



Maryland State Lottery Agency

AN ENTERPRISE FUND OF THE STATE OF MARYLAND

Comprehensive Annual Financial Report

For the Years Ended
June 30, 2006 and 2005



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For the Years Ended
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Maryland State Lottery Agency
An Enterprise Fund of the State of Maryland

Prepared by the
Accounting Department of the
Maryland State Lottery Agency



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Introductory Section



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MARYLAND LOTTERY

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Phone: 410-230-8800 • TTY users call Maryland Relay
www.mdlottery.com



Robert L. Ehrlich, Jr., *Governor* • Buddy Roogow, *Director*

November 20, 2006

The Honorable Robert L. Ehrlich Jr., Governor
Frank C. Bonaventure, Chairman, Maryland Lottery Commission
E. Randolph Marriner, Vice Chairman, Maryland Lottery Commission
Maryland Lottery Commission

INTRODUCTION

We are pleased to present to you the Comprehensive Annual Financial Report (CAFR) of the Maryland State Lottery Agency (the Lottery) for the fiscal year ended June 30, 2006. This report has been prepared by the Accounting Department of the Lottery. Responsibility for both the accuracy of the financial data and the completeness and fairness of presentation, including all disclosures, rests solely with the Lottery. To the best of our knowledge and belief, the enclosed data is accurate and is reported in a manner designed to present fairly the financial position, results of operations and cash flows of the Lottery. All disclosures necessary to enable the reader to gain an understanding of the Lottery's financial activities have been included.

This report is presented in three sections: introductory, financial and statistical. The introductory section includes this transmittal letter, a list of principal officials, an organizational chart, and the Certificate of Achievement for Excellence in Financial Reporting, awarded for fiscal year 2005. The financial section begins with the independent auditors' report, followed by management's discussion and analysis, the comparative financial statements, accompanying notes and supplemental information. The statistical section contains selected financial, demographic and operational data.

Presented in this report is information about the Lottery, an independent agency of the State of Maryland. The Lottery was established by the General Assembly through the enactment of Chapter 365 of Laws of Maryland of 1972 and the voters' approval that same year of a constitutional amendment. The amendment was ratified on November 7, 1972 and operations commenced on January 2, 1973. The Lottery is operated as a business enterprise within the framework of state laws and regulations. The mission of the Lottery is to provide revenue to the State of Maryland through the sale of entertaining lottery products to support state programs and services benefiting the citizens of Maryland.

The Lottery is an enterprise fund of the State and is included in the State's Comprehensive Annual Financial Report. Lottery activity is reported as a major enterprise fund type and includes all activity for which the Lottery is financially accountable.

The Lottery has a five-member board of commissioners who are appointed by the Governor with the advice and consent of the Senate of Maryland. The Commission provides direction and guidance to the Director of the Lottery concerning lottery operations.

HISTORY OF LOTTERIES

The history of lotteries can be traced as far back as Moses and the Bible. Since the beginning of time, lotteries have been used to award prizes and finance various projects. In the Bible, Moses used a lottery to award land west of the Jordan River. It has also been said that lottery funds were used to construct the Great Wall of China and finance cannons for the Revolutionary War. Lotteries flourished throughout the 1700's and 1800's with lotteries serving as a standard source for public and private financing. Schools, churches and some of the more notable colleges, such as Harvard, Yale and Princeton were erected with lottery proceeds. However, as lotteries became more widespread, so did corruption within these lotteries. The State of New York passed the first constitutional prohibition of lotteries in the United States, and by 1878 all states except Louisiana prohibited lotteries.

The prohibition against lotteries in the United States lasted until 1964, when New Hampshire became the first state lottery created. New York and New Jersey followed shortly thereafter and the first on-line system was implemented in New Jersey in 1971. On May 15, 1973, tickets for the Maryland Lottery's first game, Twin Win, went on sale. The 50-cent tickets were available at approximately 4,800 retail outlets throughout the state. The top prize of \$50,000 was awarded to players who matched all six numbers in the exact order. The first drawing was held on May 24, 1973 at Hopkins Plaza in Baltimore. There were four top prize winners.

