STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

TENNESSEE EDUCATION LOTTERY CORPORATION

Financial and Compliance Audit Report

For the Year Ended June 30, 2016

Justin P. Wilson, Comptroller

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STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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November 18, 2016

The Honorable Bill Haslam, Governor
Members of the General Assembly
Board of Directors, Tennessee Education Lottery Corporation

Ladies and Gentlemen:

Transmitted herewith is the financial and compliance audit of the Tennessee Education Lottery Corporation for the year ended June 30, 2016. You will note from the independent auditor's report that an unmodified opinion was given on the fairness of the presentation of the financial statements.

Consideration of internal control over financial reporting and tests of compliance resulted in no audit findings.

Sincerely,

Deborah V. Loveless

Deborah V. Loveless, CPA
Director

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Tennessee Education Lottery Corporation
For the Year Ended June 30, 2016

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Tennessee Education Lottery Corporation

For the Year Ended June 30, 2016

Opinion on the Financial Statements

The opinion on the financial statements is unmodified.

Audit Findings

The audit report contains no findings.

STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
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Independent Auditor's Report

The Honorable Bill Haslam, Governor
Members of the General Assembly
Board of Directors, Tennessee Education Lottery Corporation

Report on the Financial Statements

We have audited the accompanying financial statements of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of and for the years ended June 30, 2016, and June 30, 2015, and the related notes to the financial statements, which collectively comprise the Tennessee Education Lottery Corporation's basic financial statements as listed in the table of contents.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

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 audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tennessee Education Lottery Corporation as of June 30, 2016, and June 30, 2015, and the changes in financial position and cash flows thereof for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Other Matters

Required Supplementary Information

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4 through 14 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board, which considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Reporting Required by *Government Auditing Standards*

In accordance with *Government Auditing Standards*, we have also issued our report dated November 7, 2016, on our consideration of the Tennessee Education Lottery Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts 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 internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the Tennessee Education Lottery Corporation's internal control over financial reporting and compliance.

Deborah V. Loveless

Deborah V. Loveless, CPA
Director
November 7, 2016

TENNESSEE EDUCATION LOTTERY CORPORATION
Management's Discussion and Analysis

The Tennessee Education Lottery Corporation (TEL) offers the following discussion and analysis to the readers of the financial statements. This narrative overview provides an objective analysis of TEL's financial activity for the fiscal years ended June 30, 2016, and June 30, 2015, with comparative information presented for the fiscal year ended June 30, 2014. The overview should be considered in conjunction with the independent auditor's report, the accompanying audited financial statements, and the notes to the financial statements.

Understanding TEL's Financial Statements

TEL, a quasi-public instrumentality, is a component unit of the State of Tennessee. TEL's activities are accounted for as a business-type activity using the full accrual basis of accounting, similar to a private business entity. In accordance with accounting principles generally accepted in the United States of America, this report consists of a series of comparative financial statements, along with notes to the financial statements designed to highlight TEL's net position and changes therein resulting from business operations.

The financial statements are comprised of three components:

- **the statements of net position** – reflect TEL's financial position at June 30, 2016, and June 30, 2015;
- **the statements of revenues, expenses, and changes in net position** – report revenues and expenses incurred in relation to the sale of lottery products, as well as other non-gaming related activity for the fiscal years ended June 30, 2016, and June 30, 2015; and
- **the statements of cash flows** – outline the cash inflows and outflows related to the activity of selling lottery products and other business-related activities for the fiscal years ended June 30, 2016, and June 30, 2015.

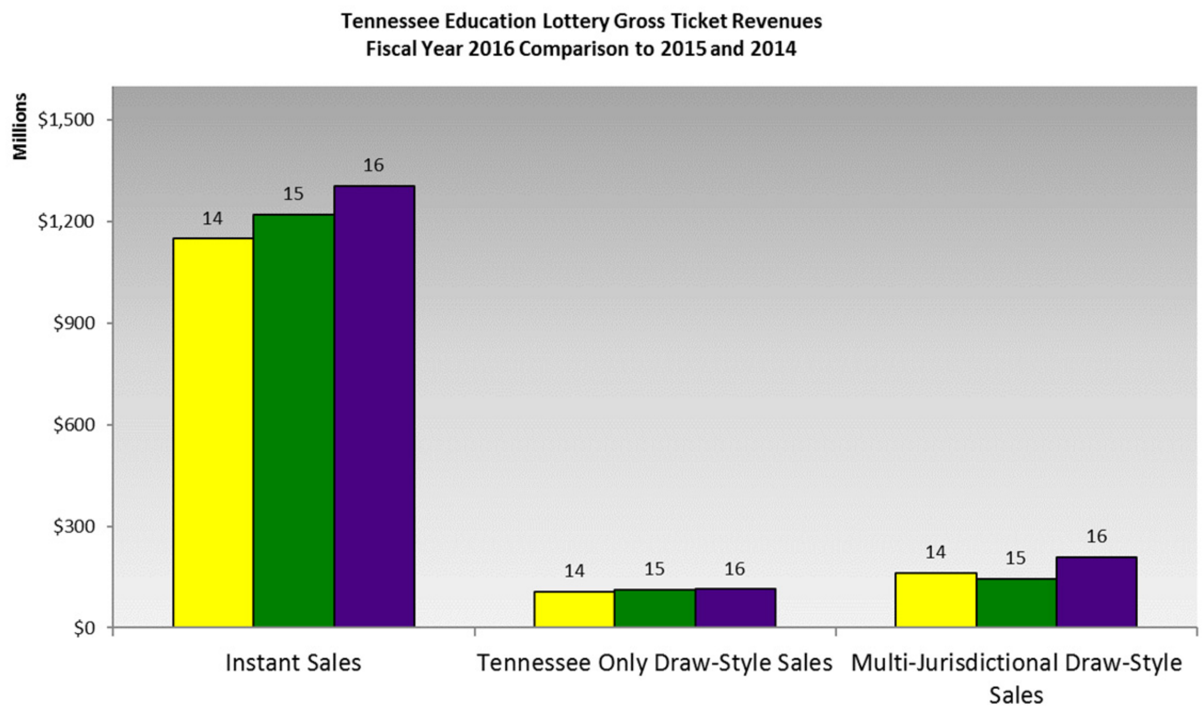
The notes to the financial statements document additional information that is essential for readers to gain a comprehensive understanding of the data provided in TEL's financial statements.

TEL's primary business purpose is to generate revenues to fund college scholarships for residential Tennessee students attending higher educational institutions within the state. Accordingly, the main focus of the financial statements is determining funds available for payment to the State of Tennessee's Lottery for Education Account. Furthermore, in addition to funding this account, TEL's unclaimed prize funds are deposited to the After-School Programs special account, which benefits after-school programs throughout the state of Tennessee.

Fiscal Year 2016 Financial Highlights

TEL reported $1.626 billion in total sales for fiscal year 2016, an increase of $151 million over last year's previous sales record of $1.476 billion, making this the 12th consecutive year of increased sales. This year's sales resulted in a contribution of $394 million for the education programs funded by TEL.

Total education funding since ticket sales began in January 2004 now stands at more than $3.81 billion, with total sales surpassing $15 billion.



Instant ticket sales and a record-setting *Powerball* jackpot ignited TEL's 12th straight year of increased sales!

Management attributes the success to staying focused on the corporation's mission to serve Tennessee students and their families by responsibly maximizing proceeds for the education programs. TEL works continually to refine our business model, introduce innovative and entertaining games for our players, promote efficiencies and best business practices across the organization, and provide quality support for the retailers selling TEL's products.

In fiscal year 2016, sales of the instant ticket games reached a record-setting high of $1.30 billion, topping last year's record of $1.22 billion by $84 million, or 6.9%.

Forty-five new instant ticket games were introduced during the year, attributing to the instant ticket success, which included the successful launch of the $30 game, *Ultimate Millions*, the introduction of the new "Scratch My Back" product, providing players with new ways to play the popular instant games; and the launch of our second most successful family of games to date, "Times the Cash!" TEL's "Bucks" family of games continued to be a top choice of players during fiscal year 2016.

The Tennessee Only draw-style games consist of draw-style games played within the state of Tennessee:

Cash 3 sales in fiscal year 2016 increased by 4.6% over fiscal year 2015.

Cash 4 sales increased by 5.3% over fiscal year 2015.

Sales for *Tennessee Cash* decreased $2.2 million during fiscal year 2016. *Tennessee Cash* is a cash jackpot drawing-style game. The sales for this game are driven by the size of the jackpot. In fiscal year 2016, *Tennessee Cash* did not experience any large jackpots of $1 million and over, compared to three jackpots near $1 million in fiscal year 2015.

Tennessee participates in the following multi-jurisdictional draw-style games:

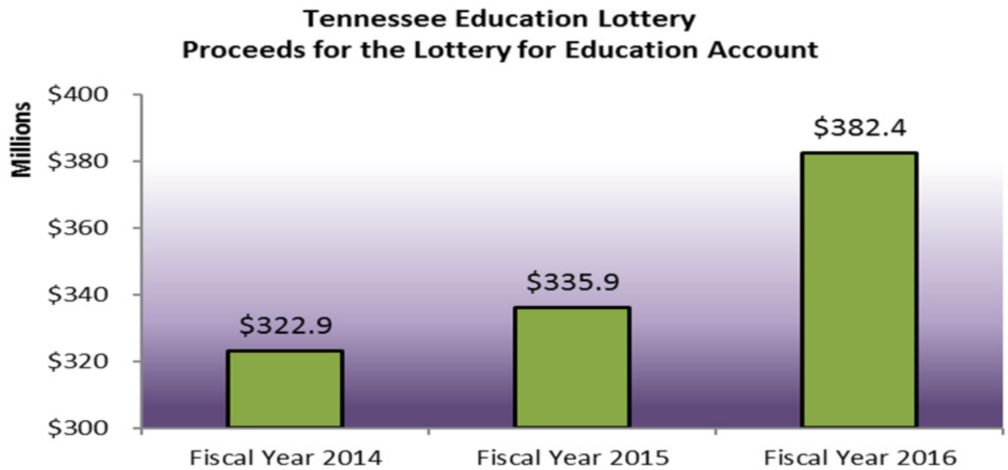
Powerball sales increased $59.5 million in fiscal year 2016. This increase was due mainly to the record-setting jackpot of $1.58 billion experienced in fiscal year 16. Tennessee also benefitted from back-to-back jackpot winners of $144.1 million in November and $528.8 million in January. The January winner was a 1/3 share of the record jackpot that was split with winners in Florida and California. Sales also saw an increase due to the carryover of the excitement from the record jackpot.

Sales for *Mega Millions* in fiscal year 2016 were $37.3 million compared to $39.2 million the prior year. The decrease in *Mega Millions* sales is attributed to the lack of comparable size jackpots year over year.

In fiscal year 2016, *Hot Lotto* sales decreased by $4 million compared to fiscal year 2015. Fiscal year 2015 sales were driven by an $11.7 million jackpot run in September 2014. *Hot Lotto* is a drawing-style game operated in 15 states with a starting jackpot of $1 million, and its statutory taxes are paid on behalf of a jackpot winner.

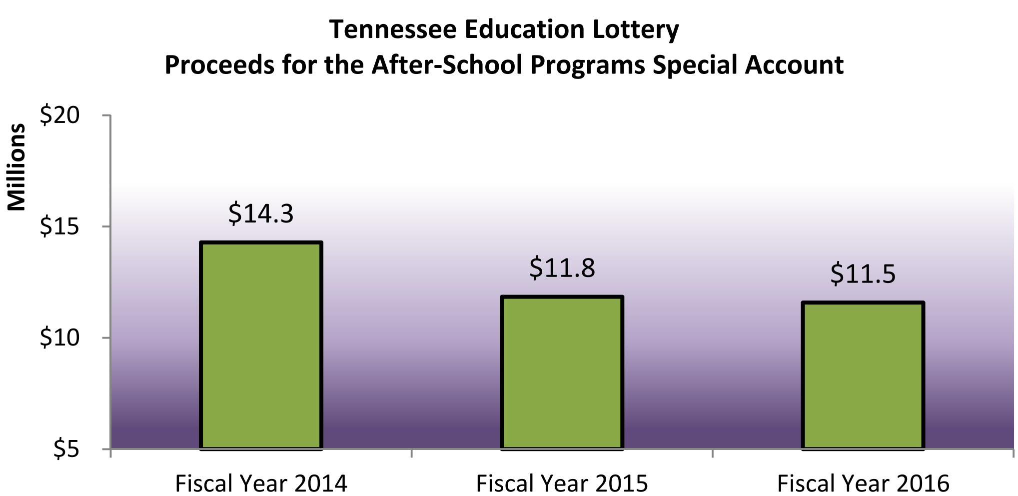
In November 2015, TEL introduced *Cash 4 Life*, a new multi-jurisdictional drawing-style game operated in six states for a chance to win $1,000 a day for life or $1,000 a week for life. Total sales were $12.4 million in fiscal year 2016.

TEL generated $382.4 million for the Lottery for Education account in fiscal year 2016, compared to $335.9 million in fiscal year 2015 and $322.9 million in fiscal year 2014.



The amounts deposited to the After-School Programs special account are derived from unclaimed instant and drawing-style game prizes at fiscal year-end. Prizes not claimed within 90 days of the announced game-end date for instant games, and within 180 days of the draw for all drawing-style games, are forfeited as unclaimed prizes.

TEL staff records estimated unclaimed prizes for each instant game within the month the game is closed and reconciles the actual amounts when the claim period ends. For drawing-style games, TEL records the actual unclaimed amounts determined after the expiration of the related claim period for the draw.



In fiscal year 2016, TEL recognized $11.5 million for the After-School Programs special account, as compared to $11.8 million in fiscal year 2015 and $14.3 million in fiscal year 2014.

Overview of Financial Position

Condensed Statement of Net Position

	June 30, 2016	Increase/ (Decrease)	June 30, 2015	Increase/ (Decrease)	June 30, 2014
Assets:					
Current Assets					
Cash	$ 111,790,000	$ 19,348,000	$ 92,442,000	$ 24,713,000	$ 67,729,000
Retailer accounts receivable, net	68,670,000	6,676,000	61,994,000	(7,302,000)	69,296,000
Other	7,356,000	104,000	7,252,000	105,000	7,147,000
Total current assets	187,816,000	26,128,000	161,688,000	17,516,000	144,172,000
Non-current assets					
Other	6,584,000	533,000	6,051,000	(84,000)	6,135,000
Capital assets, net	3,099,000	341,000	2,758,000	1,834,000	924,000
Total non-current assets	9,683,000	874,000	8,809,000	1,750,000	7,059,000
Total assets	197,499,000	27,002,000	170,497,000	19,266,000	151,231,000
Liabilities:					
Current liabilities					
Due to Lottery for Education account	89,246,000	4,813,000	84,433,000	4,054,000	80,379,000
Due to After-School Programs account	11,586,000	(262,000)	11,848,000	(2,443,000)	14,291,000
Prizes payable	79,616,000	21,524,000	58,092,000	13,133,000	44,959,000
Accounts payable and accrued liabilities	5,777,000	860,000	4,917,000	1,290,000	3,627,000
Unearned revenue	1,364,000	351,000	1,013,000	112,000	901,000
Unearned rent	165,000	-	165,000	(163,000)	328,000
Total current liabilities	187,754,000	27,286,000	160,468,000	15,983,000	144,485,000
Non-current liabilities					
Unearned rent	3,131,000	(204,000)	3,335,000	2,745,000	590,000
Non-current portion of other liabilities	6,584,000	(71,000)	6,655,000	520,000	6,135,000
Total non-current liabilities	9,715,000	(275,000)	9,990,000	3,265,000	6,725,000
Total liabilities	197,469,000	27,011,000	170,458,000	19,248,000	151,210,000
Net Position:					
Investment in capital assets	3,099,000	341,000	2,758,000	1,834,000	924,000
Unrestricted	(3,099,000)	(341,000)	(2,758,000)	(1,834,000)	(924,000)
Restricted for uncollectible retailer receivables	30,000	(9,000)	39,000	18,000	21,000
Total net position	$ 30,000	$ (9,000)	$ 39,000	$ 18,000	$ 21,000

Assets

The $27 million increase in total assets at June 30, 2016, and $19.2 million increase in total assets at June 30, 2015, were primarily due to the noted increase in lottery ticket sales for the related fiscal years, resulting in increased cash and accounts receivable.

Liabilities

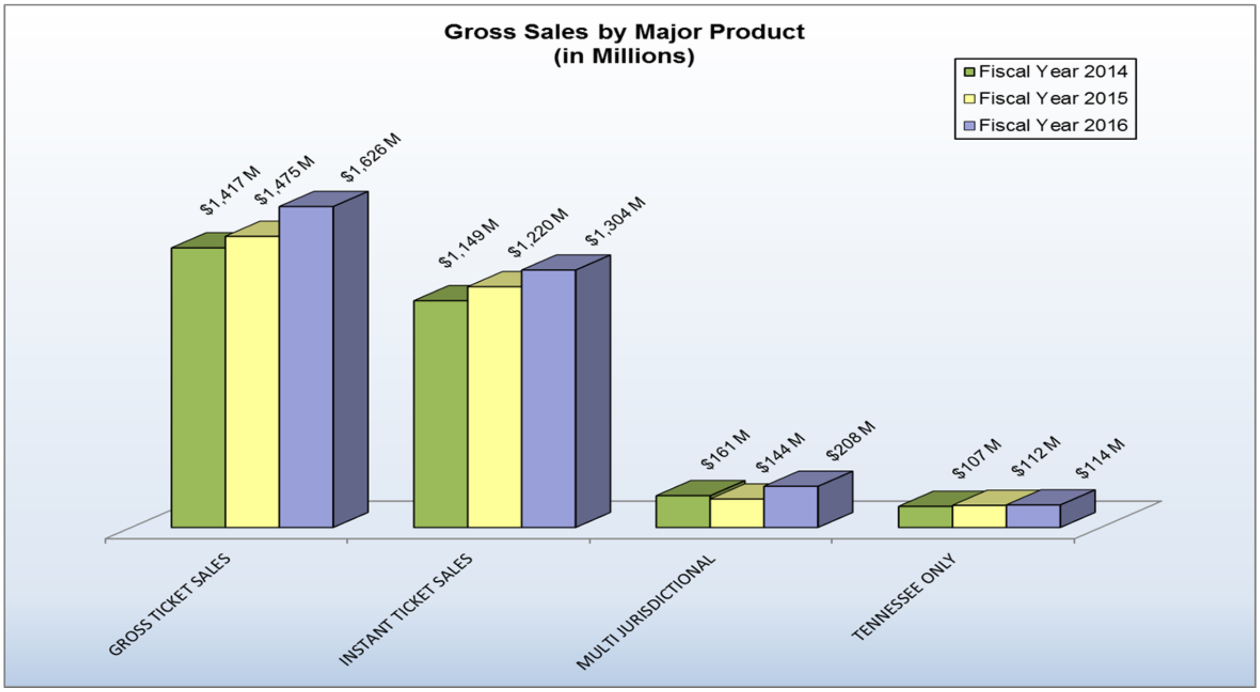
The $27 million increase in total liabilities at June 30, 2016, and $19.2 million increase in total liabilities at June 30, 2015, relate primarily to increased ticket sales, resulting in higher net proceeds payable to the Lottery for Education account and more prizes payable to players.

Condensed Statement of Revenues and Expenses

	June 30, 2015	**Increase/ (Decrease)**	**June 30, 2015**	**Increase/ (Decrease)**	**June 30, 2014**
Revenues:					
Instant games	$1,304,479,000	$84,357,000	$1,220,122,000	$70,995,000	$1,149,127,000
Draw-style games	322,471,000	66,807,000	255,664,000	(12,276,000)	267,940,000
Less instant/promotional tickets provided as prizes	(115,092,000)	(8,238,000)	(106,854,000)	(9,042,000)	(97,812,000)
Games revenue, net	1,511,858,000	142,926,000	1,368,932,000	49,677,000	1,319,255,000
Bad debt recoveries/(expense), net	(167,000)	294,000	(461,000)	(266,000)	(195,000)
Retailer service fees	3,223,000	(74,000)	3,297,000	(89,000)	3,386,000
Interest income	208,000	111,000	97,000	27,000	70,000
Other revenue	299,000	(387,000)	686,000	(218,000)	904,000
Total revenues	1,515,421,000	142,870,000	1,372,551,000	49,131,000	1,323,420,000
Expenses					
Cost of sales	1,103,311,000	96,608,000	1,006,703,000	37,717,000	968,986,000
General, administrative, and other operating expenses	18,025,000	(7,000)	18,032,000	913,000	17,119,000
Other expenses	46,000	34,000	12,000	(16,000)	28,000
Proceeds to After-School Program account	11,586,000	(262,000)	11,848,000	(2,443,000)	14,291,000
Proceeds to Lottery for Education account	382,462,000	46,524,000	335,938,000	12,956,000	322,982,000
Total expenses	1,515,430,000	142,897,000	1,372,533,000	49,127,000	1,323,406,000
Change in net position	(9,000)	(27,000)	18,000	4,000	14,000
Total net position, beginning of year	39,000	18,000	21,000	14,000	7,000
Total net position, end of year	$ 30,000	$ (9,000)	$ 39,000	$ 18,000	$ 21,000

Revenues

Gross lottery ticket sales for fiscal years 2016, 2015, and 2014 were $1.626 billion, $1.476 billion, and $1.417 billion, respectively. The following chart depicts the distribution of sales by product for the three fiscal years ended June 30:



Gross instant ticket sales for fiscal year 2016 were $1.304 billion. This represents a 6.9% increase from fiscal year 2015's instant ticket sales of $1.220 billion, which represented a 6.2% increase from fiscal year 2014 instant ticket sales of $1.149 million. Instant tickets represent approximately 81% of total gross sales in fiscal 2016, 2015, and 2014. The year-over-year increase in gross instant ticket sales is attributed to the instant-ticket marketing strategy, which involves the ongoing introduction of multiple games, including special theme games, families of games, and higher price-point games with higher prize payouts. The games most popular with the players in 2016 continue to be the "Jumbo Bucks" family.

The Tennessee Only draw-style games:

- **Cash 3** sales for fiscal years 2016, 2015, and 2014 were $61.5 million, $58.8 million, and $57.6 million, respectively.
- **Cash 4** sales were $35 million, $33.3 million, and $30.8 million in the years 2016, 2015, and 2014, respectively.
- **Tennessee Cash** sales for fiscal years 2016, 2015, and 2014 were $17.3 million, $19.5 million, and $18.3 million, respectively.

Multi-jurisdictional draw-style games:

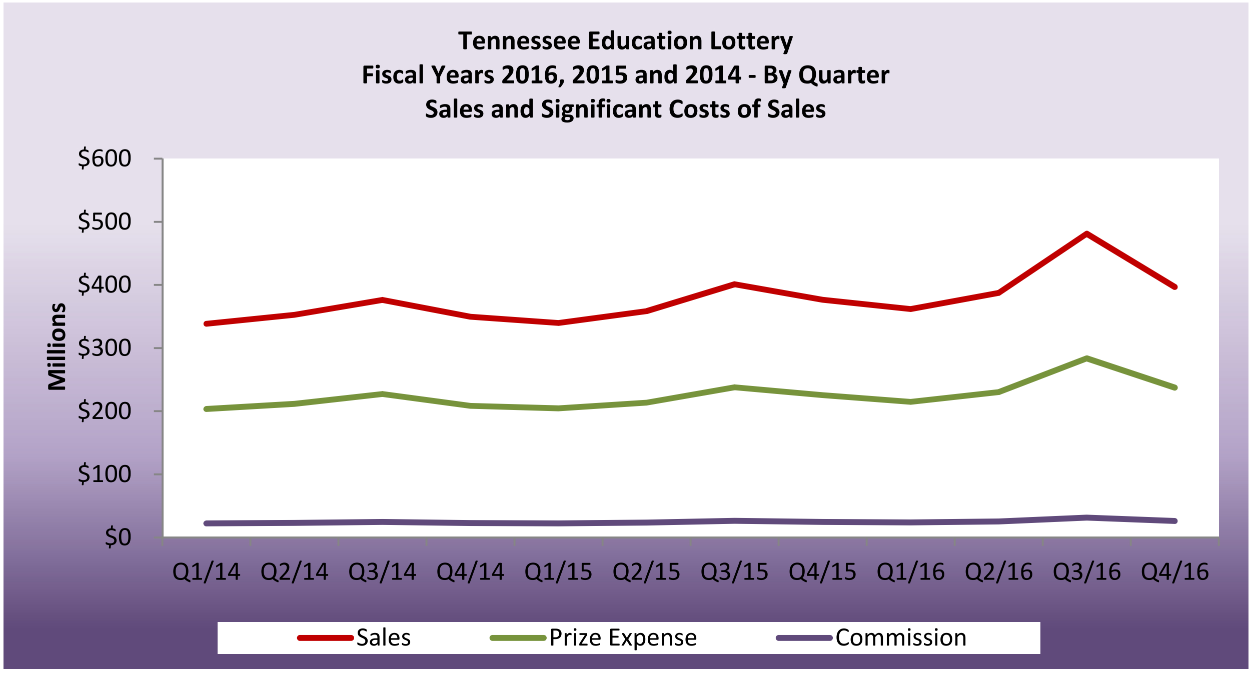
- **Powerball** is a multi-jurisdictional, drawing-style lottery game operated in the following jurisdictions in addition to Tennessee: Arizona, Arkansas, Colorado, Connecticut, Delaware, the District of Columbia, Florida, Idaho, Iowa, Indiana, Kansas, Kentucky, Louisiana, Maine, Minnesota, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, U.S. Virgin

Islands, Vermont, Wisconsin, West Virginia, and Wyoming. Starting on January 31, 2010, 10 states in the Mega Millions lottery consortium group began selling *Powerball* tickets as part of a cross-selling agreement with members of the Multi-State Lottery Association (MUSL), including Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Texas, Virginia, and Washington. Ohio and California, both members of the Mega Millions consortium, started cross-selling *Powerball* on April 16, 2010, and April 8, 2013, respectively.

Powerball sales for fiscal years 2016, 2015, and 2014 were $147.3 million, $87.8 million, and $100.9 million, respectively. These amounts represent approximately 9%, 6%, and 7% of gross ticket sales, respectively, for each fiscal year. The increase in *Powerball* sales during fiscal year 2016 can largely be contributed to the record jackpot of $1.58 billion. The game saw additional excitement when Tennessee experienced back-to-back jackpot winners. The first, in November 2015, won $144.1 million. In January 2016, the second was won by a player who split the record $1.58 billion jackpot with two players in other states.

- **Mega Millions** is a multi-jurisdictional, drawing-style lottery game administered by a lottery consortium group. The group includes the following state lotteries: California, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, and Washington. Tennessee and certain other MUSL lottery members are authorized to sell the consortium's *Mega Millions* game as part of a cross-selling agreement. Tennessee began sales for the game in January 2010. Sales for fiscal years 2016, 2015, and 2014 were $37.3 million, $39.2 million, and $47 million, respectively. The decrease in sales in fiscal years 2016 and 2015 is due to the lack of large jackpots compared to the prior year.
- **Hot Lotto** is a multi-jurisdictional, drawing-style lottery game operated in the following jurisdictions in addition to Tennessee: Delaware, the District of Columbia, Idaho, Iowa, Kansas, Maine, Minnesota, Montana, New Hampshire, New Mexico, North Dakota, Oklahoma, South Dakota, and West Virginia. Tennessee began sales for the game in May 2013. Sales were $11.2 million in 2016, $15.3 million in 2015, and $13.1 million in fiscal year 2014.
- **Cash 4 Life,** a draw-style game, was introduced in Tennessee on November 1, 2015, and has six member lotteries: Maryland, New Jersey, New York, Pennsylvania, Tennessee, and Virginia. It provides an opportunity to win a lifetime prize of $1,000 a day for life. Sales for 2016 were $12.4 million.

Cost of sales is comprised of prize expense (net of unclaimed prizes), retailer commissions, and contractor fees. As the following chart depicts, these expenses relate to and change in direct proportion with changes in ticket sales:



Gross prize expense was $965.9 million, $881.1 million, and $850.7 million in the years 2016, 2015, and 2014, respectively. Increases of $84.8 million in 2016 and $30.4 million in 2015 reflect the increases in overall ticket sales realized in the related period.

Instant games prize expense is managed through the number of tickets printed for each game and the value of prizes as determined prior to ticket production. Prize expense is recorded based on an established prize structure and a related percentage of sales for each game introduced and is recognized when products are made available for sale to the public. The aggregated prize payout for all instant games was 67.4%, 67.6%, and 68.3% of instant game sales, net of free tickets, for 2016, 2015, and 2014, respectively.

Gross prize expense for drawing-style games generally increases or decreases in direct proportion to ticket sales of the related game and is recorded at the time of the related draw. The aggregated prize payout for all drawing-style games was 50.9%, 50.3%, and 49.5% for 2016, 2015, and 2014, respectively.

Retailer commissions were $106.1 million, $96.3 million, and $92.4 million for fiscal years 2016, 2015, and 2014, respectively. Consistent with the cost driver relationship of ticket sales to retailer commissions, the increases of $9.8 million in 2016 and $3.9 million in 2015 reflect the increases in overall ticket sales realized in the related period.

Retailers are compensated a set commission percentage of 6.5% on all instant tickets settled and drawing-style tickets sold. They also receive an additional 1% bonus for cashing *Cash 3* and *Cash 4* ticket prizes. Additionally, TEL will pay a bonus of $25,000 to a retailer who sells a single jackpot-winning ticket for *Powerball* or *Mega Millions*; however, if there are multiple winning *Powerball* or *Mega Millions* jackpot winning tickets sold in Tennessee in a single drawing, the $25,000 selling bonus will be proportionately divided among the respective retailers based on the number of winning tickets sold by the retailer. TEL will also pay a $5,000 bonus to retailers selling any drawing-style game ticket where the prize won is equal to or greater than $1 million. Four *Powerball* and one *Mega Millions* jackpot ticket selling bonuses were paid during the last three fiscal years. Drawing-style game ticket selling bonuses equaling $75,000, $100,000, and $85,000 were awarded for fiscal years 2016, 2015, and 2014, respectively.

Gaming contractor fees for fiscal years 2016, 2015, and 2014 were $29.8 million, $28.3 million, and $28.6 million, respectively. TEL has retained two major gaming contractors, one for the operation of its gaming systems and network and one for the manufacturing, warehousing, and distribution of its instant ticket games. During fiscal year 2015, lower negotiated vendor fees were implemented. The instant ticket vendor receives 0.8998% of the selling price of all instant ticket activations, whereas the gaming systems and network vendor receives 1.1999% of the selling price of drawing-style tickets sold and of the selling price of instant ticket activations, net of free instant tickets available as prizes. The increase in the fees for 2016 of $1.5 million is the result of $151 million in increased sales.

Advertising costs incurred by TEL were $9.3 million, $8.9 million, and $8.1 million for the fiscal years 2016, 2015, and 2014, respectively. These costs are significantly influenced by budget directives and constraints. Management continually strives to achieve an optimal balance between advertising costs and obtained benefits, while keeping the costs relatively consistent with prior year amounts.

General, administrative, and other operating expenses were $18.0 million, $18.0 million, and $17.3 million for the fiscal years 2016, 2015, and 2014, respectively. For each of these years, the five major expense components were depreciation, personnel, professional fees, property, and telecommunications expenses. These expenses do not change in direct proportion with revenues but are instead significantly influenced by budget directives and constraints, as well as current business and economic conditions. In view of these factors, moderate variances in these expenses are expected to occur over fiscal periods. Nevertheless, to the most reasonable extent possible, TEL's management team works diligently to make these expenses relatively consistent year-over-year.

Potential Factors Impacting Future Results

TEL's mission is to maximize revenues for the purpose of maximizing payments to the Lottery for Education account. A continuous assessment of Tennessee's economic environment and TEL's own product lines and operations is essential to accomplish this mission. The following considerations have been presented to inform those interested in TEL's operations about factors that could potentially affect future results:

- TEL will continue to introduce new and/or enhanced instant and drawing-style game product offerings.
- TEL will continually review the prize payout percentages for its instant-game products to ensure we are receiving the highest actual net proceeds for each game and/or price point category.

- TEL will continue to enhance its promotional offerings and player affinity programs to improve brand awareness and increase player participation in our games.
- Tennessee's legalization of Daily Fantasy Sports Games and Operations and the level of adoption by eligible Tennesseans.

Contacting TEL's Financial Management

This financial report is designed to provide the State of Tennessee, the public, and other interested parties with an overview of the financial results of TEL's activities and to show TEL's accountability for conducting business in a fiscally responsible manner. If you have questions about this report or require additional financial information, contact TEL's Finance Department at the following address:

Tennessee Education Lottery Corporation
One Century Place
26 Century Boulevard
Suite 200
Nashville, Tennessee 37214

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Net Position
As of June 30, 2016, and June 30, 2015

	June 30, 2016	June 30, 2015
ASSETS		
Current assets:		
Cash (Note 2)	$ 111,760,000	$ 92,403,000
Restricted fidelity fund cash	30,000	39,000
Retailer accounts receivable, net	68,670,000	61,994,000
Prepaid expenses and other assets	6,964,000	6,900,000
Prize annuity investments (Note 3)	392,000	352,000
Total current assets	187,816,000	161,688,000
Noncurrent assets:		
Prize annuity investments (Note 3)	6,584,000	6,051,000
Capital assets, net of depreciation of $5,247,000 and $5,039,000 (Note 4)	3,099,000	2,758,000
Total noncurrent assets	9,683,000	8,809,000
Total assets	197,499,000	170,497,000
LIABILITIES		
Current liabilities:		
Due to Lottery for Education account (Note 7)	89,246,000	84,433,000
Due to After-School Programs account (Note 8)	11,586,000	11,848,000
Prizes payable	79,224,000	57,700,000
Accounts payable	104,000	49,000
Prize annuities payable (Notes 3 and 10)	392,000	392,000
Accrued liabilities	5,673,000	4,868,000
Unearned revenues	1,364,000	1,013,000
Unearned rent (Notes 6 and 10)	165,000	165,000
Total current liabilities	187,754,000	160,468,000
Noncurrent liabilities:		
Prize annuities payable (Notes 3 and 10)	6,584,000	6,655,000
Unearned rent (Notes 6 and 10)	3,131,000	3,335,000
Total noncurrent liabilities	9,715,000	9,990,000
Total liabilities	197,469,000	170,458,000
NET POSITION		
Investment in capital assets	3,099,000	2,758,000
Restricted:		
Restricted for uncollectible retailer receivables	30,000	39,000
Unrestricted	(3,099,000)	(2,758,000)
Total net position	$ 30,000	$ 39,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Revenues, Expenses, and Changes in Net Position
For the Years Ended June 30, 2016, and June 30, 2015

	Year Ended June 30, 2016	Year Ended June 30, 2015
OPERATING REVENUES		
Ticket sales, net	$ 1,626,782,000	$ 1,475,325,000
Less instant/promotional tickets provided as prizes	(115,092,000)	(106,854,000)
Net ticket sales	1,511,690,000	1,368,471,000
Retailer service fees	3,223,000	3,297,000
Other	263,000	656,000
Net operating revenues	1,515,176,000	1,372,424,000
OPERATING EXPENSES		
Available prizes	965,989,000	881,104,000
Current year actual unclaimed prizes (Note 8)	(11,586,000)	(11,848,000)
Net prizes	954,403,000	869,256,000
Retailer commissions and bonuses	106,145,000	96,338,000
Contractor fees	29,812,000	28,348,000
Advertising	9,317,000	8,988,000
Salaries and benefits	14,273,000	14,281,000
Retailer merchandising and marketing	3,634,000	3,774,000
Rent, utilities, and maintenance	1,723,000	1,563,000
Depreciation	544,000	789,000
Professional fees	237,000	349,000
General, administrative, and other operating	1,248,000	1,053,000
Total operating expenses	1,121,336,000	1,024,739,000
Operating income	393,840,000	347,685,000
NONOPERATING REVENUES (EXPENSES)		
Interest revenue	208,000	97,000
Retailer fees for future uncollectible retailer receivables	37,000	34,000
Fidelity fund retailer non-feasance recoupments (Note 1)	(46,000)	(12,000)
Proceeds to After-School Programs account (Note 8)	(11,586,000)	(11,848,000)
Proceeds to Lottery for Education account (Note 7)	(382,462,000)	(335,938,000)
Total nonoperating revenues (expenses)	(393,849,000)	(347,667,000)
Change in net position	(9,000)	18,000
NET POSITION		
Net position, beginning of year	39,000	21,000
Net position, end of year	$ 30,000	$ 39,000

See notes to financial statements.

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Cash Flows
For the Years Ended June 30, 2016, and June 30, 2015

	Year Ended June 30, 2016	Year Ended June 30, 2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	$ 1,505,447,000	$ 1,375,930,000
Cash received from MUSL for grand prize winner	417,630,700	187,087,000
Other operating cash received	3,397,000	3,882,000
Cash paid for prizes	(932,730,000)	(855,465,000)
Cash paid to grand prize winner	(417,630,700)	(187,087,000)
Cash paid to/on behalf of gaming vendors	(29,675,000)	(28,771,000)
Cash paid to retailers	(106,178,000)	(96,331,000)
Cash paid for advertising	(9,181,000)	(8,586,000)
Cash paid to/on behalf of employees	(14,118,000)	(12,916,000)
Other operating payments	(6,772,000)	(4,367,000)
Net cash provided by operating activities	410,190,000	373,376,000
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Payments to Lottery for Education account	(377,649,000)	(331,884,000)
Payments to After-School Programs account	(11,848,000)	(14,291,000)
Fidelity fund cash received from retailers	42,000	38,000
Fidelity fund cash refunded to retailers	(5,000)	(8,000)
Fidelity fund cash non-feasance recoupments	(46,000)	(12,000)
Net cash used in noncapital financing activities	(389,506,000)	(346,157,000)
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Purchase of property and equipment	(906,000)	(2,624,000)
Proceeds from disposal of capital assets	6,000	21,000
Net cash used in capital and related financing activities	(900,000)	(2,603,000)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of prize annuity	(644,000)	-
Interest income	208,000	97,000
Net cash provided/(used) by investing activities	(436,000)	97,000
Net cash provided by all activities	19,348,000	24,713,000
Cash - beginning of year	92,442,000	67,729,000
Cash - end of year	$ 111,790,000	$ 92,442,000
Reconciliation of cash on the statement of net position		
Cash	$ 111,760,000	$ 92,403,000
Restricted fidelity fund cash	30,000	39,000
Cash at end of year	$ 111,790,000	$ 92,442,000

TENNESSEE EDUCATION LOTTERY CORPORATION
Statements of Cash Flows (Continued)
For the Years Ended June 30, 2016, and June 30, 2015

	Year Ended June 30, 2016	Year Ended June 30, 2015
Reconciliation of net operating income to net cash provided by investing activities:		
Operating income	$ 393,840,000	$ 347,685,000
Adjustments to reconcile operating income to net cash provided by operating activities		
Bad debt expense	176,000	461,000
Depreciation	544,000	789,000
Gain on disposal of capital assets	(6,000)	(19,000)
Changes in assets and liabilities:		
Retailer accounts receivable	(6,841,000)	6,842,000
Prepaids and other assets	(64,000)	(104,000)
Accounts payable and accrued liabilities	870,000	1,289,000
Prize annuity investments	71,000	84,000
Prize annuities payable	(71,000)	560,000
Prizes payable	21,525,000	13,095,000
Unearned revenues	350,000	112,000
Unearned rent	(204,000)	2,582,000
Net cash provided by operating activities	$ 410,190,000	$ 373,376,000
Noncash investing activities:		
Increase in fair value of prize annuity investments	$ 269,000	$ 268,000

See notes to financial statements.

Note 1. Summary of Significant Accounting Policies

Organization and Description of Reporting Entity

Effective June 11, 2003, the Tennessee Education Lottery Implementation Law (the "Act"), Sections 4-51-101 et seq., *Tennessee Code Annotated*, was signed into law, creating the Tennessee Education Lottery Corporation (TEL). Pursuant with the Act, TEL was incorporated in the State of Tennessee as a body, politic and corporate, and a quasi-public instrumentality.

TEL is considered a component unit of the State of Tennessee as the state has financial accountability for fiscal matters as follows:

1. the board of directors is appointed by the Governor;
2. upon dissolution of TEL, title to all TEL property shall vest in the State of Tennessee; and
3. TEL provides financial benefits to the state in the form of deposit payments to the state treasury.

The accompanying financial statements present information only as to the transactions of TEL's programs. TEL is reported as a discretely presented component unit within the State of Tennessee's *Comprehensive Annual Financial Report,* which may be viewed at http://tn.gov/finance/act/cafr.shtml.

TEL is responsible for the provision of lotteries on behalf of the State of Tennessee in accordance with the Act and is deemed to be acting, in all respects, for the benefit of the people of the State of Tennessee.

On January 20, 2004, TEL began lottery ticket sales. During the years ended June 30, 2016, and June 30, 2015, TEL's lottery sales included a variety of instant ticket games and drawing-style games: *Cash 3*, *Cash 4*, *Tennessee Cash*, *Hot Lotto*, *Cash 4 Life*, *Powerball*, and *Mega Millions*.

Basis of Presentation

The accompanying financial statements have been prepared in conformity with the accounting principles generally accepted in the United States of America as prescribed by the Governmental Accounting Standards Board.

Basis of Accounting and Measurement Focus

Basis of accounting refers to the timing of recognition of revenues and expenses in the accounts and reporting in the financial statements, and the measurement focus refers to what transactions and events should be recorded. The financial statements are reported using the accrual basis of accounting and the economic resources measurement focus in accordance with accounting principles generally accepted in the United States of America. Under this method, revenues are recognized when they are earned and expenses are recognized when a liability is incurred, regardless of the timing of related cash flows.

Revenue Recognition

Lottery games are sold to the public by contracted retailers. Revenue is recognized for instant games when retailers make them available for sale to the public, as indicated by the retailers' activation of tickets.

Revenue for drawing-style games is recognized based on the game characteristics. For drawing-style games where the prize expense is determinable only upon occurrence of the related draw, revenues for sold tickets are recognized when the related drawing occurs. Also, amounts collected from retailers in advance of the draw are recorded as unearned revenue and recognized once the drawing occurs.

Revenues for drawing-style games where both prize expense and the draw date are known prior to ticket sales occurring are recognized at the time of the sale.

Certain instant and drawing-style games include free ticket prizes that entitle the holder to exchange a winning ticket for another of equal value. The selling price of the game ticket awarded as a prize reduces ticket revenue when the related winning ticket is validated.

Revenues are presented net of bad debt expense.

Net Position

Net position represents cumulative revenues less expenses and required beneficiary program payments in accordance with the Act (see Notes 7 and 8). Net position includes funds invested in capital assets, restricted net position, and unrestricted net position.

Cash

Cash includes cash in banks, petty cash, and deposits on account in the State of Tennessee Local Government Investment Pool (LGIP) (see Note 2).

Retailer Accounts Receivable

Retailer accounts receivable represents lottery proceeds due from retailers for ticket sales, net of commissions due to and prizes paid by the retailers, and allowance for bad debt.

Lottery proceeds are collected weekly from retailer bank accounts established in trust for TEL. Amounts not collected upon the established collection date are deemed delinquent. Delinquent accounts are reviewed periodically by TEL management. Accounts outstanding more than 180 days from the most recent date of delinquency or date of last payment are considered doubtful. At June 30, 2016, and June 30, 2015, the Allowance for Doubtful Accounts was $481 thousand and $566 thousand, respectively.

Capital Assets

Capital assets are stated at cost less accumulated depreciation. Depreciation on capital assets is computed using the straight-line method over the estimated useful lives of the assets, which is 3 to 7 years for most assets. Leasehold improvements are amortized over their expected useful lives or the lease term, whichever is shorter. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation is removed from the accounts, and any resulting gain or loss is reflected in the results from operations in the period of disposal. TEL's general threshold for capitalization is assets valued at $500 or greater.

Unearned Revenue

Funds collected from retailers for drawing-style game tickets sold in advance of the drawings are recorded as unearned revenue and recognized as revenue once the related drawing occurs.

Fidelity Fund

In accordance with Section 4-51-118(a), *Tennessee Code Annotated*, TEL retailers are assessed a one-time fidelity fund fee of $50. Fidelity fund proceeds are held in a demand deposit account at Citizens Bank and are classified as restricted fidelity fund cash on the statement of net position. These funds may be used to cover losses incurred as a result of the nonfeasance, malfeasance, or misfeasance of TEL retailers. During the years ended June 30, 2016, and June 30, 2015, $46 thousand and $12 thousand were, respectively, used to cover losses incurred as a result of uncollected accounts of TEL retailers.

At the end of each fiscal year, fidelity funds exceeding $500,000 may be treated as net proceeds from the TEL subject to deposit to the Lottery for Education account. As of the years ended June 30, 2016, and June 30, 2015, there were no fidelity funds available for deposit as net proceeds.

Retailer Commissions and Incentives

Retailers receive a commission of 6.5% on all instant tickets settled and drawing-style tickets sold. In addition, retailers cashing *Cash 3* and *Cash 4* tickets receive an additional 1% for amounts cashed. Where commission has been paid to retailers for unearned revenue ticket sales, this fee is recorded as a prepaid expense until the related revenue is recognized.

TEL will pay an incentive of $25,000 to a retailer who sells a single jackpot winning ticket for *Powerball* or *Mega Millions*; however, if there are multiple winning *Powerball* or *Mega Millions* jackpot winning tickets sold in Tennessee in a single drawing, the $25,000 selling incentive will be divided proportionately (based on the number of winning tickets sold by each retailer) between or among the respective retailers.

TEL will pay a selling incentive of $5,000 to a retailer who sells a winning non-jackpot *Powerball* or *Mega Millions* prize, or a ticket for any other drawing-style game, if the prize is equal to or greater than one million dollars ($1,000,000).

Incentives were earned as follows during the years ended June 30:

Drawing-Style Game	2016	2015
Powerball	$ 75,000	$80,000
Monopoly Millionaires' Club	-	5,000
Tennessee Cash	-	15,000
Total Retailer Bonuses	**$75,000**	**$100,000**

Contractor Fees

TEL has contracted with two vendors, IGT Corporation and Scientific Games Inc. (SGI), for the majority of the gaming systems and supplies.

IGT operates the gaming network that consists of approximately 5,000 instant and drawing-style retailer ticket terminals and associated software. On July 18, 2014, TEL signed a new contract with IGT through June 30, 2022. Terms of this contract include a new contractor service fee rate of 1.1999% on the selling price of drawing-style tickets sold and on instant ticket activations, net of free tickets available as prizes.

SGI prints, warehouses, and distributes the instant ticket games to retailers. On October 28, 2014, TEL signed a new contract with SGI through June 30, 2022. In accordance with this contract, SGI receives the negotiated fee of 0.8998% on the selling price of all instant ticket activations, as of January 4, 2015.

Prizes

In accordance with the Act, as nearly as practical, at least 50% of ticket proceeds must be made available as prize money. Gross prize expense for instant ticket sales is recognized based on a predetermined prize structure for each game in accordance with the approved game working papers when tickets are activated for sale. Gross prize expense for *Cash 3*, *Cash 4*, and *Tennessee Cash* is recognized based on historical payout experience when the related drawings occur.

Powerball and *Mega Millions* prizes are shared based on contributions made to the prize pool by all member lotteries of the Powerball Group and the Mega Millions Group of the Multi-State Lottery Association (MUSL). All *Powerball* and *Mega Millions* grand prizes won by players who purchase tickets in Tennessee are funded from pooled contributions by all participating lottery states. For *Powerball* and *Mega Millions*, the contributions are held by MUSL in trust for TEL and are paid, at the option of the prize winner, in either a lump-sum or 30 annual payments. Lump-sum payments are discounted to present value, as calculated by MUSL for the *Powerball* game, and the Mega Millions Consortium Group for the *Mega Millions* game. TEL had two *Powerball* jackpot winners in fiscal year 2016 on November 5, 2015, for $144.1 million and January 15, 2016, for $528.8 million, which was a shared win with two other states of the record $1.58 billion jackpot.

Hot Lotto prizes are shared based on contributions made to the prize pool by all member lotteries of the Hot Lotto Group of MUSL. Grand prizes won by Tennessee players are funded from pooled contributions by all participating lottery states. The contributions are held by MUSL in trust for TEL and are paid in cash as a lump sum with taxes withholding paid by the party lottery. As of June 30, 2016, there were no grand prize winners in Tennessee.

In November 2015, TEL began selling *Cash 4 Life*. *Cash 4 Life* prizes are based on a portion of gross sales set aside for payment of prizes. The prize fund for any drawing is expected to be 55% of sales, but may be higher or lower based upon the number of winners at each prize level, as well as the funding required to contribute to the jackpot and second level prize. The contributions are made to the prize pool by Maryland, New Jersey, New York, Pennsylvania, Virginia, and Tennessee lotteries. Grand prizes won by Tennessee players are funded from pooled contributions by all participating lottery states except for the winning state. As of June 30, 2016, there were no grand prize winners in Tennessee.

Unclaimed Prizes

Prizes not claimed within 90 days of the game-end date for instant games, and within 180 days of a game draw date for drawing-style games, are forfeited as unclaimed prizes.

Budget

Pursuant with the Act, annually by June 30, TEL is required to submit a proposed operating budget for the next fiscal year to the Tennessee Department of Finance and Administration, Office of Legislative Budget Analysis, and Comptroller of the Treasury. Additionally, by September 1, TEL is required to submit a preliminary operating budget for the succeeding fiscal year to the Tennessee Department of Finance and Administration for informational purposes.

Contingencies

TEL is subject to various claims and contingencies related to litigation, fines and penalties, assessments, and other matters arising out of the normal course of business. Liabilities related to contingencies are recognized when a loss is probable and can be reasonably estimated. As of the years ended June 30, 2016, and June 30, 2015, TEL has not incurred, nor was it aware of, any related liabilities.

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 certain estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures 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. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the financial statements in the period they are determined.

Advertising

Advertising costs are expensed when the related advertising takes place or the contract is non-cancelable when entered.

Nonoperating Revenues and Expenses

Revenues and expenses resulting from activities not directly associated with the sale of lottery tickets are reflected as nonoperating revenues and expenses.

Compensated Absences

Effective November 29, 2004, TEL implemented an attendance and leave policy allowing employees to earn vacation and sick leave during their employment. The corporation recognizes expense for accrued but unused vacation leave for all employees who have completed one year of service. No such expense exists for accrued but unused sick leave (Note 9).

Employment Separation

On February 17, 2016, the board of directors approved a change in separation pay policy. The revised policy allows for corporate officers hired prior to January 1, 2006, to continue accruing 40 hours of separation pay for each year of employment with TEL. Corporate officers hired January 1, 2006, and thereafter shall be granted 240 hours of leave in the event they are terminated without cause or upon retirement. After 6 years of employment in a corporate officer position, he/she shall accrue an additional 40 hours of severance pay for every year of employment. Such expense is accrued in the period it is earned (Note 9).

Note 2. Cash

A significant portion of TEL's deposits are in a financial institution that participates in the bank collateral pool administered by the State Treasurer. The securities pledged to protect these accounts are pledged in the aggregate rather than against each individual account. The members of the pool may be required by agreement to pay an assessment to cover any deficiency. Under this additional assessment agreement, public fund accounts covered by the pool are considered to be insured for purposes of credit risk disclosure. At June 30, 2016, and June 30, 2015, bank balances of approximately \$3.258 million and \$2.418 million, respectively, were insured by the bank collateral pool.

Additionally, for both the years ended June 30, 2016, and June 30, 2015, the bank balance for the fidelity fund account was approximately \$23,000 and was maintained in a demand deposit account that was insured by the Federal Deposit Insurance Corporation for up to a maximum of \$250,000.

TEL also has deposits in the Local Government Investment Pool (LGIP) administered by the State Treasurer. TEL's deposits with the LGIP were approximately \$109 million and \$90.4 million at June 30, 2016, and June 30, 2015, respectively. The LGIP is part of the State Pooled

Investment Fund. There are no minimum or maximum limitations on withdrawals with the exception of a 24-hour notification period for withdrawals of $5 million or more. The LGIP is measured at amortized costs. The fund is not rated by a nationally recognized statistical rating organization.

The fund's investment policy and required risk disclosures are presented in the *State of Tennessee Treasurer's Report*. That report is available on the state's website at http://www.treasury.tn.gov or by calling (615) 741-2956.

Note 3. Prize Annuity Investments

TEL has games where the prize structure allows for specific prizes to be paid in a cash value or annuity option. Prize annuity investments represent investments TEL has made to pay the winners entitled to multiyear payments.

In February 2015, TEL launched an instant ticket game, *$1,000,000 Jackpot*, which included three top prizes of $1 million. The annuity option guarantees the winner would receive annual gross payments of $40,000 for 25 years. As of June 30, 2015, one top prize winner elected to take the annuity option. TEL purchased one single premium, sum certain annuity from Metropolitan Life (MetLife) in July 2015 for $644,000 in its name and appointed the respective winner as the beneficiary.

