Lottery enters into various contracts for goods and services during the normal course of its business. All contracts 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, 2006 and 2005, was \$55,263 and \$65,311, 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, 2004, the base contract rate was reduced to 4.50% for the remainder of the contract term. Effective September 1, 2006, the Lottery entered into a new five-year contract 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 \$159,038,000 at June 30, 2006. Approximately \$118,072,000 of the total aggregate future payments at June 30, 2006, relate to annuities purchased from five separate insurance companies, of which approximately \$45,942,000 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, 2006, remaining aggregate minimum future payments on such purchased annuities approximated \$788,000. As of December 11, 2006, this insurance company was current in its 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 6.90%, 5.20%, and 5.20% of their compensation for the years ended June 30, 2006, 2005, and 2004, respectively, with the contributions made through payroll deduction. Employee contributions vest immediately. Total contributions to the Plan for the years ended June 30, 2006, 2005, and 2004 by the Lottery's covered employees were \$287,330, \$214,819, and \$206,574, respectively.

Matching employer member contributions were actuarially determined and fixed at 6.90%, 5.20%, and 5.20% of the compensation of all employee members for the years ended June 30, 2006, 2005, and 2004, respectively. Total matching contributions to the Plan for the years ended June 30, 2006, 2005, and 2004 by the Lottery were \$287,330, \$214,819, and \$206,574, 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, 2006, 2005, and 2004 was \$4,272,430, \$4,163,347, and \$4,056,215, 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, 2006.

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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, 2006**

	<u>Game 360</u>		<u>Game 361</u>		<u>Game 371</u>	
TICKET SALES	\$ 42,338,780	100.00 %	\$ 51,685,662	100.00 %	\$ 21,059,166	100.00 %
DIRECT EXPENSES:						
Commissions	<u>2,752,020</u>	6.50	<u>3,359,568</u>	6.50	<u>1,368,847</u>	6.50
Prizes—low tier	23,417,579	55.31	23,454,954	45.38	11,371,950	54.00
Prizes—high tier	<u>1,794,449</u>	4.24	<u>7,462,600</u>	14.44	<u>1,859,144</u>	8.83
Total prizes	<u>25,212,028</u>	59.55	<u>30,917,554</u>	59.82	<u>13,231,094</u>	62.83
Ticket purchases	796,051	1.88	950,845	1.84	453,572	2.15
Advertising	<u> </u>		<u> </u>		<u>824,833</u>	3.92
Total direct expenses	<u>28,760,099</u>	67.93	<u>35,227,967</u>	68.16	<u>15,878,346</u>	75.40
GROSS PROFIT BY GAME	<u>\$ 13,578,681</u>	32.07	<u>\$ 16,457,695</u>	31.84	<u>\$ 5,180,820</u>	24.60
	<u>Game 383</u>		<u>Game 390</u>		<u>Game 403</u>	
TICKET SALES	\$ 14,036,162	100.00 %	\$ 5,063,625	100.00 %	\$ 2,482,475	100.00 %
DIRECT EXPENSES:						
Commissions	<u>912,350</u>	6.50	<u>329,136</u>	6.50	<u>161,363</u>	6.50
Prizes—low tier	7,719,889	55.00	2,514,934	49.67	1,241,238	50.00
Prizes—high tier	<u>677,159</u>	4.82	<u>588,649</u>	11.63	<u>156,900</u>	6.32
Total prizes	<u>8,397,048</u>	59.82	<u>3,103,583</u>	61.29	<u>1,398,138</u>	56.32
Ticket purchases	235,589	1.68	193,431	3.82	81,258	3.27
Advertising	<u> </u>		<u> </u>		<u> </u>	
Total direct expenses	<u>9,544,987</u>	68.00	<u>3,626,150</u>	71.61	<u>1,640,759</u>	66.09
GROSS PROFIT BY GAME	<u>\$ 4,491,175</u>	32.00	<u>\$ 1,437,475</u>	28.39	<u>\$ 841,716</u>	33.91
	<u>Game 407</u>		<u>Game 408</u>		<u>Game 409</u>	
TICKET SALES	\$ 3,090,306	100.00 %	\$ 2,102,108	100.00 %	\$ 3,218,651	100.00 %
DIRECT EXPENSES:						
Commissions	<u>200,870</u>	6.50	<u>136,637</u>	6.50	<u>209,214</u>	6.50
Prizes—low tier	1,627,562	52.67	1,051,054	50.00	1,673,699	52.00
Prizes—high tier	<u>108,160</u>	3.50	<u>192,980</u>	9.18	<u>150,750</u>	4.68
Total prizes	<u>1,735,722</u>	56.17	<u>1,244,034</u>	59.18	<u>1,824,449</u>	56.68
Ticket purchases	72,437	2.34	44,658	2.12	78,240	2.43
Advertising	<u> </u>		<u>6,183</u>	0.29	<u> </u>	
Total direct expenses	<u>2,009,029</u>	65.01	<u>1,431,512</u>	68.10	<u>2,111,903</u>	65.61
GROSS PROFIT BY GAME	<u>\$ 1,081,277</u>	34.99	<u>\$ 670,596</u>	31.90	<u>\$ 1,106,748</u>	34.39

(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, 2006**

	<u>Game 412</u>		<u>Game 413</u>		<u>Game 414</u>	
TICKET SALES	\$ 6,625,932	100.00 %	\$ 2,513,218	100.00 %	\$ 1,474,726	100.00 %
DIRECT EXPENSES:						
Commissions	<u>430,687</u>	6.50	<u>163,359</u>	6.50	<u>95,857</u>	6.50
Prizes—low tier	2,628,287	39.67	1,256,609	50.00	752,110	51.00
Prizes—high tier	<u>1,183,323</u>	17.86	<u>238,900</u>	9.51	<u>68,550</u>	4.65
Total prizes	<u>3,811,610</u>	57.53	<u>1,495,509</u>	59.51	<u>820,660</u>	55.65
Ticket purchases	88,412	1.33	43,922	1.75	36,262	2.46
Advertising	<u>2,373</u>	0.04				
Total direct expenses	<u>4,333,082</u>	65.40	<u>1,702,790</u>	67.75	<u>952,779</u>	64.61
GROSS PROFIT BY GAME	<u>\$ 2,292,850</u>	34.60	<u>\$ 810,428</u>	32.25	<u>\$ 521,947</u>	35.39
	<u>Game 415</u>		<u>Game 418</u>		<u>Game 421</u>	
TICKET SALES	\$ 12,251,525	100.00 %	\$ 15,812,520	100.00 %	\$ 1,476,820	100.00 %
DIRECT EXPENSES:						
Commissions	<u>796,350</u>	6.50	<u>1,027,814</u>	6.50	<u>95,994</u>	6.50
Prizes—low tier	5,513,186	45.00	5,387,326	34.07	694,105	47.00
Prizes—high tier	<u>2,166,125</u>	17.68	<u>4,089,490</u>	25.86	<u>128,805</u>	8.72
Total prizes	<u>7,679,311</u>	62.68	<u>9,476,816</u>	59.93	<u>822,910</u>	55.72
Ticket purchases	215,785	1.76	87,233	0.55	36,262	2.46
Advertising	<u>22,269</u>	0.18	<u>12,616</u>	0.08		
Total direct expenses	<u>8,713,715</u>	71.12	<u>10,604,479</u>	67.06	<u>955,166</u>	64.68
GROSS PROFIT BY GAME	<u>\$ 3,537,810</u>	28.88	<u>\$ 5,208,041</u>	32.94	<u>\$ 521,654</u>	35.32
	<u>Game 422</u>		<u>Game 423</u>		<u>Game 424</u>	
TICKET SALES	\$ 1,608,439	100.00 %	\$ 1,924,391	100.00 %	\$ 3,239,688	100.00 %
DIRECT EXPENSES:						
Commissions	<u>104,548</u>	6.50	<u>125,086</u>	6.50	<u>210,581</u>	6.50
Prizes—low tier	772,051	48.00	942,952	49.00	1,609,045	49.67
Prizes—high tier	<u>133,450</u>	8.30	<u>126,600</u>	6.58	<u>449,550</u>	13.87
Total prizes	<u>905,501</u>	56.30	<u>1,069,552</u>	55.58	<u>2,058,595</u>	63.54
Ticket purchases	42,351	2.63	43,537	2.26	68,221	2.11
Advertising						
Total direct expenses	<u>1,052,400</u>	65.43	<u>1,238,175</u>	64.34	<u>2,337,397</u>	72.15
GROSS PROFIT BY GAME	<u>\$ 556,039</u>	34.57	<u>\$ 686,216</u>	35.66	<u>\$ 902,291</u>	27.85

