



NEW YORK STATE LOTTERY

Basic Financial Statements

March 31, 2005 and 2004

(With Independent Auditors' Report Thereon)

NEW YORK STATE LOTTERY

Basic Financial Statements

March 31, 2005 and 2004

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KPMG LLP
515 Broadway
Albany, NY 12207

Independent Auditors' Report

New York State Lottery:

We have audited the accompanying financial statements of the New York State Lottery (Lottery) as of March 31, 2005 and 2004, and the related statements of revenue, expenses, and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Lottery's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in note 1, the financial statements of the New York State Lottery are intended to present the financial position, and changes in financial position and cash flows, of only that portion of the financial reporting entity of the State of New York that is attributable to the transactions of the Lottery. They do not purport to, and do not, present fairly the financial position of the State of New York as of March 31, 2005 and 2004, and the changes in financial position and its cash flows, where applicable, for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the New York State Lottery as of March 31, 2005 and 2004, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2 through 8 is not a required part of the basic financial statements but is supplementary information required by accounting standards generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

July 19, 2005

NEW YORK STATE LOTTERY
Management's Discussion and Analysis
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The management of the New York State Lottery ("New York Lottery" or "Lottery") offers readers the following general overview and analysis of the New York Lottery's financial position and activities for the fiscal year ending March 31, 2005. We encourage readers to consider this information in conjunction with the detailed financial statements and explanatory notes that follow. The New York Lottery's financial statements for the fiscal years ending March 31, 2005 and 2004 have been prepared in accordance with accounting principles generally accepted in the United States of America.

Financial Highlights

New York Lottery revenues totaled \$6.270 billion, the highest total ever for the Lottery, while net proceeds earned for Lottery Aid to Education reached a record high \$2.063 billion for fiscal year 2005.

- New York Lottery revenues in fiscal year 2005 surpassed the revenues of 2004 by \$423.0 million or 7.2%. In fiscal year 2004, the annual revenue increase was \$451.5 million or 8.4%.
- Net proceeds earned for Lottery Aid to Education in fiscal year 2005 surpassed the net proceeds of 2004 by \$155.3 million or 8.1%. Comparatively, the annual increase in earnings for education in fiscal year 2004 was \$127 million or 7.1% over the earnings of 2003.
- Prize expense increased by \$217.2 million or 6.6% during fiscal year 2005. In fiscal year 2004 this increase was \$244.6 million or 8.0%. Prize expense increases directionally with increased sales.
- Operating income increased by \$108.8 million or 5.6% during fiscal year 2005. During fiscal year 2004, this increase was \$167.5 million or 9.4%.
- Nonoperating expense increased by \$60.0 million during fiscal year 2005. This increase follows a \$139.3 million increase in fiscal year 2004. These increases are due largely to an on-going decline in the unrealized fair market value of the securities purchased by the New York Lottery for the purpose of paying long-term prizes.
- Working Capital (current assets minus current liabilities) decreased to \$175.2 million at the end of fiscal year 2005. This was a change of \$.8 million or .5% over fiscal year 2004. At the end of fiscal year 2004, working capital increased by \$54.9 million over the fiscal year ended 2003.

Overview of Financial Statements

The New York Lottery presents its financial statements using an accrual method of accounting as an enterprise fund, which is comparable to the method used by many private sector businesses. The accrual method recognizes revenues when earned, not when received. Likewise, expenses are recognized when incurred, not when paid. The Lottery offers the following three financial statements for fiscal years 2005 and 2004:

Statements of Net Assets

The statement on page nine provides information on the nature and amount of the Lottery's assets, liabilities and net assets at the close of fiscal years 2005 and 2004. The relationship of assets to liabilities and resulting net assets is one indicator of the financial condition of the Lottery and can also be a reflection of changes within the Lottery.

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Statements of Revenues, Expenses, and Changes in Net Assets

The statement on page ten reflects operating revenues and expenses and those revenues and expenses of a nonoperative nature of the Lottery for the year. Income before transfers out is similar to net income before taxes for a nongovernmental business. Also illustrated in this statement is the change in net assets for the year.

Statements of Cash Flows

The comparative statement on page eleven is presented on the direct method of reporting and reflects cash flows from operating activities as well as capital and noncapital financing and investing activities. Cash collections and payments are reflected in this statement to arrive at the net increase or decrease in cash for the year.

The above mentioned financial statements, the footnotes and this management discussion and analysis provide information about the Lottery's overall financial condition.

This management discussion and analysis is meant to be an introduction to the financial statements and to assist readers in understanding the results of the operation and the financial standing of the New York Lottery. The notes to the financial statements are an integral part of the statements and include additional data and explanations which are to be used in concert with the financial statements.

The New York Lottery deposits its net proceeds into six accounts held in joint custody with the New York State Office of the State Comptroller. These six accounts and the purpose of the funds are as follows:

- Lottery Education Account – Accumulates the required deposits for Aid to Education from revenues, not including video gaming revenues.
- Prize Pending Account – Consists of Lottery prizes that have not yet been paid from revenues, excluding video gaming revenues.
- Administration – Utilized to pay for the Lottery's administrative costs that are not related to or funded by video gaming revenues.
- Video Gaming Education – Accumulates the required Education proceeds from video gaming operations.
- Video Gaming Prize Pending – Consists of video gaming prizes awarded that have not yet been claimed.
- Video Gaming Administration – Utilized to pay the administrative costs of video gaming.

Net Assets

Unrestricted Net Assets listed on the statement of net assets are largely the cumulative result of increased fair market value of United States guaranteed marketable securities held by the Lottery to pay prize winners on an annuity basis. The New York Lottery's policy and practice is to hold these investments to maturity to meet these prize payment obligations. As such, the Lottery does not expect to realize any fair value gain on these investments. Investments consist of United States Government-backed obligations of zero coupon bonds and stripped securities that equal the face amount of the bond or security upon maturity.

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Restricted Net Assets for future prizes consist of prize funds that are in excess of prizes actually claimed at the fiscal year end, but which are necessary to ensure future prize payments. For example, prize funds from past sales, which are to be utilized to pay an accumulating or future New York Lotto or Mega Millions jackpot or contributions towards a created but unclaimed instant ticket prize. These amounts are available by statute for this purpose.

Financial Analysis

Summary of Net Assets

The comparative statement of net assets represents the Lottery's financial position as of the fiscal years ended for 2005, 2004, and 2003 (in millions):

	FY 2005	FY 2004	FY 2003	FY 2005 vs. FY 2004		FY 2004 vs. FY 2003	
				Dollar change	Percent change	Dollar change	Percent change
Current assets	\$ 776	838	688	(62)	(7.4)%	\$ 150	21.8%
Noncurrent assets	1,247	1,370	1,460	(123)	(9.0)	(90)	(6.2)
Total assets	\$ 2,023	2,208	2,148	(185)	(8.4)%	\$ 60	2.8%
Current liabilities	\$ 600	662	567	(62)	(9.4)%	\$ 95	16.8%
Noncurrent liabilities	1,133	1,181	1,248	(48)	(4.1)	(67)	(5.4)
Total liabilities	\$ 1,733	1,843	1,815	(110)	(6.0)%	\$ 28	1.5%
Restricted net assets	\$ 151	142	91	9	6.3%	\$ 51	56.0%
Unrestricted net assets	139	223	242	(84)	(37.7)	(19)	(7.9)
Total net assets	\$ 290	365	333	(75)	(20.5)%	\$ 32	9.6%

Current and Noncurrent Assets

Current assets consist of cash and cash equivalents, accounts receivable, instant ticket inventory and the current portion of annuity investments. The total current assets decreased by 7.4% during the fiscal year 2005. The majority of the decrease was due to a decrease of \$99 million in cash offset by a \$48 million increase in accounts receivable.

The cash decrease was mainly caused by a decrease in the balance of the two Education accounts of \$62.0 million and in the two Prize Pending accounts of \$46.8 million. The accounts receivable increase was caused by the increase in instant cash game sales. In comparison, fiscal year 2004 currents assets increased by 21.8% over the prior fiscal year caused primarily by a \$142 million increase in cash, the majority of which occurred in the two Education accounts.

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Noncurrent assets consist primarily of investments held in United State Treasury Securities utilized to fund installment payments to the Lottery's Lotto, Mega Millions and select instant game grand-prize winners. The total market value for these securities decreased by 9.0% to \$1.44 billion as of March 31, 2005. This change is due to the increase in the yield on United States Treasury Securities in the market. Comparatively, the total fair market value of these Securities as of March 31, 2004 was \$1.58 billion (a decrease of \$105.5 million from March 31, 2003). This 6.2% decrease was related to the increase in the yield on held securities and the overall market for this investment type.

\$1.24 billion and \$1.37 billion were invested in securities at March 31, 2005 and 2004, respectively, for prizes that are payable beyond one year from that date. The remaining value of securities at each fiscal year end is related to prizes that are due during the next fiscal year and that value is reflected in current assets.

Current Liabilities

Current liabilities consist of the current portion of long-term prizes payable, prizes awarded in the past year that yet remain unclaimed, amounts due to Education on an accrual basis, accrued expenses, accounts payable, the sales value of Lottery tickets purchased in advance of game drawings and the short-term portion of capitalized leases. In total, these accounts decreased by \$62.0 million during fiscal year 2005 due in large part to a \$30.5 million decrease in Due to Education (caused by changes in the timing of receipts and cash draw downs for Aid to Education), a \$13.2 million decrease in annuitant type prizes due to winners over the next year (Prizes Payable), a drop of \$10.3 million in prizes awarded but unclaimed (Unclaimed Prizes) and an \$8.7 million reduction in Accounts Payable and Accrued Expenses. These decreases were offset by an increase in both Capitalized Lease Obligations and Deferred Ticket Sales. These changes can be compared to the fiscal year ended March 31, 2004 when a \$94.6 million annual increase in total current liabilities was recorded. For that period, the increase was mainly due to a \$72.3 million increase in Due to Education and an increase in Unclaimed Prizes of \$8.2 million.

Noncurrent Liabilities

Noncurrent or long-term liabilities consist of installment prizes due in fiscal years after 2005, the amount due to employees for unused vacation and sick leave, and the long-term portion of capitalized leases. During the fiscal year this category of liabilities declined by \$48.4 million. The drop was caused mainly by a \$53.0 million decrease in the amount of long-term prizes payable outstanding offset by an increase in capitalized leases by \$4.2 million from new video gaming equipment. The drop in long term prizes was also present last fiscal year when a \$70.4 million decline was recorded. The decline in the dollar value of installment prizes payable is the result of few new large prize winners selecting to be paid over an extended payment stream, combined with the scheduled payments during the fiscal year.

Net Assets

Net assets represent the excess of the Lottery's assets over its liabilities. Restricted net assets for prizes include forfeited prizes and other prize assets that are to be used for future prize expenses. Unrestricted net assets reflect the cumulative difference between the market value of the Lottery's United States Treasury Securities and the book value of prize liabilities for the securities being funded. It is the Lottery's policy and practice to purchase and hold securities to maturity and then pay the associated installment prize, thus eliminating any realization of any fair value gain.

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Summary of Revenues, Expenses, and Changes in Net Assets

The following summary compares the Lottery's operating revenues, expenses and changes in net assets for the fiscal years 2005, 2004 and 2003 (in millions).

	FY 2005	FY 2004	FY 2003	FY 2005 vs. FY 2004		FY 2004 vs. FY 2003	
				Dollar change	Percent change	Dollar change	Percent change
Operating revenue:							
Lottery revenue, net	\$ 6,270	5,847	5,396	423	7.2%	\$ 451	8.4%
Operating expenses:							
Direct expenses	(4,092)	(3,788)	(3,502)	(304)	8.0	(286)	8.2
Indirect expenses	(115)	(105)	(107)	(10)	9.5	2	(1.9)
Total operating expenses	(4,207)	(3,893)	(3,609)	(314)	8.1	(284)	7.9
Operating income	2,063	1,954	1,787	109	5.6	167	9.3
Nonoperating income (expenses)	(75)	(16)	123	(59)	368.8	(139)	(113.0)
Income before transfers out	1,988	1,938	1,910	50	2.6	28	1.5
Transfers out – contribution for aid to education	(2,063)	(1,907)	(1,780)	(156)	8.2	(127)	7.1
Change in net assets	\$ (75)	31	120	(106)	(341.9)%	\$ (99)	(76.2)%

Revenues

The New York Lottery exists for the sole purpose of raising revenue to help support Aid to Education. The Lottery achieves its mission through the sale of Lottery tickets at approximately 16,000 licensed retail locations across the state and through video lottery gaming at four licensed video gaming facilities located in Saratoga, Monticello, Farmington and Hamburg, New York in fiscal year 2005. Three of these facilities were operating in 2004 and none in 2003.

During the fiscal year 2005, the Lottery achieved \$3.033 billion in on-line sales, \$3.005 billion in instant sales and \$232 million in video gaming net machine income for a total of \$6.270 billion, a 7.2% (\$423.0 million) increase over the previous fiscal year. This record year was posted after the prior record year of 2004 when revenues reached \$5.847 billion, a \$451.5 million or 8.4% increase. Significant growth was reflected in the instant game category during both fiscal years and in video gaming in 2005. In fiscal year 2003 total revenues were \$5.396 billion.

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The following compares the Lottery's revenues by game and the percentage of total revenues by game for the fiscal years 2005, 2004, and 2003 (in millions).

Game	FY 2005		FY 2004		FY 2003	
	Revenue	Percent of total revenues	Revenue	Percent of total revenues	Revenue	Percent of total revenues
Mega Millions	\$ 446	7.1%	\$ 474	8.1%	\$ 373	6.9%
Lotto	306	4.9	356	6.1	392	7.2
Take 5	348	5.6	363	6.2	381	7.1
New York's Numbers	790	12.6	758	13.0	754	14.0
Win 4	624	9.9	593	10.1	579	10.7
Quick Draw	474	7.6	500	8.5	476	8.8
Pick 10 and Instant Win	45	0.7	47	0.8	52	1.0
Instant	3,005	47.9	2,734	46.8	2,389	44.3
Subtotal traditional lottery	6,038	96.3	5,825	99.6	5,396	100.0
Video Gaming, net	232	3.7	22	0.4	—	—
Total revenues	\$ 6,270	100.0%	\$ 5,847	100.0%	\$ 5,396	100.0%

Direct Expenses

Direct Expenses consist of prize expense for traditional Lottery games, commissions to Lottery retailers and video gaming facilities, fees to gaming contractors, expenses of providing instant tickets to players, and telecommunications. The largest expenditure in this category is prize expense. This expense increased by \$217.2 million to \$3.524 billion in fiscal year 2005, along with traditional retailer commissions which increased by \$12.6 million to \$362.0 million, video gaming commissions to facilities which increased \$60.9 million to \$67.2 million, and video gaming contractor fees which increased \$15.2 million to \$16.9 million, accounted for the majority of the increase in this category.

During fiscal year 2004 prize expense increased by \$244.6 to \$3.306 billion and, along with retailer commissions, which increased by \$24.4 million to \$349.3 millions and commissions to video gaming facilities which totaled \$6.3 million account for nearly all of the increase in direct expenses. Approximately 65% of revenues have gone towards direct expenses in the past three fiscal years.

Other Operating Expenses

Other operating expenses include marketing, state agency charges, personal services, fringe benefits and other administrative costs. These costs increased by \$10.0 million during the fiscal year as expenses related to video gaming increased. This increase was the result of three facilities being open the entire fiscal year and one other for nine months of the fiscal year. As stated previously, these facilities generated \$231.7 million in net machine income for the fiscal year. In 2004, the three operating facilities opened in the final quarter of the fiscal year.

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Management's Discussion and Analysis

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Nonoperating Revenues (Expenses)

Nonoperating revenues and expenses consist of small amounts of miscellaneous income plus the net growth or decline in the book and fair value of the United States Treasury Securities used to fund long term prizes. Investment income (\$15.0 million in 2005, \$83.6 million in 2004 and \$230.4 million in 2003) consists of both the fair value adjustments of investments plus the normal growth of the value of Lottery investments as the securities move closer to maturity. The market driven, fair value adjustment is the primary factor in the fluctuation in this amount from year to year. Investment expense is a reflection of the Lottery expending the investment income to increase the valuation of the long-term prizes payable to winners. The annual fair value adjustments of investments (shown here as income) flows to the unrestricted net assets balance on the Statement of Net Assets. This fair value adjustment is unrealized by the Lottery since it expects to hold investments to maturity.

Income Before Transfers Out and Change in Net Assets

The revenues and expenses for fiscal year 2005 resulted in income before transfers out totaling \$1,988 billion. This amount consists of \$2,063 billion that transfers out as a contribution for aid to education and a \$75.1 million reduction in net assets for the year. The \$75.1 million reduction in net assets is a combination of an \$8.9 million increase in net assets restricted for prizes and an \$84.0 million decrease in unrestricted net assets. During fiscal year 2004, the income before transfers out totaled \$1,938 billion. \$1,907 billion of this income transferred out as a contribution for aid to education and \$31.4 million flowed to the Statement of Net Assets. \$50.4 million of the amount flowing to the Statement of Net Assets was transferred as an increase in net assets restricted for prizes and the remaining \$19.0 million decreased unrestricted net assets.

Summary and Outlook

The revenues reported here include those from four video gaming facilities which were operational during fiscal year 2005. Additional revenues from a fifth facility, located in Batavia, New York that opened on May 18, 2005 will contribute to the revenues earned for the 2006 fiscal year. On May 3, 2005, the Court of Appeals for the State of New York upheld the constitutionality of New York's Video Gaming and Multi-State Lottery programs. In April 2005, legislation was enacted which increases the financial incentives for operators of video gaming facilities. These two actions are seen as clearing the way for the future development of additional video gaming facilities, increased marketability of the operating facilities and higher Lottery aid to education revenues.

Contacting New York Lottery's Financial Management of the New York State Lottery

This financial report is designed to provide the State of New York, the public and other interested parties with an overview of the financial results of the New York State Lottery and an explanation of the Lottery's financial condition. If you have any questions about this report or require additional information, email Questions@Lottery.state.ny.us or write to The New York Lottery Communications office, One Broadway Center, P.O. Box 7500, Schenectady, NY 12301-7500.

NEW YORK STATE LOTTERY

Statements of Net Assets

March 31, 2005 and 2004

(In thousands)

Assets	2005	2004
Current assets:		
Cash and cash equivalents	\$ 173,901	272,594
Accounts receivable	390,806	343,234
Instant ticket inventory	11,796	8,344
Investments	199,295	213,400
Total current assets	<u>775,798</u>	<u>837,572</u>
Long-term investments, net	1,237,322	1,365,669
Other assets	10,189	4,497
Total assets	<u>2,023,309</u>	<u>2,207,738</u>
Liabilities		
Current liabilities:		
Prizes payable	203,601	216,766
Unclaimed prizes	210,081	220,400
Due to education	150,289	180,824
Accounts payable and accrued liabilities	24,536	33,223
Capital lease obligations	2,276	820
Deferred ticket sales	9,796	9,502
Total current liabilities	<u>600,579</u>	<u>661,535</u>
Compensated absences	5,566	5,263
Long-term capital lease obligations	7,710	3,461
Long-term prizes payable	1,119,793	1,172,751
Total liabilities	<u>1,733,648</u>	<u>1,843,010</u>
Net Assets		
Restricted for future prizes	150,905	141,935
Unrestricted	138,756	222,793
Total net assets	<u>\$ 289,661</u>	<u>364,728</u>

See accompanying notes to basic financial statements.

NEW YORK STATE LOTTERY

Statements of Revenue, Expenses, and Changes in Net Assets

Years ended March 31, 2005 and 2004

(In thousands)

	2005	2004
Operating revenue:		
Lottery revenue, net	\$ 6,270,487	5,847,500
Operating expenses:		
Prize expense	(3,523,530)	(3,306,335)
Retailer commissions	(429,182)	(355,656)
Gaming contractor fees	(78,008)	(61,511)
Instant ticket direct expenses	(31,174)	(32,511)
Telecommunications	(29,946)	(31,618)
Total direct expenses	(4,091,840)	(3,787,631)
Online games/jackpot marketing	(32,555)	(31,160)
Personal service and fringe benefits	(24,934)	(21,985)
Instant games marketing	(20,357)	(22,150)
All games marketing	(17,793)	(15,621)
Other administrative costs	(12,717)	(10,749)
State agency charges	(6,811)	(3,547)
Total indirect expenses	(115,167)	(105,212)
Total operating expenses	(4,207,007)	(3,892,843)
Operating income	2,063,480	1,954,657
Nonoperating revenue and (expenses):		
Investment income	14,957	83,626
Other revenues, net	166	644
Investment expense, net	(90,968)	(100,102)
Total nonoperating expense	(75,845)	(15,832)
Income before transfers out	1,987,635	1,938,825
Transfers out – contribution for aid to education	(2,062,702)	(1,907,402)
Change in net assets	(75,067)	31,423
Net assets beginning of year	364,728	333,305
Net assets end of year	\$ 289,661	364,728

See accompanying notes to basic financial statements.

NEW YORK STATE LOTTERY

Statements of Cash Flows

Years ended March 31, 2005 and 2004

(In thousands)

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Cash received from net Lottery revenue	\$ 6,231,696	5,826,616
Cash payments for prizes	(3,706,983)	(3,456,654)
Cash payments for commissions	(429,267)	(355,596)
Cash payments for contractor fees	(78,003)	(61,419)
Cash payments for telecommunications	(29,946)	(31,618)
Cash payments for instant ticket direct expenses	(34,329)	(32,790)
Cash payments for other operating expenses	(113,947)	(100,838)
Net cash provided by operating activities	<u>1,839,221</u>	<u>1,787,701</u>
Cash flows from investing activities:		
Proceeds from investment maturities	214,711	225,901
Purchases of investments	(65,353)	(39,373)
Interest on cash and cash equivalents	7,701	2,078
Net proceeds from swaps of investment securities	—	101
Other	166	644
Net cash provided by investing activities	<u>157,225</u>	<u>189,351</u>
Cash flows from noncapital financing activities:		
Cash transfer to State for Aid to Education	(2,093,237)	(1,835,140)
Cash flows from capital financing activities:		
Cash payments for equipment and leasehold improvements	(1,902)	(148)
Net cash used by capital financing activities	<u>(1,902)</u>	<u>(148)</u>
Net (decrease) increase in cash and cash equivalents	(98,693)	141,764
Cash and cash equivalents, beginning of year	272,594	130,830
Cash and cash equivalents, end of year	\$ <u>173,901</u>	<u>272,594</u>
Reconciliation of operating income to cash provided by operating activities:		
Operating income	\$ 2,063,480	1,954,657
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	1,916	179
Change in operating assets and liabilities:		
Increase in accounts receivable, net	(47,572)	(18,464)
Increase in ticket inventory	(3,452)	(362)
Decrease in prizes payable	(156,742)	(175,174)
(Decrease) increase in unclaimed prizes	(10,319)	8,241
Increase in compensated absences	303	214
(Decrease) increase in accounts payable and accrued liabilities	(8,687)	19,185
Increase (decrease) in deferred ticket sales	294	(775)
Net cash provided by operating activities	\$ <u>1,839,221</u>	<u>1,787,701</u>
Noncash investing activities:		
Decrease in unrealized gains on investments	\$ (84,036)	(19,038)
Amortization of investment discount	90,942	100,072

See accompanying notes to basic financial statements.

NEW YORK STATE LOTTERY

Notes to Basic Financial Statements

March 31, 2005 and 2004

(1) Summary of Significant Accounting Policies

The New York State Lottery (the Lottery) was established in 1967. The Lottery is currently administered by the Division of the Lottery, an independent unit of the Department of Taxation and Finance, which operates in accordance with the provisions of the New York State Lottery for Education Law (Tax Law Article 34). The purpose of the Lottery is to raise revenue for education in the State of New York (State) through the administration of lottery games.

The Lottery is included in the State of New York's Basic Financial Statements as an enterprise fund. These financial statements present only the Lottery and do not present the financial position of the State of New York, and changes in its financial position and cash flows.

The Lottery prepares its financial statements under the economic resources measurement focus whereby all inflows, outflows and balances affecting net assets are reported, and uses the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred. The primary operating revenue of the Lottery is ticket sales from games. Nonoperating income consists mostly of investment income and unrealized gains on investments. Operating expenses consist of direct expenses for prizes, commissions to Lottery retailers, fees to gaming contractors, expenses for providing instant tickets to players, and telecommunications. Other operating expenses that are indirect to the results of each game include marketing, state agency charges, personal services, and fringe benefits. Nonoperating expense is the amortization of the discount on long-term prizes payable. The Lottery applies all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Statements and Interpretations of the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARB's) of the Committee on Accounting Procedure. The Lottery has elected the option, under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Government Entities that Uses Proprietary Funds*, not to apply all FASB Statements and Interpretations issued after November 30, 1989.

The more significant accounting policies of the Lottery are described below:

(a) Revenue Recognition

(i) On-Line Games

Revenue from ticket sales for Lotto, Quick Draw, Take Five, Pick 10, Mega Millions, Instant Win, New York's Numbers and Win-4 games (on-line games) is recognized when the related drawing takes place. Receipts from subscription sales and other ticket sales for future drawings are recorded as deferred revenue and recognized when the related drawings take place.

(ii) Instant Cash Games

Revenue from instant cash games is recognized based on the dollar value of the total number of tickets available for sale. Tickets are available for sale upon being activated on the Lottery Validation System at the retailer locations.

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Notes to Basic Financial Statements

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(iii) Video Lottery

Revenue from Video Lottery is recognized based on net machine income which is defined as amounts played less prizes won.

(b) Commissions and Fees

Retailers selling online and instant cash game tickets receive a commission of 6% based on the total tickets sold. For Video Lottery, video gaming entertainment facilities receive a commission of 29% of net machine income. The on-line game contractor and the Video Lottery central processing contractor receive fees equal to a contractual percentage of the sales generated through the network maintained by the respective contractor. The instant game contractor is paid a fee equal to a contractual percentage of instant sales. Video Lottery terminal contractors receive a fee equal to a contractual percentage of revenue, adjusted for the units of service provided. All other gaming contractors are paid fees based on the units of service provided (see note 13).

(c) Accounts Receivable

Accounts receivable represents amounts due from retailers through a Lottery gaming contractor and Video Lottery gaming facilities, net of commissions and fees, as well as amounts due from agents for instant cash game tickets which have been activated, but not yet settled. Instant ticket settlements occur not more than 45 days after a book of tickets is activated.

(d) Allocation of Revenue from Ticket Sales

The allocation of ticket sales is made in accordance with the provisions of the New York State Lottery for Education Law which requires:

- Allocations of ticket sales revenue to New York State for educational purposes to be at least 20% for the New York State Lottery instant cash games, 35% for Take Five, New York's Numbers, Win-4, Mega Millions and Pick 10, 45% for Lotto and Instant Win, and 25% for Quick Draw. In addition, the Lottery has legislative authority to issue up to three Instant Games per year with at least 10% for educational purposes. For Video Lottery, the required allocation to education is 61% of sales revenue after payout for prizes.
- Allocations of ticket sales revenue for the payment of lottery prizes are not to exceed 65% for the New York State Lottery instant cash games, 50% for Take Five, New York's Numbers, Win-4, Mega Millions, and Pick 10, 40% for Lotto and Instant Win, and 60% for Quick Draw. In addition, the Lottery has legislative authority to issue up to three Instant Games per year with 75% allocated to prizes. Video Lottery is required to pay prizes that average no less than 90% of gross sales.

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- Allocations of ticket sales revenue from all traditional games for the payment of Lottery administrative expenses (including agent commissions and contractor fees) are not to exceed 15%. For Video Lottery, 10% of net sales (the total revenue wagered after payout for prizes) is allocated for Lottery Administration. Any excess of the maximum allocation over administrative expenses is allocated to education. Such allocations amounted to approximately \$312,709,000 and \$289,528,000 for fiscal years 2005 and 2004, respectively. Administrative expenses incurred by the Lottery represent telecommunications, advertising, salary and other operating costs.

(e) Cash and Cash Equivalents

For purposes of the statements of cash flows, the Lottery considers cash equivalents to be amounts held with banks and amounts held under the joint custody of the Commissioner of Taxation and Finance and the Comptroller of the State of New York through the Short-Term Investment Pool, which have a maturity of one year or less when purchased, which is used for the temporary investment of funds not required for immediate payments.

(f) Investments

Investments, consisting of U.S. Government-backed obligations (zero coupon bonds and stripped Government securities), are carried at fair value. Investment income represents amortized discount, interest on deposits, realized gains and losses, and change in net unrealized gains (losses) on investments.