In February 2013, TEL relaunched the *Win for Life* instant ticket game; this time the top prize guaranteed the winners would receive $156,000, gross, a year for the remainder of his/her life, with a minimum of 20 annual payments totaling $3,120,000. As of June 30, 2013, one top prize winner elected the annuity option. In April 2014, TEL purchased one single premium, sum certain lifetime annuity from Nationwide for approximately $3,387,000 in its name and appointed the respective winner as the beneficiary.

The prize structure of the *Millionaire Jumbo Bucks* instant ticket game includes top prizes of $1 million. The annuity option guarantees the winner would receive annual gross payments of $40,000 for 25 years. As of June 30, 2012, one top prize winner elected the annuity option. TEL purchased one single premium, sum certain annuity for approximately $634,000 in its name from MetLife, and appointed the respective winner as the beneficiary.

In August 2004, the *Win for Life* instant ticket game was launched and included three top prizes in the form of lifetime annuities. These top prizes guaranteed the winner would receive the gross amount of $52,000 a year for the remainder of his/her life, with a minimum of 20 annual payments totaling $1,040,000. As of June 30, 2006, all of the top prizes were claimed by and awarded to winners.

In fiscal year 2007, TEL purchased one single premium, sum certain lifetime annuity contract for approximately $739,000 in its name from Athene (formally known as Aviva Life) and appointed the respective *Win for Life* prize winner as the beneficiary.

In fiscal year 2006, TEL purchased two single premiums, sums certain lifetime annuity contracts for approximately $904,000 and $848,000 in its name from MetLife, and appointed the respective *Win for Life* prize winners as the beneficiaries.

In accordance with its investment policy, TEL may enter into insurance annuity contracts in order to fund annuity prizes. All life insurance annuity contracts must be issued by companies which are financially rated "A" or better by a nationally recognized rating agency duly licensed, admitted, and authorized to transact business in the State of Tennessee.

Credit risk – This is the risk that a counterparty will fail to fulfill its obligation. TEL mitigates this risk through its investment policy, which limits purchase of investments to those financially rated "A" or better by a nationally recognized rating agency. Consistent with this policy, the annuities purchased from MetLife were rated A+ (Superior) by A.M. Best as of June 30, 2016, and June 30, 2015. The annuity purchased from Athene was rated A- (Excellent) by A.M. Best as of June 30, 2016, and June 30, 2015. The annuity purchased from Nationwide was rated A+ (Superior) by A.M. Best as of June 30, 2016, and June 30, 2015.

Concentration of credit risk – This risk relates to an investor's failure to adequately diversify its investments and is specifically defined as investments of 5% or more in the securities of a single issuer. Though TEL does not have a policy specific to this risk, as a condition of the purchase, and for the duration of the contract, MetLife, Athene, and Nationwide are required to maintain insurance sufficient to reimburse TEL for any losses resulting from its failure or inability to meet related obligations.

Custodial credit risk – For an investment, this is the risk that in the event of the failure of the counterparty to a transaction, the investor will not be able to recover the value of its investments that are in the possession of an outside party. Investments are subject to custodial credit risk only if they are evidenced by securities that exist in physical or book entry form. Given that annuity contracts do not meet this condition, no related custodial credit risk exists as of the years ended June 30, 2016, and June 30, 2015.

TEL staff record all investments purchased to fund annuity prizes at fair value. Liabilities for annuity prizes are recorded at their discounted present value as prize annuities payable.

In relation to both the prize annuity investments and prize annuities payables, payments due from insurance companies and due to prize winners within the next fiscal year are classified as current, whereas the remaining portion is classified as noncurrent on the statement of net position.

Changes in the fair value of the prize annuity investments are presented as noncurrent prize annuities payable. As of the years ended June 30, 2016, and June 30, 2015, the fair value of the prize annuity investments increased by $269 thousand and $268 thousand, respectively.

Note 4. Capital Assets

Capital assets consisted of the following as of June 30, 2016:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	$ 849,000	$ 11,000	$(21,000)	$ 839,000
Computer equipment	723,000	197,000	(76,000)	844,000
Vehicles	238,000	85,000	(16,000)	307,000
High mileage vehicles - vans	1,414,000	359,000	(177,000)	1,596,000
Leasehold improvements	2,546,000	33,000	-	2,579,000
Communication equipment	710,000	5,000	(67,000)	648,000
Software	781,000	-	-	781,000
Gaming equipment	536,000	216,000	-	752,000
Total capital assets	7,797,000	906,000	(357,000)	8,346,000
Less accumulated depreciation	(5,039,000)	(544,000)	336,000	(5,247,000)
Total capital assets, net	**$ 2,758,000**	**$ 362,000**	**$ (21,000)**	**$ 3,099,000**

Capital assets consisted of the following as of June 30, 2015:

	Beginning Balance	Increases	Decreases	Ending Balance
Furniture and fixtures	$ 833,000	$ 19,000	$ (3,000)	$ 849,000
Computer equipment	620,000	132,000	(29,000)	723,000
Vehicles	218,000	20,000	-	238,000
High mileage vehicles - vans	1,259,000	155,000	-	1,414,000
Leasehold improvements	264,000	2,282,000	-	2,546,000
Communication equipment	712,000	1,000	(3,000)	710,000
Software	767,000	14,000	-	781,000
Gaming equipment	535,000	1,000	-	536,000
Total capital assets	5,208,000	2,624,000	(35,000)	7,797,000
Less accumulated depreciation	(4,284,000)	(789,000)	34,000	(5,039,000)
Total capital assets, net	**$ 924,000**	**$1,835,000**	**$ (1,000)**	**$ 2,758,000**

Note 5. Leasing Arrangements

TEL’s leasing arrangements consist of non-cancelable operating leases for office space, outdoor advertising billboards, and related equipment that expire at various dates through 2025. Certain of these leases contain provisions for scheduled rental increases and are renewable at the option of TEL. During the year ended June 30, 2016, no options were exercised.

The following is a schedule by years of future minimum rental payments required of TEL under all non-cancelable operating leases with original terms of one year or more:

Year Ending June 30:	2016
2017	$ 2,723,000
2018	2,249,000
2019	1,692,000
2020	1,570,000
2021	1,562,000
2022 – 2025	6,107,000
Total minimum rental payments	**$15,903,000**

TEL also subleases office space under operating leases expiring through 2025 to its major gaming vendors. Minimum rental payments at June 30, 2016, have not been reduced by minimum sublease rentals of $1.008 million over the remaining sublease rental period.

The following is a schedule by years of future minimum sublease rental payments due to TEL under all non-cancelable operating leases with original terms of one year or more as of June 30:

Year Ending June 30:	2016
2017	$ 106,000
2018	109,000
2019	112,000
2020	114,000
2021	117,000
2022	120,000
2023	114,000
2024	117,000
2025	99,000
Total minimum sublease payments	**$1,008,000**

The following schedule shows the composition of total rental expense, net of unearned rent expense and income, for all operating leases for the years ended June 30:

	2016	2015
Minimum rentals:		
Property	$1,282,000	$1,280,000
Billboards	1,258,000	1,251,000
Less: Sublease rentals	(126,000)	(51,000)
Total minimum rentals	**$2,414,000**	**$2,480,000**

Rental expense under all operating leases totaled approximately $2,414,000 and $2,480,000 for the years ended June 30, 2016, and June 30, 2015, respectively.

Note 6. Unearned Rent

As an incentive for entering into certain lease agreements, TEL received rent abatements approximating $3,795,000 from landlords. In accordance with Governmental Accounting Standards Board Statement 13, *Accounting for Operating Leases with Scheduled Rent Increases*, TEL defers rent incentives over the entire lease term on a straight-line basis. Additionally, where lease agreements stipulate escalation of rental payments over the term of the lease, TEL recognizes related rental expense on a straight-line basis over the entire term of the lease.

At June 30, 2016, total unearned rent consisted of $3,500,000 in the straight-lining of rental expense over the life of the related lease terms less rent abatements of $204,000 for net unearned rent of $3,296,000.

At June 30, 2015, total unearned rent consisted of $5,506,000 in the straight-lining of rental expense over the life of the related lease terms less rent abatements of $2,006,000 for net unearned rent of $3,500,000.

Note 7. Due to Lottery for Education Account

In accordance with the Act, all net proceeds of TEL are due to the Lottery for Education account. "Net proceeds" are defined under the Act as "all revenue derived from the sale of lottery tickets or shares and all other monies derived from lottery games less operating expenses." "Operating expenses" are defined under the Act as "all costs of doing business, including, but not limited to, prizes, commissions, and other compensation paid to lottery retailers, advertising and marketing costs, rental fees, personnel costs, capital costs, depreciation of property and equipment, amounts held in or paid from a fidelity fund, and all other operating costs." All other expenses are considered nonoperating.

Net proceeds and operating expenses for the years ended June 30, 2016, and June 30, 2015, are summarized as follows:

	2016	**2015**
Operating revenues:		
Ticket sales (net)	$ 1,626,782,000	$ 1,475,325,000
Less tickets provided as prizes	(115,092,000)	(106,854,000)
Net ticket sales	1,511,690,000	1,368,471,000
Fees and other revenue	3,486,000	3,953,000
Total lottery proceeds	1,515,176,000	1,372,424,000
Operating expenses, as defined:		
Gaming	1,114,897,000	1,018,551,000

Operating	18,025,000	18,032,000
Total operating expenses, as defined	1,132,922,000	1,036,583,000
Net proceeds before distribution of unrestricted net position	382,254,000	335,841,000
Nonoperating revenue and expenses		
Interest income	208,000	97,000
Total nonoperating revenue and expenses	208,000	97,000
Net proceeds	$ 382,462,000	$ 335,938,000
Amount due to Lottery for Education account for year	$ 382,462,000	$ 335,938,000
Amount paid during year	(293,216,000)	(251,505,000)
Amount due to Lottery for Education account, end of year	$ 89,246,000	$ 84,433,000

All amounts due at the end of each fiscal year were deposited to the Lottery for Education account in July of the subsequent fiscal year.

Note 8. Due to After-School Programs Special Account

In accordance with the Act, at the end of each fiscal year, one hundred percent of any unclaimed prize money shall be deposited in the After-School Programs special account.

The amounts due to the After-School Programs special account are derived from unclaimed prizes for instant games that have been officially closed and drawing-style games that have exceeded the 180-day claim period.

Unclaimed prizes for instant games are estimated based upon historical percentages of actual unclaimed dollars at the time of game close and reconciliation at the end of the 90-day redemption period.

For drawing-style games, the actual unclaimed amounts are determined after the expiration of the related claim period for the draw.

For instant games, prizes not claimed within 90 days of the announced game-end date are forfeited as unclaimed prizes. For drawing-style games, prizes not claimed within 180 days of a game draw date are forfeited as unclaimed prizes.

For fiscal year 2016, unclaimed prizes were $11,586,000, which was current and payable to the After-School Programs special account at June 30, 2016.

For fiscal year 2015, unclaimed prizes were $11,848,000, which was current and payable to the After-School Programs special account at June 30, 2015.

All amounts due at the end of each fiscal year were deposited to the After-School Programs special account by August 1 of the subsequent fiscal year.

Note 9. Employee Benefits

A. Deferred Compensation

Effective September 22, 2003, TEL provided its employees with a deferred compensation plan created in accordance with Internal Revenue Code Section 457 (the 457 Plan). The 457 Plan is available to all eligible employees at their option and permits participants to defer a portion of their salary until future years. The deferred compensation is not available to participants until termination, retirement, death, or unforeseeable emergency. During the years ended June 30, 2016, and June 30, 2015, employees contributed approximately $502,000 and $486,000, respectively, to the 457 Plan.

The aggregate fair value of the plan's assets was approximately $5,067,000 and $4,926,000, net of administrative fees, as of June 30, 2016, and June 30, 2015, respectively.

B. Defined Contribution Plan

Effective September 22, 2003, the TEL Board of Directors established a defined contribution plan in accordance with Internal Revenue Code Section 401(a) (the 401(a) Plan). Under the 401(a) Plan, all eligible employees receive compensation from TEL in the form of non-voluntary deferrals to their individual 401(a) accounts as follows:

1. contribution of 5% of employee's compensation;
2. matching contribution of 75% of the participant's contributions to the 457 Plan, up to the first 5% of the participant's compensation; and
3. changes to the plan must be approved by TEL's Board of Directors.

These contributions vest over a 4-year period at a rate of 25% per year and are not available to participants until termination, retirement, death, or unforeseeable emergency. TEL expensed approximately $723,000 and $712,000 to the 401(a) Plan on behalf of its employees for the years ended June 30, 2016, and June 30, 2015, respectively.

In accordance with the 401(a) Plan, forfeitures of employer contributions may be used to offset plan administrative expenses and/or reduce future contribution costs. As of the years ended June 30, 2016, and June 30, 2015, forfeited amounts of approximately $15,000 and $35,000, respectively, were used to offset employer contributions and plan administrative expenses.

Section 1448 of the Small Business Job Protection Act of 1996 added Subsection (g) to Section 457 of the Internal Revenue Code to provide that all assets and income under a Section 457(b) Plan that are maintained by a state or local government employer must be held in trust for the exclusive benefit of plan participants and their beneficiaries. The 457 Plan and 401(a) Plan assets are held in aggregate by John Hancock Financial, the plans' custodian.

The aggregate fair value of the plans' assets was approximately $7,122,000 and $7,062,000, net of forfeitures and administrative fees, as of June 30, 2016, and June 30, 2015, respectively.

As of June 30, 2016, and June 30, 2015, TEL's employer liability outstanding was $31,000 and $33,000, respectively.

C. Compensated Absences

Vacation leave can be earned at various rates depending on the employee's position and years of service. Carryover of vacation leave is limited to the number of hours earned in the prior year. Employees must complete 12 months of service from the date of hire before they receive termination payment for any unused vacation hours. The current portion of the compensated absence liability, expected to be due within one year of the statement date, June 30, 2016, is estimated using historical trends. At June 30, 2016, and June 30, 2015, the estimated current portion of the compensated absences liability was $598 thousand and $573 thousand, respectively.

Sick leave is earned at the end of each pay period at the rate of four hours per pay period for all employees. Sick leave may be carried over from year to year, but all such accrued sick leave is forfeited upon separation of employment.

D. Employment Separation

On February 17, 2016, the board of directors approved a change in separation pay policy. The revised policy allows for corporate officers hired prior to January 1, 2006, to continue accruing 40 hours of separation pay for each year of employment with TEL. Corporate officers hired January 1, 2006, and thereafter shall be granted 240 hours of leave in the event they are terminated without cause or upon retirement. After 6 years of employment in a corporate officer position, he/she shall accrue an additional 40 hours of severance pay for every year of employment. TEL had $516 thousand and $413 thousand accrued for employment separation obligations for each of the years ending June 30, 2016, and June 30, 2015, respectively.

Note 10. Non-current Liabilities

Non-current liabilities consisted of the following as of June 30, 2016:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Prize annuities payable	$ 7,047,000	$269,000	$(340,000)	$ 6,976,000	$392,000
Unearned rent	3,500,000	-	(204,000)	3,296,000	165,000
Total non-current liabilities	$10,547,000	$269,000	$(544,000)	$10,272,000	$557,000

Non-current liabilities consisted of the following as of June 30, 2015:

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Prize annuities payable	$6,487,000	$ 912,000	$ (352,000)	$ 7,047,000	$392,000
Unearned rent	918,000	4,588,000	(2,006,000)	3,500,000	165,000
Total non-current liabilities	$7,405,000	$5,500,000	$(2,358,000)	$10,547,000	$557,000

Note 11. Risk Management

Effective July 31, 2005, TEL became a member of the Risk Management Fund, an internal service fund of the State of Tennessee. The Risk Management Fund allocates the cost of providing claims servicing and claims payment by charging a premium to TEL based on a percentage of TEL's expected loss costs, which includes both experience and exposures. This Risk Management Fund provides general and automobile liability up to $300,000 per person and $1,000,000 per occurrence. For property, the deductible is the first $25,000 of losses for a member.

Additionally, in order to minimize financial losses resulting from the occurrence of theft; employee dishonesty; legal judgments; work-related employee injury and accidents; and catastrophic events, TEL maintains insurance from various other providers. At June 30, 2016, additional insurance coverage was provided at the following maximum amounts:

Coverage	2016
Employee Fidelity	$ 500,000
Automobile/Property	1,000,000
Workers' Compensation	1,000,000
Employment Practices	5,000,000
General Liability/Umbrella	5,000,000

Over the past three fiscal years, in the ordinary course of business, TEL has filed insurance claims with both the risk pool and the commercial insurers. None of the related settlements exceeded the provided insurance coverage.

Note 12. Commitments and Contingencies

Legal - TEL is subject to litigation in the ordinary course of its business. In the opinion of management and legal counsel, the outcome of such litigation will not have a material impact on the financial position or cash flows of TEL. Furthermore, as of the year ended June 30, 2016, management is not aware of any related liabilities.

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Independent Auditor's 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*

The Honorable Bill Haslam, Governor
Members of the General Assembly
Board of Directors, Tennessee Education Lottery Corporation

We have audited the financial statements of the Tennessee Education Lottery Corporation, a component unit of the State of Tennessee, as of and for the year ended June 30, 2016, and the related notes to the financial statements, which collectively comprise the Tennessee Education Lottery Corporation's basic financial statements, and have issued our report thereon dated November 7, 2016. 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 of the financial statements, we considered the Tennessee Education Lottery Corporation's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Tennessee Education Lottery Corporation's internal control. Accordingly, we do not express an opinion on the effectiveness of the Tennessee Education Lottery Corporation's internal control.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Tennessee Education Lottery Corporation's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, 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*.

Purpose of This Report

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and the results of that testing, and not to provide an opinion on the effectiveness of the entity's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the entity's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

Deborah V. Loveless

Deborah V. Loveless, CPA
Director
November 7, 2016