(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, 2006**

	<u>Game 425</u>		<u>Game 429</u>		<u>Game 432</u>	
TICKET SALES	\$ 10,442,980	100.00 %	\$ 1,556,379	100.00 %	\$ 1,637,794	100.00 %
DIRECT EXPENSES:						
Commissions	<u>678,795</u>	6.50	<u>101,166</u>	6.50	<u>106,457</u>	6.50
Prizes—low tier	4,493,614	43.03	747,062	48.00	851,653	52.00
Prizes—high tier	<u>1,777,012</u>	17.02	<u>132,300</u>	8.50	<u>73,705</u>	4.50
Total prizes	<u>6,270,626</u>	60.05	<u>879,362</u>	56.50	<u>925,358</u>	56.50
Ticket purchases	133,927	1.28	47,721	3.07	40,190	2.45
Advertising	<u>2,692</u>	0.02				
Total direct expenses	<u>7,086,040</u>	67.85	<u>1,028,249</u>	66.07	<u>1,072,005</u>	65.45
GROSS PROFIT BY GAME	<u>\$ 3,356,940</u>	32.15	<u>\$ 528,130</u>	33.93	<u>\$ 565,789</u>	34.55
	<u>Game 433</u>		<u>Game 434</u>		<u>Game 435</u>	
TICKET SALES	\$ 1,224,759	100.00 %	\$ 2,923,328	100.00 %	\$ 3,344,829	100.00 %
DIRECT EXPENSES:						
Commissions	<u>79,610</u>	6.50	<u>190,017</u>	6.50	<u>217,414</u>	6.50
Prizes—low tier	587,884	48.00	1,490,897	51.00	1,661,265	49.67
Prizes—high tier	<u>94,410</u>	7.70	<u>240,380</u>	8.22	<u>372,600</u>	11.13
Total prizes	<u>682,294</u>	55.70	<u>1,731,277</u>	59.22	<u>2,033,865</u>	60.80
Ticket purchases	33,144	2.71	40,662	1.39	75,215	2.25
Advertising					<u>1,530</u>	0.05
Total direct expenses	<u>795,048</u>	64.91	<u>1,961,956</u>	67.11	<u>2,328,024</u>	69.60
GROSS PROFIT BY GAME	<u>\$ 429,711</u>	35.09	<u>\$ 961,372</u>	32.89	<u>\$ 1,016,805</u>	30.40
	<u>Game 436</u>		<u>Game 437</u>		<u>Game 438</u>	
TICKET SALES	\$ 5,167,540	100.00 %	\$ 1,190,208	100.00 %	\$ 2,932,948	100.00 %
DIRECT EXPENSES:						
Commissions	<u>335,892</u>	6.50	<u>77,364</u>	6.50	<u>190,642</u>	6.50
Prizes—low tier	2,583,770	50.00	607,006	51.00	1,583,791	54.00
Prizes—high tier	<u>726,885</u>	14.07	<u>60,690</u>	5.10	<u>173,240</u>	5.91
Total prizes	<u>3,310,655</u>	64.07	<u>667,696</u>	56.10	<u>1,757,031</u>	59.91
Ticket purchases	60,175	1.16	33,709	2.83	41,807	1.42
Advertising	<u>19,331</u>	0.37			<u>203,313</u>	6.93
Total direct expenses	<u>3,726,053</u>	72.10	<u>778,769</u>	65.43	<u>2,192,793</u>	74.76
GROSS PROFIT BY GAME	<u>\$ 1,441,487</u>	27.90	<u>\$ 411,439</u>	34.57	<u>\$ 740,155</u>	25.24