(g) Inventory

Instant cash game tickets are purchased from printing vendors. Tickets not activated for sale are held in inventory and are valued at cost by game. Tickets are charged to instant ticket direct expense under the first-in, first-out (FIFO) accounting method when activated for sale by the agents. At the conclusion of an instant cash ticket game, unused inventory is charged to instant ticket direct expense.

(h) Capital Assets

Capital assets consists of equipment and leasehold improvements which are carried at cost and are recorded in Other Assets. Depreciation of equipment is computed using the straight-line method over five years, the estimated useful lives of the assets. Leasehold improvements and equipment acquired under capital leases are amortized using the straight-line method over ten and five years, respectively, which is the lesser of their useful lives or the term of the leases.

When assets are retired or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts and any resulting gain or loss is reflected in Other revenues, net in the period of disposal.

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(i) Prizes Payable

Lotto and Mega Millions jackpot players have the option at the time of ticket purchase of selecting a lump sum payment in lieu of long-term annuity payments. Prizes payable represents the liability for those prizes which are payable in annual installments. Such prize payments are funded by the Lottery's investment in U.S. Government-backed securities. The periodic amortization of discount is recorded as investment expense in these financial statements. Any excess of investment maturities over prize payments is made available for prizes.

(j) Unclaimed Prizes

Unclaimed prizes at March 31, 2005 and 2004 were \$210,081,000 and \$220,400,000, respectively. Prizes unclaimed for one year after the drawing date (lapsed) are forfeited by the ticket holder. Total prizes lapsed amounted to approximately \$75,054,000 and \$84,114,000 for fiscal years 2005 and 2004, respectively. These forfeited prizes are netted against prize expense in the statement of Revenues, Expenses, and Changes in Net Assets.

Under the Tax Law, the Lottery retains forfeited prizes for supplemental prizes in subsequent lottery games. During the fiscal years 2005 and 2004, these supplemental prizes were used for Lotto, Mega Millions, Instant Win, Numbers, Win 4, Quick Draw, Take Five, and various Instant Games.

(k) Restricted Net Assets

Restricted net assets for prizes includes forfeited prizes and other prize assets that are restricted under New York State Tax Law Sections 1612 and 1614 for the purpose of meeting future prize expense.

(2) Cash and Cash Equivalents

Lottery deposits of cash and cash equivalents are made in accordance with New York State Finance Law Sections 92c and 98a and New York State Tax Law Sections 1611 and 1612. Lottery sales receipts are allocated and deposited in separate fund accounts for prizes, education, and administration under the joint custody of the Commissioner of Taxation and Finance and the Comptroller of the State of New York. The account for prizes earns interest through participation in a short-term investment pool administered by the State Comptroller. The interest is used for future lottery prizes. Beginning in September 2004, the Lottery Administration Accounts and the VLT Education Account also began to earn interest. The carrying amount of the accounts included in cash and cash equivalents were \$178,020,000 and \$275,113,000 at March 31, 2005 and 2004, respectively. The carrying value of cash equivalents approximates market value.

The Lottery also maintains sole custody accounts which are used for daily cash management purposes. The Lottery manages the investment of its cash balances to minimize its uninvested funds. At March 31, 2005 and 2004 the amount of accounts included in cash and cash equivalents related to the sole custody accounts were \$(4,119,000) and \$(2,519,000), respectively.

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The Lottery's deposits are collateralized under a program administered by the Office of the State Comptroller of the State of New York. To manage credit risk, the State requires that its depository banks pledge collateral based on available bank balances. All securities pledged as collateral are held by the State's fiscal agent in the name of the State. The Lottery's deposits with financial institutions were fully collateralized at fiscal year-end. The Lottery manages custodial credit risk by using several financial institutions and by minimizing balances in the sole custody accounts.

(3) Investments

The Lottery is authorized by State statute to invest in U.S. Government-backed obligations (U.S. Treasury strips), which will provide for the payment of prizes payable (see note 4). During fiscal years 2005 and 2004, approximately \$90,942,000 and \$100,072,000, respectively, of amortized discount was included in investment income.

These investments consisted of the following at March 31 (in thousands):

	2005	2004
Maturity value	\$ 1,974,676	2,072,916
Less unamortized discount	676,816	716,640
Total at amortized cost	1,297,860	1,356,276
Less investments, maturing within one year, at amortized cost	196,550	207,024
Long-term investments, at amortized cost	\$ 1,101,310	1,149,252
Total fair value of investments reported	\$ 1,436,617	1,579,069

Maturities of the investments in each of the five fiscal years following March 31, 2005, and the total thereafter, are as follows (in thousands):

2006	\$	203,685
2007		189,013
2008		176,848
2009		164,336
2010		149,806
2011-2015		517,238
2016-2020		251,359
2021-2025		207,209
2026-2030		85,412
2031-2035		29,770
	\$	1,974,676

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The Lottery periodically enters into certain transactions whereby stripped government securities are exchanged for other stripped government securities with substantially identical terms and characteristics. During fiscal year 2004, the face value of the securities swapped amounted to \$6,010,000 resulting in a gain of approximately \$101,000 which was included in investment income in the statement of revenue, expenses, and changes in net assets. No such transactions took place during fiscal year 2005.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to a transaction, the Lottery will not be able to recover the value of investment securities that are in the possession of an outside party. In order to manage this risk, all of the Lottery's investments are insured or registered or securities held by the Lottery or its agent in the Lottery's name.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Lottery's policy for managing this risk is to hold investment securities to maturity, at which time the fair value of the investment is equal to its stated maturity value.

(4) Prizes Payable

Prizes payable consisted of the following at March 31 (in thousands):

	<u>2005</u>	<u>2004</u>
Total obligation	\$ 1,998,741	2,104,366
Unamortized discount	<u>(675,347)</u>	<u>(714,849)</u>
Total carrying amount	1,323,394	1,389,517
Less prizes payable within one year	<u>203,601</u>	<u>216,766</u>
Long-term prizes payable	<u><u>\$ 1,119,793</u></u>	<u><u>1,172,751</u></u>

The amortized discount on the prizes payable is based on interest rates which range from 0.96% to 13.55% and reflect the interest rates earned by the investments held to fund the related liabilities. The amortization of discount is recorded as investment expense in the statements of revenues, expenses, and changes in net assets and amounted to \$90,618,000 and \$99,689,000 for fiscal years 2005 and 2004, respectively. Also, included in investment expense for the year ended March 31, 2005 and 2004 is approximately \$350,000 and \$413,000, respectively, of interest expense related to a lapsed Mega Millions jackpot.

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The aggregate amount of prizes payable due in each of the five fiscal years following March 31, 2005, and the five year incremental totals thereafter, is as follows (in thousands):

2006	\$	205,541
2007		190,088
2008		177,974
2009		165,554
2010		149,444
2011-2015		520,392
2016-2020		238,167
2021-2025		146,350
2026-2030		13,907
Thereafter		191,324
	\$	1,998,741

(5) Long-Term Liabilities

The Lottery's long-term liabilities, as of March 31, 2005 and 2004 are comprised of the following, (in thousands):

	<u>Balance at March 31, 2004</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at March 31, 2005</u>	<u>Current portion</u>
Capital lease obligations (note 12) \$	4,281	7,487	(1,782)	9,986	2,276
Compensated absences (note 11)	5,263	368	(65)	5,566	—
Prizes payable (note 4)	1,389,517	153,977	(220,100)	1,323,394	203,601
	<u>Balance at March 31, 2003</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at March 31, 2004</u>	<u>Current portion</u>
Capital lease obligations (note 12) \$	—	4,359	(78)	4,281	820
Compensated absences (note 11)	5,049	304	(90)	5,263	—
Prizes payable (note 4)	1,465,002	99,689	(175,174)	1,389,517	216,766

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(6) Aid to Education

The required allocation and contribution transferred out for aid to education during the fiscal years ended March 31, 2005 and 2004, are as follows (in thousands):

	2005	2004
Cash transferred to education	\$ 2,093,237	1,835,140
Prior year payable	(180,824)	(108,562)
Cash transferred related to current year operations	1,912,413	1,726,578
Current year payable	150,289	180,824
Required allocation to education	\$ 2,062,702	1,907,402

(7) Pension Benefits

Substantially all employees of the Lottery are members of the New York State and Local Employees' Retirement System (ERS) and the Public Employees' Group Term Life Insurance Plan (System), a cost-sharing, multiple employer public employee retirement system. The State Comptroller is sole trustee and administrative head of the System. The System issues a publicly available financial report that includes financial statements and required supplementary information which may be obtained by writing to New York State and Local Employees' Retirement Systems, 110 State Street, Albany, New York 12236.

The System provides retirement benefits as well as death and disability benefits. All benefits vest after five years of accredited service. Retirement benefits are established by the New York State Retirement and Social Security Law. Retirement benefits and contributory requirements depend upon the point in time at which an employee last joined the System. Most members of the System who joined before July 27, 1976 are enrolled in a noncontributory plan; the Lottery contributes the entire amount determined to be payable to the System. Personnel who joined the System after July 27, 1976 are required by law to contribute 3% of their gross salary for their first ten years of employment; the Lottery contributes the balance payable to the System for these employees.

The Lottery paid to the New York State Comptroller's Office \$1,463,000 for 2005, \$798,000 for 2004, and \$836,000 for 2003, to cover required employer contributions for retirement benefits. These payments made represent 9.41%, 5.29%, and 5.38% of covered payroll for each of the years, respectively.

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(8) Operating Income

Composition of operating income for fiscal 2005 and 2004 by type of lottery game is as follows (in thousands):

	2005					
	Expenses					Net
	Revenue	Prizes **	Commissions	Fees	Instant direct expense	
Mega Millions	\$ 446,205	(207,089)	(26,837)	(5,734)	—	206,545
Lotto	305,863	(141,687)	(17,511)	(3,737)	—	142,928
Take five	348,179	(175,303)	(20,938)	(4,474)	—	147,464
Pick 10	33,764	(16,247)	(2,029)	(434)	—	15,054
New York's Numbers	790,470	(397,357)	(47,490)	(10,157)	—	335,466
Win 4	624,200	(309,207)	(37,501)	(8,021)	—	269,471
Instants	3,095,589	(1,983,561)	(180,571)	(22,336)	(31,174)	787,947
Instant Win	10,905	(6,956)	(655)	(140)	—	3,154
Quick Draw	473,594	(286,150)	(28,452)	(6,085)	—	152,907
Total traditional lottery	6,038,769	(3,523,557)	(361,984)	(61,118)	(31,174)	2,060,936
Video Lottery	231,718 *	27	(67,198)	(16,890)	—	147,657
	\$ 6,270,487	(3,523,530)	(429,182)	(78,008)	(31,174)	2,208,593
Telecommunications						(29,946)
Other operating expenses						(115,167)
Total operating income						\$ 2,063,480

	2004					
	Expenses					Net
	Revenue	Prizes **	Commissions	Fees	Instant direct expense	
Mega Millions	\$ 474,432	(212,091)	(28,466)	(6,096)	—	227,779
Lotto	356,428	(152,268)	(20,519)	(4,382)	—	179,259
Take five	363,106	(179,567)	(21,786)	(4,666)	—	157,087
Pick 10	34,111	(14,665)	(2,047)	(438)	—	16,961
New York's Numbers	757,533	(377,041)	(45,452)	(9,734)	—	325,306
Win 4	592,757	(263,233)	(35,565)	(7,617)	—	286,342
Instants	2,733,939	(1,798,472)	(164,701)	(20,317)	(32,511)	717,938
Instant Win	13,224	(8,374)	(793)	(170)	—	3,887
Quick Draw	500,194	(300,624)	(30,012)	(6,428)	—	163,130
Total traditional lottery	5,825,724	(3,306,335)	(349,341)	(59,848)	(32,511)	2,077,689
Video Lottery	21,776 *	—	(6,315)	(1,663)	—	13,798
	\$ 5,847,500	(3,306,335)	(355,656)	(61,511)	(32,511)	2,091,487
Telecommunications						(31,618)
Other operating expenses						(105,212)
Total operating income						\$ 1,954,657

* Video Lottery revenue represents net machine income after awarding prizes.