Throughout the years, lotteries have evolved and have become more diversified offering players a variety of choices. Today, 42 states and the District of Columbia operate lotteries selling both on-line games and instant tickets. During fiscal year 2006, these lotteries generated in excess of \$51.7 billion in sales. The Maryland Lottery ranked fifth among state lotteries in per capita sales during this time period.

Lotteries continue to fund various initiatives and provide benefits to the citizens of their states. Since its inception, the Lottery has exceeded \$25.9 billion in sales and has contributed more than \$9.7 billion to the State of Maryland. Lottery revenues are contributed to the State's General Fund and used to support various programs and services such as education, public health and safety, and human resources. In addition, the Lottery is required by statute to contribute a defined amount each year to the Maryland Stadium Authority.

ECONOMIC OUTLOOK

Maryland's economy has slowed in 2006. Maryland's employment growth at 1.4% in 2005 was below national growth for the first time in six years. Through nine months of 2006, the gap has widened with Maryland's employment growth falling under 1.3%. Unemployment is still at historically low levels at 4.0%, which is more than half a point below the national average; however, the gap is narrowing. Slowdowns in the construction, leisure and hospitality services, and professional and business services industries have offset the acceleration of education and health services, and information industries. While Maryland's economy is expected to continue to expand, it, like the national economy, is expected to slow through 2007.

Over the past five years, Maryland's housing market has outperformed the national market. In 2000, the median price of existing homes was nearly the same in Maryland as it was in the nation. Since then, home prices in Maryland have increased by 100%, while national prices have increased by 66%. Maryland's construction, building supplies, finance, and real estate industries all benefited over the past five years. The increase caused a surge in housing-related employment and resulted in a 39.8% growth as compared to the rest of the private sector, which grew by 3.0%. However, the housing market has turned and the drivers of economic growth over the past five years are likely to become drags. The impact of the housing market on construction employment is one of the key factors facing the State's economy at this point. Nonresidential construction will play a critical role in determining whether economic growth in 2007 will be stagnant, negative, or relatively strong for this point in the business cycle.

The State's economy faces other risks such as energy prices. Although energy prices have fallen dramatically over the past few months, they could spike at any time. The high cost of energy over the past year did not have a noticeable effect on Marylanders' spending, but much of the spending was financed with debt. Another session of high gasoline or natural gas prices may not be easily absorbed by Marylanders. If the national economy falls into a recession, Maryland will not escape unscathed.

Maryland's economy is expected to continue to grow, although at a slower rate than in 2005. Housing-related industries, including construction, finance, and real estate will join with a declining manufacturing sector and stagnant trade industry to offset healthy expansion in the services, especially education and health services. Federal spending will continue to provide a solid base for the State, as will the State's wealth and increasing number of high-skill jobs. Employment growth is expected to reach 1.4% in 2006 before slowing to 1.1% in 2007 and should experience a modest acceleration to 1.3% in 2008. Finally, wage and salary growth will reach 7.6% in 2006 before slowing to 5.6% in 2007 and 2008.

MARYLAND LOTTERY PRODUCTS

The Lottery introduced a number of different games since its inception, and continues to provide players with the opportunity to participate in a variety of on-line and instant ticket games. On-line games allow the players to pick their numbers or utilize automatic computer-generated plays. Customers receive their ticket and then wait for the drawing to see if they have won. Instant games are played by scratching a latex covering off a play area to reveal pre-printed combinations. If a winning combination appears, the customer is an "instant winner".

Games offered during fiscal year 2006 include the following:

PICK 3

***Fiscal Year 2006 Statistics:
\$298.1 million in net sales
19.1% of total net sales
\$2.0 million increase from fiscal year 2005 Pick 3 net sales***

PICK 3 was introduced in July 1976 and was the first on-line game offered by the Lottery. Players choose three numbers from 0 to 9 for the chance of winning prizes ranging from \$25 to \$500. Drawings are currently held twice daily, seven days-a-week.

PICK 4

***Fiscal Year 2006 Statistics:
\$236.5 million in net sales
15.1% of total net sales
\$11.1 million increase over fiscal year 2005 Pick 4 net sales***

PICK 4 was introduced in April 1983. Players choose four numbers from 0 to 9 for the chance of winning prizes ranging from \$100 to \$5,000. