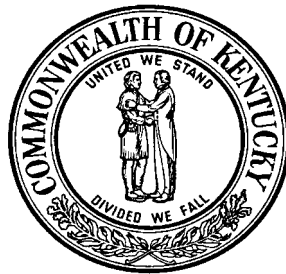


**REPORT OF THE AUDIT OF THE
KENTUCKY LOTTERY CORPORATION**

**For The Years Ended
June 30, 2009 and 2008**



**CRIT LUALLEN
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CRIT LUALLEN
AUDITOR OF PUBLIC ACCOUNTS

To the People of Kentucky

Honorable Steven L. Beshear, Governor

Honorable David L. Williams, President, Kentucky Senate

Honorable Greg Stumbo, Speaker, Kentucky House of Representatives

Board of Directors, Kentucky Lottery Corporation

The enclosed report prepared by Harding, Shymanski and Company, P.S.C., Certified Public Accountants and Consultants, presents the financial and compliance audit of the books and records of the Kentucky Lottery Corporation for the years ended June 30, 2009 and 2008, as required by KRS 154A.130.

We engaged Harding, Shymanski and Company, P.S.C. to perform the audit in accordance with auditing standards generally accepted in the United States of America. We worked closely with the firm during our report review process.

Respectfully submitted,

A handwritten signature in cursive script that reads "Crit Luallen".

Crit Luallen
Auditor of Public Accounts

Enclosure





KENTUCKY LOTTERY®

Financial Report

June 30, 2009

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INDEPENDENT AUDITOR'S REPORT

To the Auditor of Public Accounts,
Commonwealth of Kentucky, and
the Board of Directors of the
Kentucky Lottery Corporation



**HARDING, SHYMANSKI
AND COMPANY, P.S.C.**

Certified Public Accountants
and Consultants

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*An Independently
Owned Member of the
RSM McGladrey Network*

We have audited the accompanying financial statements of the Kentucky Lottery Corporation (KLC), a component unit of the Commonwealth of Kentucky, as of and for the years ended June 30, 2009 and 2008, as listed in the table of contents. These financial statements are the responsibility of the KLC's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial positions of the KLC, as of June 30, 2009 and 2008, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

INDEPENDENT AUDITOR'S REPORT (CONTINUED)



In accordance with *Government Auditing Standards* for the years ended June 30, 2009, we have also issued our report dated September 18, 2009, on our consideration of the KLC's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audits.

Harding, Shymanski & Company, P.S.C.

Louisville, Kentucky
September 18, 2009

Kentucky Lottery Corporation
Management's Discussion and Analysis

Our discussion of the Kentucky Lottery Corporation's (KLC) financial performance provides an overview of the KLC's financial activities for the fiscal years ended June 30, 2009 and 2008. Please read it in conjunction with the financial statements, which follow.

Financial Highlights

- Ticket Sales for 2009 were a record \$810.5 million compared to \$778.2 million in 2008, an increase of \$32.3 million or 4.2 percent. Scratch-off ticket sales increased \$33.2 million or 7 percent, the tenth consecutive year of sales growth.
- Due to a decrease in prize payouts, 61.5 percent of sales in 2009 compared to 63.4 percent of sales in 2008, gross profit for 2009 was \$235.3 million compared to \$225.8 million in 2008, an increase of \$9.5 million, or 4.2 percent.
- Operating expenses for 2009 decreased \$4.2 million to \$33.1 million or 4.5 percent of sales, the lowest operating percentage in KLC history. For the past three years, operating expenses have decreased \$7.4 million or 18.3 percent.
- Payments to the Commonwealth of Kentucky's KEES/Education programs in 2009 were \$204.4 million or 26.7 percent of sales compared to \$192.1 million or 24.7 percent of sales in 2008, an increase of \$12.3 million or 6.4 percent.

Using This Annual Report

The KLC is accounted for as an enterprise fund, reporting on all of the activity's assets and liabilities using the accrual basis of accounting much like a private business activity. As such, this annual report consists of a series of financial statements, along with explanatory notes to the financial statements and supplemental schedules. The Statements of Net Assets and the Statements of Revenues, Expenses, and Changes in Net Assets report the KLC's net assets and changes in them.

To assess the KLC's financial position and financial health, the reader of these statements should pay particular attention to changes in the components of assets and liabilities as set forth on the Statements of Net Assets, and in changes in operating revenues and expenses as set forth in the Statements of Revenues, Expenses, and Changes in Net Assets.

Total Assets

Total assets consist primarily of cash and cash equivalents, investments, accounts receivable, and capital assets. As shown in Table 1, the KLC's total assets decreased \$22.6 million from \$218.8 million in 2008 to \$196.2 million in 2009. In 2008, total assets decreased \$19.1 million during the year from \$237.9 million to \$218.8 million. Cash, cash equivalents, and investments decreased \$20.8 million in 2009 from \$173.9 million to \$153.1 million; and in 2008, decreased \$20.2 million from \$194.1 million to \$173.9 million. The change in this account is due primarily to a decrease in market value of the KLC's investments and to the fact that there were minimal additions to the pool of installment prizes in 2009 and 2008. Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value. Accounts receivable represents revenue to be collected from the sales of on-line and instant game tickets to retailers. Capital assets consist of buildings, game equipment, data processing equipment, etc. utilized by the KLC in the sale of on-line and instant game tickets.

Kentucky Lottery Corporation
Management's Discussion and Analysis (Continued)

Capital Assets

The KLC's investment in capital assets, net of accumulated depreciation in 2009 and 2008, was \$7.7 million and \$9 million, respectively. The investment in capital assets includes buildings, game equipment, data processing equipment, automobiles, software, and furniture and fixtures. The total decrease in the KLC's investment in net capital assets for 2009 was \$1.3 million or 14.4 percent compared to a decrease of \$2.2 million or 19.6 percent in 2008. The major capital asset events during 2009 and 2008 were the purchase of data processing equipment. Additional information on the KLC's capital assets can be found in Note 6 to the financial statements.

Table 1
Net Assets
(in millions)

	<u>2009</u>	<u>2008</u>	<u>% Change</u>	<u>2007</u>
Current and Other Assets	\$78.3	\$78.6	-0.4%	\$81.7
Investments	105.5	126.4	-16.5%	140.4
Capital assets, net	7.7	9.0	-14.4%	11.2
Deposits with MUSL	4.7	4.8	-2.1%	4.6
Total assets	<u>196.2</u>	<u>218.8</u>	<u>-10.3%</u>	<u>237.9</u>
Current Liabilities	62.8	63.3	-0.8%	68.6
Long-term liabilities	97.0	116.3	-16.6%	134.3
Total liabilities	<u>159.8</u>	<u>179.6</u>	<u>-11.0%</u>	<u>202.9</u>
Net Assets				
Invested in capital assets	7.7	9.0	-14.4%	11.2
Unrestricted- accumulated unrealized gains on investments	12.9	13.9	-7.2%	8.0
Unrestricted	15.8	16.3	-3.1%	15.8
Total net assets	<u>\$36.4</u>	<u>\$39.2</u>	<u>-7.1%</u>	<u>\$35.0</u>

Table 2
Liabilities
(in millions)

	<u>Current</u>			<u>Long-term</u>		
	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Prize liabilities	\$ 53.0	\$ 55.7	\$ 54.9	\$ 97.0	\$ 116.3	\$ 134.3
Due to Commonwealth	3.6	0.3	6.6			
Accounts payable and other liabilities	6.2	7.3	7.1			
Total liabilities	<u>\$ 62.8</u>	<u>\$ 63.3</u>	<u>\$ 68.6</u>	<u>\$ 97.0</u>	<u>\$ 116.3</u>	<u>\$ 134.3</u>

Total current liabilities decreased \$.5 million or .7 percent in 2009 and \$5.3 million or 7.7 percent in 2008. The account titled "Due to Commonwealth" increased \$3.3 million in 2009 and decreased \$6.3 million in 2008. This is a timing issue and represents payments due to the General Fund and the KEES Reserve Fund after the fiscal year-end.

Long-term liabilities consist principally of prize liability for prizes paid in installments over several years. Long-term prize liability decreased \$19.3 million or 16.6 percent in 2009 and \$18 million or 13.4 percent in 2008. The decrease is attributable to the maturing of some long-term prize liabilities as well as minimal additions to the pool of annuitized installment prizes. More detailed information can be obtained in Note 7 to the financial statements.

Kentucky Lottery Corporation
Management's Discussion and Analysis (Continued)

Net Assets

As shown below in Table 3, the KLC's net assets in 2009 decreased \$2.7 million. The decrease was mainly attributable to the decrease in market value of investments the KLC holds to fund future payments due on annuitized lottery prizes. Accounting principles dictate the KLC record in its financial records the gain or loss related to the change in market value of these investments. Zero-coupon U.S. government bonds have been purchased for the payment of installment prize awards and are generally held to maturity. The change in the market value of these investments (i.e. the unrealized losses on investments) was recorded as a decrease in unrestricted net assets. The accumulated unrealized gain on investments included in unrestricted net assets at June 30, 2009 is not available for transfer to the Commonwealth's general fund. The KLC's investment in capital assets, net of related debt, of \$7.7 million is also not available for transfer to the Commonwealth's general fund as these assets are utilized in the KLC's day-to-day operations. The remaining net assets of \$15.8 million are unrestricted and are available for transfer to the Commonwealth's general fund based on the KLC's cash flow and working capital requirements. In 2008, net assets increased \$4.2 million to \$39.2 million.

Changes in Net Assets

Table 3
Changes in Net Assets
(in millions)

	2009	2008	2007
Operating revenues			
Instant games	\$ 518.3	\$ 486.4	\$ 458.0
On-line games	292.2	291.8	286.2
Less tickets provided as prizes	(45.5)	0.0	0.0
Total operating revenues	765.0	778.2	744.2
Nonoperating revenues	8.0	17.5	12.9
Total revenues	773.0	795.7	757.1
Operating expenses			
Direct costs:			
Prize expense	470.4	493.1	456.3
Commissions to retailers	50.3	50.1	47.8
Ticket costs	9.0	9.2	8.1
Total direct costs	529.7	552.4	512.2
Administrative expenses	33.1	37.3	38.2
Total operating expenses	562.8	589.7	550.4
Nonoperating expenses	8.5	9.8	11.8
Payments to the Commonwealth of KY	204.4	192.1	196.3
Total expenses	775.7	791.6	758.5
Changes in net assets	(\$2.7)	\$4.1	(\$1.4)

Kentucky Lottery Corporation
Management's Discussion and Analysis (Continued)

See Statements of Revenues, Expenses, and Changes in Net Assets for items included in each line of Table 3. See Tables 4, 5, and 6 for explanation of differences in the above items for 2009 and 2008.

Sales and Prize Expenses

Sales

Table 4 compares sales, prizes, unclaimed prizes, and gross margin (sales minus net prizes) for each lottery game category for FY 2009, FY 2008, and FY 2007. In 2009, the KLC produced record sales of \$810.5 million; an increase of \$32.3 million or 4.2 percent when compared to 2008. Beginning in FY 2009, certain scratch-off games included free tickets as prizes, which entitled the holder to exchange one instant ticket for another of equal value. The selling price of free tickets reduces instant ticket revenue when the ticket is claimed by a player. Total ticket sales, net of \$45.5 million of free tickets provided as prizes, were \$765 million.

Operating revenues consist of ticket sales from two product categories, instant games and on-line games. Instant games consist of scratch-off tickets and pull-tab tickets. Scratch-off ticket sales, which accounted for 62.2 percent of all KLC sales, reached an all time high in 2009 of \$470.9 million, an increase of \$33.2 million or 7 percent over 2008. Sales growth within this product category continued to occur at the \$5, \$10, and \$20 price points with increases of \$15.2 million or 9.9 percent, \$13.6 million or 16.7 percent, and \$4.7 million or 7 percent, respectively. The \$5, \$10, and \$20 price points accounted for 69.6 percent of scratch-off sales compared to 67.3 percent in 2008. Slight sales declines were recognized at the \$1 and \$2 price points with decreases of \$.2 million or .5 percent and \$.1 million or .1 percent, respectively. Pull-tab tickets experienced its ninth consecutive annual decline with sales of \$14.2 million, a decrease of \$1.3 million or 8.1 percent.

In 2009, on-line games, which consisted of Pick 3, Pick 4, KY Cash Ball, Powerball, Win for Life, Three Line Lotto, and Tic Tac Cash, accounted for 36 percent of all 2009 KLC sales compared to 37.5 percent in 2008. On-line game sales were \$292.2 million, an increase of \$.4 million or .1 percent when compared to FY 2008. Sales increases were recognized in the following on-line games: Pick 3, an increase of \$4.1 million or 3.4 percent; Pick 4, an increase of \$1.5 million or 4.3 percent; and KY Cash Ball, an increase of \$.4 million or 3 percent. Pick 3 and Pick 4 sales were impacted by higher prize payouts compared to previous years. Sales decreases were recognized in Powerball, a decrease of \$1.5 million or 1.5 percent; Three Line Lotto, a decrease of \$2.3 million or 17.2 percent; and Win for Life, a decrease of \$1.8 million or 15.8 percent. Powerball sales were negatively impacted by the lack of a jackpot above \$222 million.

In 2008, the KLC produced record sales of \$778.2 million; an increase of \$34 million or 4.6 percent when compared to 2007. Scratch-off ticket sales, which accounted for 60.5 percent of all KLC sales, reached an all time high in 2008 at \$470.9 million, an increase of \$31.3 million or 7.1 percent over 2007. Pull-tab tickets experienced its eighth consecutive annual decline with sales of \$15.5 million, a decrease of \$2.9 million or 15.8 percent.

On-line games during 2008, consisted of Pick 3, Pick 4, KY Cash Ball, Powerball, Win for Life, Three Line Lotto, one raffle style game (Lucky 7's sales began in May 2007 and concluded in August 2007), and Tic Tac Cash, accounted for 37.5 percent of all 2008 KLC sales compared to 38.5 percent in 2007. On-line game sales were \$291.8 million, an increase of \$5.6 million or 2 percent when compared to FY 2007.

Kentucky Lottery Corporation
Management's Discussion and Analysis (Continued)

Table 4
Lottery Sales
(in millions)

	Scratch-off			Pull-tab			Pick 3		
	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Sales	\$ 504.1	\$ 470.9	\$ 439.6	\$ 14.2	\$ 15.5	\$ 18.4	\$ 124.4	\$ 120.3	\$ 116.8
Less Tkts as prizes	(45.5)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Ticket Sales	458.6	470.9	439.6	14.2	15.5	18.4	124.4	120.3	116.8
Gross Prizes	308.3	329.3	305.6	9.8	10.7	12.7	78.8	75.8	64.5
Less Unclaimed Prizes	(6.8)	(4.9)	(4.0)	(0.1)	(0.1)	(0.2)	(0.9)	(0.8)	(0.7)
Net Prizes	301.5	324.4	301.6	9.7	10.6	12.5	77.9	75.0	63.8
Gross Margin	\$ 157.1	\$ 146.5	\$ 138.0	\$ 4.5	\$ 4.9	\$ 5.9	\$ 46.5	\$ 45.3	\$ 53.0

	Pick 4			3 Line Lotto / Raffles / Tic Tac Cash			Powerball		
	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Sales	\$ 36.1	\$ 34.6	\$ 35.0	\$ 11.2	\$ 13.6	\$ 11.2	\$ 96.9	\$ 98.4	\$ 93.8
Less Tkts as prizes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total Ticket Sales	36.1	34.6	35.0	11.2	13.6	11.2	96.9	98.4	93.8
Gross Prizes	19.0	16.6	14.7	6.9	8.8	6.6	48.5	49.1	47.0
Less Unclaimed Prizes	(0.3)	(0.3)	(0.5)	(0.4)	(0.4)	(0.1)	(2.0)	(1.9)	(2.8)
Net Prizes	18.7	16.3	14.2	6.5	8.4	6.5	46.5	47.2	44.2
Gross Margin	\$ 17.4	\$ 18.3	\$ 20.8	\$ 4.7	\$ 5.2	\$ 4.7	\$ 50.4	\$ 51.2	\$ 49.6

	KY Cash Ball			Win for Life			Total		
	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
Sales	\$ 14.2	\$ 13.7	\$ 14.6	\$ 9.4	\$ 11.2	\$ 14.8	\$ 810.5	\$ 778.2	\$ 744.2
Less Tkts as prizes	0.0	0.0	0.0	0.0	0.0	0.0	(45.5)	0.0	0.0
Total Ticket Sales	14.2	13.7	14.6	9.4	11.2	14.8	765.0	778.2	744.2
Gross Prizes	6.4	6.4	7.2	3.6	5.3	6.9	481.3	502.0	465.2
Less Unclaimed Prizes	(0.2)	(0.2)	(0.2)	(0.2)	(0.3)	(0.5)	(10.9)	(8.9)	(9.0)
Net Prizes	6.2	6.2	7.0	3.4	5.0	6.4	470.4	493.1	456.2
Gross Margin	\$ 8.0	\$ 7.5	\$ 7.6	\$ 6.0	\$ 6.2	\$ 8.4	\$ 294.6	\$ 285.1	\$ 288.0

Kentucky Lottery Corporation
Management's Discussion and Analysis (Continued)

Prize Expense

In general, prize expense by game should increase or decrease from year to year in proportion to the increase or decrease in sales for a particular game. However, except for the instant game product category, prize expense is also impacted by the luck of the draw. Prize expense for the instant game product category is controllable, to a large degree, by printing a predetermined number and value of winning tickets in the production of each instant game. Prize expense for the on-line lottery products is not predetermined. While each of these lottery products is designed to yield a certain ratio of prizes to sales over a large number of drawings, actual prize payout is determined by lottery players' luck in matching the particular set of numbers randomly selected in each drawing for each game. With that background, Table 4 shows the prize payout by lottery product for 2009, 2008, and 2007.

Gross prize expense in 2009 of \$481.3 million, reflects a 4.1 percent decrease from 2008 gross prize expense of \$502 million. Following is a discussion of notable variances in prize expense within certain product categories.

As was noted in the Sales discussion above, beginning in 2009, the KLC implemented the use of "free ticket prizes" as the entry prize for each new scratch-off game. This strategy helped reduce gross prize expense for instant games in 2009 to 67.2 percent of cash instant sales compared to 69.9 percent in 2008.

Gross prize expense for on-line games increased .7 percent, while sales from on-line games increased .1 percent. In 2009, gross prize expense for on-line games was 55.8 percent of on-line sales compared to 55.5 percent in 2008. Pick 3 gross prize expense was 63.3 percent of Pick 3 sales compared to 63 percent for 2008 and 60 percent of budgeted FY 2009 Pick 3 sales. Pick 4 gross prize expense was 52.5 percent of Pick 4 sales compared to 48 percent for 2008 and 50 percent of budgeted FY 2009 Pick 4 sales. Gross prize expense for the remainder of the on-line games was at or below FY 2009 budgeted levels.

Net prize expense in 2009 was \$470.4 million or 61.5 percent of sales compared to \$493.1 million or 63.4 percent of sales in 2008. Unclaimed prizes in 2009 were \$10.9 million compared to \$8.9 million in 2008.

Gross prize expense in 2008 of \$502 million, reflects a 7.9 percent increase from 2007 gross prize expense of \$465.2 million. Following is a discussion of notable variances in prize expense within certain product categories.

Within product lines, gross prize expense for the instant games increased 6.8 percent while sales from instant games increased 6.2 percent. In 2008, gross prize expense for instant games was 69.9 percent of instant sales compared to 69.5 percent in 2007. This reflects the continuing shift to the higher price points (\$5, \$10, and \$20 games) as was noted in the scratch-off sales discussion above. As a rule, instant games with higher price points payout more in prizes than instant games with lower price points.

Gross prize expense for on-line games increased 10.1 percent, while sales from on-line games increased 2 percent. In 2008, gross prize expense for on-line games was 55.5 percent of on-line sales compared to 51.4 percent in 2007. Pick 3 gross prize expense was 63 percent of Pick 3 sales compared to 55.2 percent for 2007 and 61 percent of budgeted Pick 3 sales. Gross prize expense for Three Line Lotto of 64.4 percent was higher than 2007 and the current year budgeted amount. Gross prize expense for the remainder of the on-line games was below budgeted levels for 2008.

Net prize expense in 2008 was \$493.1 million or 63.4 percent of sales compared to \$456.4 million or 61.3 percent of sales in 2007. Unclaimed prizes in 2008 were \$8.9 million compared to \$9 million in 2007.

Kentucky Lottery Corporation
Management's Discussion and Analysis (Continued)

Other Expenses

Table 5
Commissions, Operating, and Nonoperating Expenses
(in millions)

	<u>2009</u>	<u>2008</u>	<u>% Change</u>	<u>2007</u>
Retailer commissions	\$ 50.3	\$ 50.1	0.4%	\$ 47.8
Ticket costs	\$ 9.0	\$ 9.2	-2.2%	\$ 8.1
Operating expenses	\$ 33.1	\$ 37.3	-11.3%	\$ 38.2
Nonoperating expenses				
Amortization of prize discount	\$ 8.5	\$ 9.8	-13.3%	\$ 11.8

Retailer commissions cover base selling and cashing commissions as well as a retailer incentive plan based on the sale of instant tickets. Retailer commissions for 2009 and 2008 were 6.6 percent and 6.4 percent of sales, respectively. Ticket costs include the cost to produce and ship instant tickets. Ticket costs for 2009 and 2008 were 1.2 percent of sales. Operating expenses decreased \$4.2 million for FY 2009 and were 4.3 percent of sales, the lowest percentage of sales in the KLC's history, compared to 4.8 percent of sales in FY 2008. Amortization of prize discount, which reflects the periodic write-off of the difference between the present value of installment prizes and the face value of said prizes, decreased \$1.3 million and \$2 million in 2009 and 2008, respectively.

Other Revenues

	<u>2009</u>	<u>2008</u>	<u>% Change</u>	<u>2007</u>
Unrealized gain (loss)				
on investments	\$ (1.0)	\$ 5.9	-116.9%	\$ (1.4)
Amortization on bonds	\$ 8.5	\$ 9.8	-13.3%	\$ 11.8
Interest income	\$ 0.3	\$ 1.6	-81.3%	\$ 2.2
Other miscellaneous revenue	\$ 0.2	\$ 0.2	0.0%	\$ 0.3
Total nonoperating revenues	<u>\$ 8.0</u>	<u>\$ 17.5</u>	<u>-54.3%</u>	<u>\$ 12.9</u>

Unrealized gain (loss) on investments represents the impact on income of recording investments at their fair value compared to the historical cost method.

Interest income consists principally of interest on the KLC's cash balance, which is invested in short-term investments. The decrease in interest income reflects the federal government's continued policy to lower short-term interest rates in 2009.

Miscellaneous revenues consist primarily of various fees assessed to retailers and income earned from a security-lending program and the sale of fixed assets.

Kentucky Lottery Corporation
Management's Discussion and Analysis (Continued)

Payments to the Commonwealth of Kentucky

In 2009 and 2008, payments to the Commonwealth of Kentucky represent a transfer of funds from the KLC to the Commonwealth's general fund and the KEES Program Reserve Account. Payments to the general fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are appropriated by the General Assembly to provide funding for postsecondary education and literacy development. Payments to the KEES Reserve Account are used to provide funding for postsecondary education. Payments to the Commonwealth of Kentucky in 2009 were \$204.4 million, an increase of \$12.3 million or 6.4 percent when compared to 2008. Payments in 2008 were \$192.1 million, a decrease of \$4.2 million or 2.1 percent when compared to 2007.

Currently Known Facts, Decisions, or Conditions

The current economic recession, including double-digit unemployment, has adversely affected the disposable income available for lottery purchases by our players.

In an effort to increase sales, the KLC is evaluating new on-line games as well as changes to other existing on-line games. The KLC is also planning to introduce up to three new double-sided scratch-off tickets.

Contacting the KLC's Financial Management

This financial report is designed to provide the public and other interested parties with an overview of the financial results of the KLC's activities, and to show the KLC's accountability for the revenue that it generates. If you have any questions about this report or need additional financial information, contact the KLC's Public Relations Department at the Kentucky Lottery Corporation, 1011 West Main Street, Louisville, Kentucky 40202.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF NET ASSETS

June 30, 2009 and 2008

(dollars in thousands)

	2009	2008
ASSETS		
Current Assets		
Cash and equivalents	\$ 17,824	\$ 16,049
Investments at fair value, current portion	29,694	31,482
Accounts receivable, net	30,240	30,498
Ticket inventories	107	117
Other	398	470
Total current assets	<u>78,263</u>	<u>78,616</u>
Noncurrent Assets		
Investments at fair value, less current portion	105,536	126,415
Capital assets, net	7,694	9,013
Deposits with Multi-State Lottery Association	4,717	4,731
Total noncurrent assets	<u>117,947</u>	<u>140,159</u>
Total assets	<u><u>196,210</u></u>	<u><u>218,775</u></u>
LIABILITIES		
Current Liabilities		
Accounts payable and accrued expenses	6,260	7,302
Due to the Commonwealth of Kentucky	3,575	357
Estimated prize liability, current portion	52,991	55,668
Total current liabilities	<u>62,826</u>	<u>63,327</u>
Noncurrent Liabilities		
Estimated prize liability, less current portion	<u>96,964</u>	<u>116,323</u>
Total liabilities	<u>159,790</u>	<u>179,650</u>
NET ASSETS		
Invested in capital assets	7,694	9,013
Unrestricted	<u>28,726</u>	<u>30,112</u>
Total net assets	<u><u>\$ 36,420</u></u>	<u><u>\$ 39,125</u></u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

For the Years Ended June 30, 2009 and 2008

(dollars in thousands)

	2009	2008
Operating revenues		
Instant games	\$ 518,361	\$ 486,425
On-line games	292,183	291,786
Less instant tickets provided as prizes	<u>(45,510)</u>	<u>0</u>
Total operating revenues	<u>765,034</u>	<u>778,211</u>
Direct costs		
Prize expense		
Instant games	311,352	335,039
On-line games	<u>159,085</u>	<u>158,020</u>
Total prize expense	470,437	493,059
Commissions to retailers	50,248	50,142
Ticket costs	<u>9,037</u>	<u>9,198</u>
Total direct costs	<u>529,722</u>	<u>552,399</u>
Gross profit	<u>235,312</u>	<u>225,812</u>
Operating expenses		
Advertising and promotion	8,435	10,379
Salaries, wages, and benefits	12,938	14,538
Contracted and professional services	6,901	7,060
Depreciation	2,583	3,052
Other general and administrative	<u>2,247</u>	<u>2,268</u>
Total operating expenses	<u>33,104</u>	<u>37,297</u>
Operating income	<u>202,208</u>	<u>188,515</u>
Nonoperating income (expense)		
Payments to the Commonwealth of Kentucky	(204,394)	(192,083)
Investment income	7,791	17,259
Interest expense	(8,531)	(9,794)
Other income	<u>221</u>	<u>215</u>
Total nonoperating expense	<u>(204,913)</u>	<u>(184,403)</u>
Increase (decrease) in net assets	<u>(2,705)</u>	<u>4,112</u>
Net assets at beginning of year	<u>39,125</u>	<u>35,013</u>
Net assets at end of year	<u>\$ 36,420</u>	<u>\$ 39,125</u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF CASH FLOWS

For the Years Ended June 30, 2009 and 2008

(dollars in thousands)

	2009	2008
Cash Flows from Operating Activities		
Cash received from customers	\$ 765,292	\$ 775,048
Cash payments to prize winners	(501,004)	(520,007)
Cash payments to suppliers	(77,764)	(78,955)
Cash payments to employees for services	(13,000)	(14,369)
Net cash provided by operating activities	<u>173,524</u>	<u>161,717</u>
Cash Flows from Noncapital Financing Activities		
Payments to the Commonwealth of Kentucky	<u>(201,176)</u>	<u>(198,344)</u>
Cash Flows from Capital and Related Financing Activities		
Purchases of capital assets	(1,266)	(822)
Proceeds from disposal of capital assets	0	43
Net cash used in capital and related financing activities	<u>(1,266)</u>	<u>(779)</u>
Cash Flows from Investing Activities		
Proceeds from sale of investments	31,842	32,297
Purchase of investments	(1,626)	(2,682)
Increase (decrease) in deposits at the Multi-State Lottery Association	14	(142)
Investment income	463	1,765
Net cash provided by investing activities	<u>30,693</u>	<u>31,238</u>
Net increase (decrease) in cash and cash equivalents	1,775	(6,168)
Cash and equivalents at beginning of year	<u>16,049</u>	<u>22,217</u>
Cash and equivalents at end of year	<u><u>\$ 17,824</u></u>	<u><u>\$ 16,049</u></u>

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

STATEMENTS OF CASH FLOWS (CONTINUED)

For the Years Ended June 30, 2009 and 2008

(dollars in thousands)

	2009	2008
Reconciliation of Operating Income to Net Cash		
Provided by Operating Activities		
Operating income	<u>\$ 202,208</u>	<u>\$ 188,515</u>
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	2,585	3,052
Provision for losses on accounts receivable	162	68
Increase (decrease) in cash due to changes in:		
Accounts receivable, net	96	(3,231)
Ticket inventories	10	19
Other assets	72	60
Accounts payable and accrued expenses	(1,042)	182
Estimated prize liability	<u>(30,567)</u>	<u>(26,948)</u>
Total adjustments	<u>(28,684)</u>	<u>(26,798)</u>
Net cash provided by operating activities	<u>\$ 173,524</u>	<u>\$ 161,717</u>

Noncash capital and investing activities:

The accretion of interest on investments held to fund grand prizes, which increased prize liability for the years ended June 30, 2009 and 2008 totaled \$8,531 and \$9,794, respectively.

The fair value of investments decreased \$980 and increased \$5,878 for the years ended June 30, 2009 and 2008, respectively.

See accompanying notes.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 1 – Organization

The Kentucky Lottery Corporation (KLC) was created with the enactment of House Bill No. 1 in December 1988 as an independent de jure municipal corporation and political subdivision of the Commonwealth of Kentucky (Commonwealth). The KLC is to be managed in such a manner that enables the people of the Commonwealth to benefit from its profits and to enjoy the best possible lottery games. The operations of the KLC are separate and distinct from other operations of the Commonwealth.

The KLC commenced operations on April 4, 1989 with the sale of instant game tickets. Sales of on-line games began October 16, 1989. In January 1991, the KLC joined the Multi-State Lottery Association (MUSL), a group of states that combine lottery sales for on-line games.

Note 2 – Summary of Significant Accounting Policies

Reporting Entity

The KLC has adopted the provisions of Government Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, as amended by GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units*, under which the financial statements include all the organizations, activities, functions, and component units for which the KLC is financially accountable. Financial accountability is defined as the appointment of a voting majority of the component unit's Board, and either (1) the KLC's ability to impose its will over the component unit, or (2) the possibility that the component unit will provide a financial benefit to or impose a financial burden on the KLC.

The KLC has determined that no outside agency meets the above criteria and, therefore, no other agency has been included as a component unit in the KLC's financial statements. In addition, since the KLC provides a financial benefit for the Commonwealth, the KLC is part of the reporting entity of the Commonwealth and is, therefore, included in the Commonwealth's Comprehensive Annual Financial Report as a blended component unit. The accompanying financial statements are not intended to present the financial position or the results of operations and cash flows of the Commonwealth or its proprietary funds.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 2 – Summary of Significant Accounting Policies (Continued)

Basis of Presentation

The KLC is accounted for as an enterprise fund. The financial statements are prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. The KLC has elected to apply all applicable GASB pronouncements as well as Financial Accounting Standards Board (FASB) pronouncements and Accounting Principles Board (APB) opinions issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements. The KLC has further elected not to apply FASB pronouncements issued after November 30, 1989, in accordance with GASB Statement No. 20.

As an enterprise fund, the KLC distinguishes *operating* revenues and expenses from *non-operating* items. Operating revenues and expenses generally result from providing services and delivering goods in connection with the KLC's principal ongoing operations. The principal operating revenues of the KLC are charges to customers for sales of lottery products. Operating expenses include the cost of sales and services, selling and administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Revenue and Accounts Receivable Recognition

Revenue and accounts receivable for on-line games are recognized when tickets are sold to the public by contracted retailers.

Revenue and accounts receivable for instant games are recognized upon activation or issuance of tickets for sale by the contracted retailers, or 50 days from the date of issuance of the tickets to the retailers, whichever is sooner. During the fiscal year ended June 30, 2009, the KLC implemented certain instant games that include free tickets, which entitle the holder to exchange one instant ticket for another of equal value. The redemption of free tickets is netted against total operating revenue.

Allowance for Doubtful Accounts

The KLC uses the allowance method to account for uncollectible accounts receivable. Trade receivables are written-off when deemed uncollectible. Recoveries of trade receivables previously written-off are recorded when received. KLC wrote off \$162,000 and \$67,500 for the years ended June 30, 2009 and 2008, respectively. A trade receivable is considered uncollectible after no payment has been received in 120 days.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 2 – Summary of Significant Accounting Policies (Continued)

Prizes

Prize expense for instant ticket games is recorded as an estimate at the time the related revenue is recognized based on the predetermined prize structure for each game; periodically, the prize expense is adjusted to reflect amounts actually won. Prize expense for on-line games is recorded at the time the related revenue is recognized based on the known prize payout structure. Grand prizes are awarded related to the Win for Life and Powerball on-line games.

Win for Life grand prizes are paid in quarterly installments of \$13,000 for the life of a winner, or a minimum of 10 years. The KLC recognizes Win for Life prize expense at the time the related revenue is recognized based on the known prize payout structure calculated by an actuarial study. The KLC reviews those statistics to actual results for any changes that may need to be made based on the age of the winner. A portion of the Win for Life sales of the KLC is remitted to the Virginia State Lottery, the designated administrator for Win for Life, to fund grand prize payments. All Win for Life grand prizes are funded through the purchase of U.S. Treasury zero-coupon bonds. The Party Lottery which sold the grand prize winning ticket has the first option of purchasing the investments, but may defer the purchase to another Party Lottery.

Powerball grand prizes are paid in 30 annual installments or in a single lump-sum payment equal to the estimated present cash value of 30 annual payments. The KLC recognizes Powerball prize expense at the time the related revenue is recognized based on the known prize payout structure. A portion of Powerball sales of the KLC is remitted to MUSL to fund prize payments. MUSL purchases U.S. Treasury certificates and other U.S. Government backed investments to fund prize liability to Powerball winners electing annual installments.

Cash and Equivalents

For financial statement purposes, the KLC considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

Investments

Investments consist of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities carried at fair value in accordance with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*. Fair value of investments is based on quoted market prices. Investments are in U.S. Treasury zero-coupon bonds and are purchased to meet future installment payments to grand prize winners. There are generally no realized gains or losses on investments, as it is the KLC's policy to hold the investments to maturity.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 2 – Summary of Significant Accounting Policies (Continued)

Ticket Inventories

Inventories are carried at cost (as determined by the specific identification method) and consist of pull-tab tickets located in the KLC's warehouses or held by retailers. The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above. Instant scratch-off tickets are held in the KLC's warehouse on a consignment basis, and are not recorded as inventory.

Capital Assets

Capital assets are carried at cost less accumulated depreciation. The KLC defines capital assets as assets with an initial, individual cost of more than \$500 and an estimated useful life in excess of one year. Depreciation is computed using the straight-line method over estimated lives of the assets. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations in the period of disposal. The estimated useful lives by general classification are as follows:

	<u>Years</u>
Buildings	30
Leasehold improvements	The lesser of the life of the lease or asset
Game equipment	5
Data processing equipment	5
Automobiles, furniture, and fixtures	3-5

Amortization of leasehold improvements is computed using the straight-line method over lease terms ranging from three to five years. Interest related to construction of capital assets is capitalized. No interest was capitalized for the years ended June 30, 2009 and 2008.

Deposits with MUSL

Deposits are carried at cost. MUSL is a non-profit, government-benefit voluntary association created for the purpose of administering joint lottery games, such as Powerball. MUSL currently includes 30 state lottery entities, the District of Columbia, and the U.S. Virgin Islands. The chief executive officer of each member lottery serves on the MUSL Board of Directors. As a member of MUSL, the KLC is required to contribute to various prize reserve funds maintained by MUSL. The prize reserve funds serve as a contingency reserve to protect MUSL from unforeseen prize liabilities. All prize reserve funds remitted, and the related interest earnings, will be returned to the KLC upon leaving MUSL, less any portion of unanticipated prize claims which may have been paid from the fund.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 2 – Summary of Significant Accounting Policies (Continued)

Compensated Absences

It is the KLC's policy to permit employees to accumulate earned but unused vacation and sick pay benefits. There is no liability recorded for unpaid accumulated sick leave since the KLC does not have a policy to pay unused amounts when employees separate from service. All vacation pay is accrued when incurred. Accrued vacation totalling approximately \$1,057,000 and \$932,000, as of June 30, 2009 and 2008, respectively, is included in accrued expenses in the accompanying statements of net assets.

Estimated Prize Liability

A liability for grand prize winners electing equal annual installments is recorded based on the cost of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. The estimated prize liability is presented in the statement of net assets net of this imputed interest. Imputed interest is amortized to interest expense over the life of the annuity utilizing the effective interest method.

On-line, non-grand prize liabilities are known and recorded daily after each draw. Instant, non-grand prize liabilities are based on the prize statistics that each game is designed around, and are booked each time a box of instant tickets are activated by a contracted retailer.

Net Assets

Net assets of the KLC are classified and displayed as three components:

- a. Invested in capital assets - Consists of capital assets, including restricted capital assets, net of accumulated depreciation and reduced by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets.
- b. Restricted net assets - Consists of assets with constraints placed on the use either by (1) external groups such as creditors, grantors, contributors, or laws or regulations of other governments; or (2) law through constitutional provisions or enabling legislation.
- c. Unrestricted net assets - All other net assets that do not meet the definition of "invested in capital assets, net of related debt" or "restricted".

As of June 30, 2009 and 2008, the KLC had no restricted net assets.

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 as of the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Accordingly, actual results could differ from those estimates.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS June 30, 2009 and 2008

Note 2 – Summary of Significant Accounting Policies (Continued)

Pending Accounting Pronouncements Not Yet Adopted

As of June 30, 2009, the GASB has issued the following statements not yet implemented by the KLC. The statements which might impact the KLC are as follows:

- GASB Statement No. 51, Accounting and Financial Reporting for Intangible Assets, issued July 2007, will be effective for the KLC's year ending June 30, 2010. This Statement provides guidance regarding how to identify, account for, and report intangible assets. The new standard characterizes an intangible asset as an asset that lacks physical substance, is nonfinancial in nature, and has an initial useful life extending beyond a single reporting period. Examples of intangible assets include easements, computer software, water rights, timber rights, patents, and trademarks. This standard provides that intangible assets be classified as capital assets (except for those explicitly excluded from the scope of the new standard, such as capital leases). Relevant authoritative guidance for capital assets should be applied to these intangible assets.
- GASB Statement No. 53, Accounting and Financial Reporting for Derivative Instruments, issued June 2008, will be effective for the KLC beginning with its year ending June 30, 2010. This Statement will improve how state and local governments report information about derivative instruments in their financial statements. The Statement specifically requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting. The guidance in this Statement also addresses hedge accounting requirements.
- GASB Statement No. 54, Fund Balance Reporting and Governmental Fund Type Definitions, issued March 2009, will be effective for the KLC beginning with its year ending June 30, 2011. This Statement is intended to improve the usefulness of information provided to financial report users about fund balances by providing clearer, more structured fund balance classifications, and by clarifying the definitions of existing governmental fund types. Fund balance information is among the most widely and frequently used information in state and local government financial reports. The GASB developed this standard to address the diversity of practice and the resulting lack of consistency that had evolved in fund balance reporting. To reduce confusion, the new standard establishes a hierarchy of fund balance classification based primarily on the extent to which a government is bound to observe spending constraints.

The KLC's management has not yet determined the effect these statements will have on the KLC's financial statements.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 3 – Cash Deposits

All of the KLC's deposits are either insured or collateralized. All deposits exceeding the federal depository insurance coverage level are collateralized with securities held by the KLC's agents in the KLC's name. The KLC's policy regarding custodial credit risk for deposits is for all overnight repurchase agreements to be fully collateralized by U.S. Government securities held by the KLC or by the KLC's agent in the KLC's name.

The KLC had deposits with financial institutions at June 30, 2009 and 2008 of approximately \$179,000 and \$117,000, respectively, which are fully covered by federal depository insurance.

Note 4 – Investments

At June 30, 2009, the KLC's investment balances were as follows (in thousands):

<u>Investment Type</u>	<u>Fair Value</u>	<u>Maturity</u>
Those investments included in cash and cash equivalents on the balance sheet		
Overnight repurchase agreement deposits	\$ <u>18,135</u>	Current
Those investments included in investments on the balance sheet		
U.S. Treasury Strips	\$ 51,363	Weighted average maturity of 3.37 years
Other U.S. Government backed	<u>83,867</u>	Weighted average maturity of 3.33 years
Total	\$ <u>135,230</u>	

Interest Rate Risk – The KLC has a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates. It is the policy of the KLC to hold investments to maturity.

Credit Risk – This is the risk that a counter party will fail to fulfil its obligation. The KLC mitigates this risk through its investment policy, which limits purchase of investments to U.S. Treasury Strips or other debt securities backed by the U.S. Government.

Concentration of Credit Risk – The KLC's general investment policy is to take a very conservative approach when investing KLC money. The policy requires 100 percent of KLC's investments must be in U.S. Treasuries or other debt securities backed by the U.S. Government.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 4 – Investments (Continued)

Custodial Credit Risk – The custodial credit risk for investments is the risk that in the event of the failure of the counterparty to a transaction, a government will not be able to recover the value of its investments or collateral securities that are in the possession of another party. A trust agreement documenting the custody arrangement is executed between the custodian and the KLC. Such agreement provides, among other stipulations, that the securities are not assets of the custodian subject to disposition in the event of the insolvency of the custodian.

At June 30, 2008, the KLC’s investment balances were as follows (in thousands):

<u>Investment Type</u>	<u>Fair Value</u>	<u>Maturity</u>
Those investments included in cash and cash equivalents on the balance sheet		
Overnight repurchase agreement deposits	\$ <u>16,730</u>	Current
Those investments included in investments on the balance sheet		
U.S. Treasury Strips	\$ 63,310	Weighted average maturity of 3.42 years
Other U.S. Government backed	<u>94,587</u>	Weighted average maturity of 3.74 years
Total	<u>\$ 157,897</u>	

The net increase in the fair value of investments includes all changes in fair value that occurred during the year. The components of investment income for the years ended June 30, 2009 and 2008 consisted of the following (in thousands):

	<u>2009</u>	<u>2008</u>
Net increase in fair value of investments	\$ 7,551	\$ 15,672
Interest income	<u>240</u>	<u>1,587</u>
Total investment income	<u>\$ 7,791</u>	<u>\$ 17,259</u>

When compared to the historical cost method, recording investments at fair value results in a decrease in income by approximately \$980,000 and an increase of \$5,878,000 in 2009 and 2008, respectively.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 4 – Investments (Continued)

Unrealized gains accumulated in unrestricted net assets at June 30, 2009 and 2008 are as follows (in thousands):

	<u>2009</u>	<u>2008</u>
Unrestricted net assets excluding unrealized gains on investments	\$ 15,841	\$ 16,247
Unrealized gains on investments	<u>12,885</u>	<u>13,865</u>
Total unrestricted net assets	<u>\$ 28,726</u>	<u>\$ 30,112</u>

The KLC is authorized by state statutes and investment policies approved by the Board of Directors to lend its investment securities. The lending is managed by the KLC's custodial bank. All loans can be terminated on demand by either the KLC or the borrowers, although the average term of loans is approximately one week. The custodial bank and its affiliates are prohibited from borrowing the KLC's securities. There were no securities which were lent at the end of June 30, 2009 and 2008.

Note 5 – Accounts Receivable

Accounts receivable at June 30, 2009 and 2008 consisted of the following (in thousands):

	<u>2009</u>	<u>2008</u>
Accounts receivable	\$ 30,571	\$ 30,809
Allowance for doubtful accounts	<u>(331)</u>	<u>(311)</u>
Accounts receivable, net	<u>\$ 30,240</u>	<u>\$ 30,498</u>

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 6 – Capital Assets

Capital asset activity for the year ended June 30, 2009 was as follows (in thousands):

	<u>Beginning balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending balance</u>
Capital assets not being depreciated:				
Land	<u>\$442</u>	<u>\$0</u>	<u>\$0</u>	<u>\$442</u>
Net capital assets, non-depreciable	<u>\$442</u>	<u>\$0</u>	<u>\$0</u>	<u>\$442</u>
Capital assets being depreciated:				
Buildings	\$7,285	\$20	\$0	\$7,305
Leasehold improvements	354	24	0	378
Game equipment	9,391	0	(989)	8,402
Data processing equipment	26,791	913	(47)	27,657
Automobiles, furniture, and fixtures	<u>3,409</u>	<u>309</u>	<u>(282)</u>	<u>3,436</u>
Total other capital assets at cost	<u>\$47,230</u>	<u>\$1,266</u>	<u>(\$1,318)</u>	<u>\$47,178</u>
Less accumulated depreciation for:				
Buildings	(\$2,580)	(\$246)	\$0	(\$2,826)
Leasehold improvements	(357)	(12)	0	(369)
Game equipment	(9,130)	(178)	989	(8,319)
Data processing equipment	(23,700)	(1,830)	47	(25,483)
Automobiles, furniture, and fixtures	<u>(2,892)</u>	<u>(319)</u>	<u>282</u>	<u>(2,929)</u>
Total accumulated depreciation	<u>(\$38,659)</u>	<u>(\$2,585)</u>	<u>\$1,318</u>	<u>(\$39,926)</u>
Net capital assets, depreciable	<u>\$8,571</u>	<u>(\$1,319)</u>	<u>\$0</u>	<u>\$7,252</u>

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS
June 30, 2009 and 2008

Note 6 – Capital Assets (Continued)

Capital asset activity for the year ended June 30, 2008 was as follows (in thousands):

	Beginning balance	Increases	Decreases	Ending balance
Capital assets not being depreciated:				
Land	\$442	\$0	\$0	\$442
Net capital assets, non-depreciable	<u>\$442</u>	<u>\$0</u>	<u>\$0</u>	<u>\$442</u>
Capital assets being depreciated:				
Buildings	\$7,267	\$18	\$0	\$7,285
Leasehold improvements	354	0	0	354
Game equipment	9,429	1	(39)	9,391
Data processing equipment	26,589	507	(305)	26,791
Automobiles, furniture, and fixtures	4,117	296	(1,004)	3,409
Total other capital assets at cost	<u>\$47,756</u>	<u>\$822</u>	<u>(\$1,348)</u>	<u>\$47,230</u>
Less accumulated depreciation for:				
Buildings	(\$2,334)	(\$246)	\$0	(\$2,580)
Leasehold improvements	(342)	(15)	0	(357)
Game equipment	(8,922)	(247)	39	(9,130)
Data processing equipment	(21,737)	(2,268)	305	(23,700)
Automobiles, furniture, and fixtures	(3,614)	(276)	998	(2,892)
Total accumulated depreciation	<u>(\$36,949)</u>	<u>(\$3,052)</u>	<u>\$1,342</u>	<u>(\$38,659)</u>
Net capital assets, depreciable	<u>\$10,807</u>	<u>(\$2,230)</u>	<u>(\$6)</u>	<u>\$8,571</u>

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 7 – Estimated Prize Liability

Estimated prize liability at June 30, 2009 and 2008 consisted of the following (in thousands):

	<u>2009</u>	<u>2008</u>
Current:		
Grand prizes	\$ 28,233	\$ 29,821
Other prizes	<u>24,758</u>	<u>25,847</u>
Total current portion	<u>\$ 52,991</u>	<u>\$ 55,668</u>
Long-term:		
Grand prizes	<u>\$96,964</u>	<u>\$116,323</u>

Long-term liability activity of grand prize awards payable was as follows (in thousands):

<u>Years Ended June 30,</u>	<u>Beginning balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending balance</u>
2009	\$146,144	\$9,530	(\$30,477)	\$125,197
2008	\$165,687	\$9,794	(\$29,337)	\$146,144

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 7 – Estimated Prize Liability (Continued)

Liabilities for future payments of grand prize liabilities are summarized as follows (in thousands):

<u>Years Ending June 30,</u>	
2010	\$ 28,233
2011	27,531
2012	22,219
2013	19,605
2014	14,764
2015 through 2019	26,599
2020 through 2024	7,390
2025 through 2029	4,070
2030 through 2031	<u>986</u>
Total	\$ 151,397
Less unamortized discount	<u>(26,200)</u>
Total at present value	\$ 125,197
Less current portion	<u>(28,233)</u>
Total long-term portion at present value	<u><u>\$ 96,964</u></u>

Estimated prize liability for grand prizes is based on the cost of U.S. Treasury zero-coupon bonds and other U.S. Government agency securities purchased to fund the liability, adjusted for the accretion of interest based upon the purchased yield and maturity date. This adjustment of approximately \$8,531,000 and \$9,794,000 in 2009 and 2008, respectively, is included in interest expense. These amounts comprise the entire amounts of interest expense for the years ended June 30, 2009 and 2008.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 8 – Retirement Plan

KRS 154A.080 states "That the corporation shall provide a retirement plan for its employees". The KLC Board of Directors has the authority to establish contribution requirements and amend any of the plan's provisions. The KLC has a money-purchase retirement plan (Plan) which covers all full-time employees. The fair value of investments is determined by the quoted market prices for each investment at the close of market. Prior to April 1, 2007, under the terms of the Plan, the KLC and employees each contribute 6.2 percent (Mandatory and Supplemental Contributions) of the employee's compensation for the calendar year, not to exceed the Taxable Wage Base as defined by the Plan. Employees become eligible for participation and are fully vested at the date of employment for this portion of the Plan. On and after April 1, 2007, a participant, as defined by the Plan, who makes and for whom the employer makes payments into the Social Security System under the Federal Insurance Contributions Act, shall not be eligible for the Mandatory and Supplemental Contributions.

The KLC also makes a contribution (Basic Contribution) equal to eight percent of the employee's earned annual base salary. For this portion, employees hired prior to October 1, 1993 became eligible at the date of employment and are fully vested providing participation requirements are met. Employees hired after September 30, 1993 become eligible one year after the date of employment and are fully vested after five years of service providing participation requirements are met.

For 2009 and 2008, total payroll was approximately \$9,935,000 and \$11,327,000, respectively. During 2009 and 2008, the KLC's contributions were calculated using the base salary amount for full-time employees of \$8,358,000 and \$9,528,000, respectively, for the 6.2 percent employer match contribution, and \$9,702,000 and \$10,476,000, respectively, for the eight percent additional employer contribution. Employer requirements and contributions actually made to the Plan were approximately \$1,294,000 and \$1,429,000 (15.5 percent and 15 percent of covered payroll) and employee contributions to the Plan were approximately \$518,000 and \$591,000 (6.2 percent of covered payroll) in 2009 and 2008, respectively.

In addition to the Plan, the KLC's employees are also eligible to participate in two deferred compensation plans sponsored by the Commonwealth of Kentucky. These plans are organized as a Section 457 plan and as a Section 401(k) plan under the Internal Revenue Code. Both plans permit employees to defer a portion of their salary until future years. Deferred compensation is not available to employees until termination, retirement, death, or financial hardship. The Commonwealth's Comprehensive Annual Financial Reports should be referred to for further disclosures related to the deferred compensation plans.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 9 – Leases

The KLC has entered into operating leases for the rental of office equipment and office and warehouse space under initial lease terms of one to five years.

Approximate minimum rental payments are (in thousands):

<u>Years Ending June 30,</u>	
2010	\$ 686
2011	339
2012	41
2013	37
2014	37
	<hr/>
	<u>\$ 1,140</u>

Total rental expense for 2009 and 2008 was approximately \$855,000 and \$531,000, respectively.

Note 10 – Payments to the Commonwealth

Payments to the Commonwealth represent transfers of funds from the KLC to the Commonwealth's General Fund and the KEES Program Reserve Account. The payments to the General Fund, which are approved by the Board of Directors and remitted to the Commonwealth on a monthly basis, are used to benefit all Kentuckians. The payments to the KEES Program Reserve Account are used to provide college or technical school scholarships to Kentucky high school students. The amounts payable to the KEES Program Reserve Account result from unclaimed prizes on instant and on-line games. Prizes not claimed within 180 days of the drawing date for on-line games or game ending date for instant tickets are forfeited and considered unclaimed. In accordance with Kentucky Revised Statute (KRS) 154A.110(3), any unclaimed prize money from these games may be retained by the KLC and added to the pool from which future prizes are to be awarded or used for special prize promotions, or may be appropriated by the General Assembly directly from the KLC for any public purpose. During the years ended June 30, 2009 and 2008, all unclaimed prize money was transferred to the KEES Program Reserve Account as required by General Assembly House Bill 04HB395. Payments are made as necessary at the end of each quarter.

On April 18, 2008, Kentucky House Bill 406 (HB406) was signed into law. HB 406 provided that the Kentucky Lottery Corporation shall remit no less than 28 percent of gross revenues each year to the General Fund. The approved legislation was estimated to generate an additional \$7 million for the Commonwealth, increasing the Consensus Forecasting Group FY 09 estimate for the KLC from \$191.5 million plus unclaimed prizes (\$200.5 million) to \$198.5 million plus unclaimed prizes (\$207.5 million). Based on economic conditions (recession and double-digit unemployment) that occurred during fiscal year 2009, the Office of the State Budget Director in April 2009 revised the estimate for the KLC to \$193.5 million plus unclaimed prizes.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 10 – Payments to the Commonwealth (Continued)

Payments to the Commonwealth for the years ended June 30, 2009 and 2008 included payments to the following funds (in thousands):

	<u>2009</u>	<u>2008</u>
General fund	\$ 193,499	\$ 183,201
KEES scholarship reserve fund	<u>10,895</u>	<u>8,882</u>
	<u>\$ 204,394</u>	<u>\$ 192,083</u>

Note 11 – Risk Management

The KLC is exposed to various risks of loss related to torts; theft of, damage to, and the destruction of assets; errors and omissions; injuries to employees; and natural disasters. The KLC has purchased commercial insurance to cover these risks except for workers' compensation and damage to buildings and personal property for which the KLC utilizes the Commonwealth's Risk Management Fund to cover the exposure to these potential losses. The Commonwealth's Comprehensive Annual Financial Reports should be referred to for additional disclosures related to the Risk Management Fund. The KLC also retains risk of loss for the value of certain gaming equipment located at retail establishments. As of June 30, 2009 there were no outstanding liabilities or unpaid claims regarding this gaming equipment. The amount of commercial coverage has not decreased nor has the amount of settlements exceeded coverage in any of the past three fiscal years.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 12 – Commitments and Contingencies

In December 2002, a Jefferson Circuit Court jury awarded \$4.3 million to the plaintiffs in a suit filed against the KLC. The suit included a retaliatory discharge claim under the Kentucky Civil Rights Act, a common law wrongful termination claim, and a defamation claim. Upon a motion filed by the KLC, the Circuit Court vacated the jury verdict and ordered a new trial for a determination of liability and damages as to the defamation claim and for a determination of damages only as to the retaliatory discharge claim. The liability verdict on the retaliatory discharge claim was allowed to stand. The common law claim was dismissed. The new trial was held in August 2004 and a Jefferson Circuit Court jury awarded approximately \$250,000 to the plaintiffs for damages on the retaliatory discharge claim. There was no finding of liability for the defamation claim. The trial court subsequently allowed the plaintiffs to recover approximately \$210,000 for attorneys' fees. The plaintiffs subsequently appealed the trial court's decision to order a new trial, as well as the trial court's decision for the amount of recovery of the plaintiffs' attorneys' fees. On September 8, 2006, the Court of Appeals rendered its Opinion affirming the judgment in the second trial and all related decisions of the trial court. The Hills filed a motion for discretionary review with the Supreme Court and the KLC filed a response. The Supreme Court granted discretionary review. The KLC then filed a cross appeal on various issues, in order to ensure that all possible issues are raised. The Court granted the cross motion, and the parties filed their briefs. Oral argument took place in June 2009, and the case is now submitted for the Court's ruling. Seneca Insurance Company has defended the action on behalf of the KLC. If liability is ultimately determined to exist, the insurance coverage provided by Seneca should cover a significant portion, if not all, of any such liability. The ultimate outcome of this matter cannot be determined at this time, and as such, any potential adjustments to the financial statements are unknown.

In 2003, three actions were filed in the Jefferson Circuit Court against the KLC regarding Extra Cash, a game which was offered in connection with two KLC on-line games, Pick 3 and Pick 4. In all three actions, the plaintiffs allege that the advertising for the Pick 3 and Pick 4 Extra Cash games is false and misleading. In 2005, an action was filed against the KLC by a plaintiff alleging that the KLC engaged in false advertising in connection with a scratch-off game known as Kentucky Millionaire. In all four cases, the plaintiffs seek compensatory and punitive damages. One of the Extra Cash cases was tried in April 2008 and the jury returned a unanimous verdict in favor of the KLC, finding no liability whatsoever. The Plaintiff did not appeal. Unless punitive damages can be recovered, the exposure for each individual plaintiff's claim in the other cases is not likely to be material. The most any of these plaintiffs have claimed that they spent on tickets is no more than several hundred dollars. The KLC's motions for summary judgment are pending in two of the three remaining cases (the third is inactive). Also, the same attorney represents the plaintiffs in the two remaining Extra Cash cases and in the Kentucky Millionaire case, and in each of these cases, a class has been alleged. The attorney requested class certification three times in one of the Extra Cash cases, and the motions have been denied each time. The Plaintiff in the Kentucky Millionaire case also moved to certify a class, but requested the hearing be continued, and it has not been rescheduled. If summary judgment is not granted, the KLC will make the same arguments that were successful in defeating the motion to certify a class in the one Extra Cash case. If a class is certified, the exposure to the KLC would increase materially. The type and extent of damages possible is unknown, but could be material. It should be noted that the KLC will defend against the motion to certify by advising the court that a majority of courts that have considered the question have decided that it is not appropriate to certify a class of lottery players. Of course, law from other jurisdictions is not controlling upon Kentucky courts.

KENTUCKY LOTTERY CORPORATION

NOTES TO FINANCIAL STATEMENTS

June 30, 2009 and 2008

Note 12 – Commitments and Contingencies (Continued)

On March 12, 2007, the KLC was served with a Complaint in an action styled Kathy Cheatham on behalf of herself and all other persons similarly situated, v. Kentucky Lottery Corporation. et al., Jefferson Circuit Court, Division Two, Case No. 07-CI-002434. Plaintiff Cheatham is a former KLC employee and alleged a class action on behalf of all KLC employees and former employees. Plaintiff raised various causes of action relating to her participation in the KLC retirement plan. Plaintiff requested judgment for an undisclosed amount of damages. Following the KLC's removal of the action to federal court and filing of a motion to dismiss (based on various grounds), Cheatham voluntarily dismissed the action. Cheatham and a new Plaintiff, Hirschman, a current KLC employee, re-filed the action in state court on July 10, 2007. KLC again removed the action to federal court (U.S. Dist. Ct., W.D. of Ky., No. 3:07-CV-00391-S) and filed a motion to dismiss. Plaintiffs moved to remand the action to state court. The federal court remanded the action to state court, where the KLC filed a motion to dismiss for failure to state a claim. Primarily, KLC argued that Plaintiffs' claims are not ripe for adjudication because they are not eligible for retirement benefits. In an opinion dated September 3, 2008, the Court ruled that Plaintiffs' claims are ripe for adjudication and that the action may go forward. The KLC will continue to vigorously defend the action. The parties have engaged in written discovery. Plaintiffs have moved to certify a class, and the hearing is set for September 11, 2009. AIG, KLC's insurer, is providing the defense (retention was \$10,000 and was not applicable to the re-filed action), up to \$5,000,000 subject to a reservation of rights.

**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**



To the Auditor of Public Accounts,
Commonwealth of Kentucky, and
the Board of Directors of the
Kentucky Lottery Corporation

**HARDING, SHYMANSKI
AND COMPANY, P.S.C.**

Certified Public Accountants
and Consultants

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*An Independently
Owned Member of the
RSM McGladrey Network*

We have audited the financial statements of the KLC as of and for the year ended June 30, 2009, and we have issued our report thereon dated September 18, 2009. 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 audits, we considered the KLC's internal control over financial reporting as a basis for designing our auditing procedures 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 KLC's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the entity's internal control over financial reporting.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with accounting principles generally accepted in the United States of America such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

**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 (CONTINUED)**



Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the KLC's financial statements are free of material misstatement, we performed tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements, non-compliance 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 audits and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of non-compliance or other matters that are required to be reported under *Government Auditing Standards*.

We noted certain matters that we reported to management of the KLC in a separate letter dated September 18, 2009.

This report is intended solely for the information and use of the Audit Committee, management of the KLC, and the Auditor of Public Accounts of the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties.

Harding, Shymanski & Company, P.S.C.

Louisville, Kentucky
September 18, 2009

KENTUCKY LOTTERY CORPORATION

SCHEDULE OF FINDINGS

Year Ended June 30, 2009

Schedule of auditor's results

We have issued an unqualified opinion, dated September 18, 2009, on the financial statements of the KLC as of and for the year ended June 30, 2009.

Our audit disclosed no instances of non-compliance which are material to the KLC's financial statements.

Findings relating to the financial statements

Our audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.

KENTUCKY LOTTERY CORPORATION

SCHEDULE OF PRIOR AUDIT FINDINGS AND THEIR RESOLUTIONS

Year Ended June 30, 2009

The prior year's audit disclosed no findings which are required to be reported in accordance with *Government Auditing Standards*.