** Prizes unclaimed after one year are forfeited and are netted against prizes.

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(9) Deferred Compensation

New York State offers its employees, including Lottery employees, a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All amounts of compensation deferred under the plan are placed in trust for the participants and their beneficiaries.

(10) Postretirement Benefits

In addition to the pension benefits described in note 7, the State provides health insurance coverage and survivor benefits for retired employees and their survivors. Substantially all of the State's employees may become eligible for these benefits if they reach normal retirement age while working for the State. Health care benefits are provided through an insurance company whose premiums are based on the benefits paid during the year. The State recognizes the cost of providing health insurance by recording its share of insurance premiums as an expenditure in the general fund in the year paid. Additionally, the survivor's benefit program provides for a death benefit to be paid by the State to a retiree's designated beneficiary. The Lottery is not directly charged for these benefits to or on behalf of its former employees.

(11) Employees' Compensated Absences

Under the terms of the Lottery's personnel policies and its union agreements, vacation pay benefits may be paid upon termination up to a maximum of 225 hours. In addition, unused sick leave benefits may be paid upon retirement up to a maximum of 1,500 hours. The Lottery recognizes employees' compensated absence benefits when earned. The liability for employees' compensated absences was approximately \$5,566,000 and \$5,263,000 as of March 31, 2005 and 2004, respectively, and is recorded as a long-term liability in the statements of net assets.

(12) Leases

The Lottery leases surveillance equipment at its video gaming facilities under capital leases with Key Government Finance, Inc. and Koch Financial Corporation. Fixed asset amounts for capital leases, which are included in other assets on the statement of net assets, were approximately \$11,836,000 and \$4,349,000 at March 31, 2005 and 2004, respectively. Accumulated depreciation on these fixed assets was approximately \$1,875,000 and \$72,000 at March 31, 2005 and 2004, respectively.

The Lottery has entered into leases for equipment and building space. Rental expense was approximately \$4,744,000 and \$4,709,000 in 2005 and 2004, respectively.

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Future minimum lease payments under all noncancelable leases having initial or remaining terms in excess of one year as of March 31, 2005 are as follows:

	<u>Operating leases</u>	<u>Capital leases</u>
2006	\$ 2,616,000	2,571,000
2007	897,000	2,571,000
2008	753,000	2,571,000
2009	734,000	2,493,000
2010 – 2014	<u>1,024,000</u>	<u>500,000</u>
Total minimum payments required	\$ <u>6,024,000</u>	10,706,000
Less amounts representing interest		<u>720,000</u>
Present value of minimum lease payments		9,986,000
Less current portion		<u>2,276,000</u>
Long-term capital lease obligations		\$ <u>7,710,000</u>

(13) Commitments and Contingencies

(a) Contractual Arrangements

The Lottery maintains a gaming network of approximately 16,000 on-line locations where all traditional Lottery games are sold. GTECH Corporation (GTECH) is responsible for operating all traditional Lottery games under a contract expiring on March 1, 2007. Instant cash game sales are also supported by the services of three contractors:

- (1) Under a contract expiring March 25, 2006, Pollard Banknote Limited is responsible for production of instant cash game tickets.
- (2) Under a contract expiring October 15, 2006, Scientific Games, Inc. is a back-up instant cash game ticket supplier.
- (3) Instant cash game tickets are also sold through approximately 4,200 vending machines at approximately 3,600 locations. A contract with Interlott, Inc., which expires on April 30, 2007, provides for maintenance of the vending machines.

Video Lottery Games are offered on approximately 5,100 Video Gaming Machines spread over four gaming facilities. Multimedia Games, Inc. provides a central processing system for the operation of Video Lottery Games under a contract expiring on January 27, 2010. Video Gaming Machines are provided under contracts expiring December 31, 2007 with four different companies (Bally Gaming, International Game Technology, Sierra Design Group, Inc., and Spielo USA, Inc.).

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(b) Insurance Contracts

Prior to 1983, the Lottery had entered into agreements with New York insurance companies under which the Lottery purchased contracts that provide payments corresponding to the Lottery's obligation to the prizewinners. The types of contracts entered into include agreements that pay installments for a specific term (investment contracts) as well as agreements to make installment payments to prizewinners over the winners' lifetime. Because it is the intent of the Lottery that the insurance companies make future installment payments directly to each prize winner, the present value of the future payments under these contracts are not reflected in the accompanying financial statements. The Lottery may be liable for such future payments if the insurance companies were to default on their payments. All amounts under the investment contracts have been paid. For contracts other than investment contracts, the insurance companies are carrying long-term liabilities of approximately \$6,087,000 as of March 31, 2005.

(c) Litigation

The Lottery has been named as a defendant in several lawsuits. While the ultimate outcome of these lawsuits cannot be predicted at this time, it is the opinion of management and in-house counsel that the disposition of any litigation in which the Lottery is involved will not have a material adverse effect on the financial position of the Lottery.

(14) Subsequent Events

In April 2005 amendments to the Tax Law changed the allocation of video gaming revenue. The allocations continue to be based on total video gaming revenue after payment of prizes (net machine income) and the Lottery continues to retain 10% of such revenue to be used for administration. The racetrack operator of video gaming will retain a vendor's fee of 32% of the first \$50 million in net machine income annually, 29% of the next \$100 million annually, and 26% thereafter. In addition, the operator will receive a vendor's marketing allowance of 8% of the first \$100 million annually and 5% thereafter, except for track operators in Queens or Westchester County where the amount will not exceed 4%. The marketing allowance is subject to the overall supervision of the Lottery. All remaining revenue will go to education.