(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, 2006**

	<u>Game 441</u>		<u>Game 442</u>		<u>Game 444</u>	
TICKET SALES	\$ 1,629,882	100.00 %	\$ 2,903,962	100.00 %	\$ 2,670,978	100.00 %
DIRECT EXPENSES:						
Commissions	<u>105,944</u>	6.50	<u>188,758</u>	6.50	<u>173,613</u>	6.50
Prizes—low tier	782,344	48.00	1,364,862	47.00	1,282,069	48.00
Prizes—high tier	<u>140,100</u>	8.60	<u>375,326</u>	12.92	<u>312,700</u>	11.71
Total prizes	<u>922,444</u>	56.60	<u>1,740,188</u>	59.92	<u>1,594,769</u>	59.71
Ticket purchases	38,841	2.38	42,508	1.47	44,665	1.67
Advertising	<u> </u>		<u> </u>		<u> </u>	
Total direct expenses	<u>1,067,229</u>	65.48	<u>1,971,454</u>	67.89	<u>1,813,047</u>	67.88
GROSS PROFIT BY GAME	<u>\$ 562,653</u>	34.52	<u>\$ 932,508</u>	32.11	<u>\$ 857,931</u>	32.12
	<u>Game 445</u>		<u>Game 448</u>		<u>Game 454</u>	
TICKET SALES	\$ 2,640,864	100.00 %	\$ 2,709,960	100.00 %	\$ 1,043,601	100.00 %
DIRECT EXPENSES:						
Commissions	<u>171,659</u>	6.50	<u>176,148</u>	6.50	<u>67,836</u>	6.50
Prizes—low tier	1,190,993	45.10	1,327,880	49.00	500,928	48.00
Prizes—high tier	<u>397,350</u>	15.04	<u>317,400</u>	11.71	<u>86,650</u>	8.30
Total prizes	<u>1,588,343</u>	60.14	<u>1,645,280</u>	60.71	<u>587,578</u>	56.30
Ticket purchases	62,769	2.38	66,666	2.46	34,109	3.27
Advertising	<u> </u>		<u>302,720</u>	11.17	<u> </u>	
Total direct expenses	<u>1,822,771</u>	69.02	<u>2,190,814</u>	80.84	<u>689,523</u>	66.07
GROSS PROFIT BY GAME	<u>\$ 818,093</u>	30.98	<u>\$ 519,146</u>	19.16	<u>\$ 354,078</u>	33.93
	<u>Game 460</u>		<u>Game 464</u>			
TICKET SALES	\$ 988,400	100.00 %	\$ 1,091,515	100.00 %		
DIRECT EXPENSES:						
Commissions	<u>64,246</u>	6.50	<u>70,951</u>	6.50		
Prizes—low tier	593,040	60.00	513,012	47.00		
Prizes—high tier	<u>32,400</u>	3.28	<u>102,780</u>	9.41		
Total prizes	<u>625,440</u>	63.28	<u>615,792</u>	56.41		
Ticket purchases			30,521	2.80		
Advertising	<u> </u>		<u>96,661</u>	8.86		
Total direct expenses	<u>689,686</u>	69.78	<u>813,925</u>	74.57		
GROSS PROFIT BY GAME	<u>\$ 298,714</u>	30.22	<u>\$ 277,590</u>	25.43		

(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, 2006**

	Pick Drawings (1/1/05–12/31/05)		Fantasy 5 Drawings (1/1/05–12/31/05)		Powerball Drawings (1/1/05–12/31/05)	
TICKET SALES	<u>\$ 48,499,344</u>	100.00 %	<u>\$ 9,460,367</u>	100.00 %	<u>\$ 127,847,782</u>	100.00 %
DIRECT EXPENSES:						
Commissions	3,152,445	6.50	614,918	6.50	8,310,099	6.50
Total prizes	24,991,966	51.53	4,493,673	47.50	63,923,891	50.00
Advertising	<u>1,454,430</u>	3.00	<u> </u>	0.00	<u>1,640,363</u>	1.28
Total direct expenses	<u>29,598,841</u>	61.03	<u>5,108,591</u>	54.00	<u>73,874,353</u>	57.78
GROSS PROFIT BY GAME	<u>\$ 18,900,503</u>	38.97	<u>\$ 4,351,776</u>	46.00	<u>\$ 53,973,429</u>	42.22
	Pick 3 Drawings (1/1/05–12/31/05)					
TICKET SALES	<u>\$ 7,482,264</u>	100.00 %				
DIRECT EXPENSES:						
Commissions	486,342	6.50				
Total prizes	3,741,132	50.00				
Advertising	<u> </u>	0.00				
Total direct expenses	<u>4,227,474</u>	56.50				
GROSS PROFIT BY GAME	<u>\$ 3,254,790</u>	43.50				

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, 2006.

(Concluded)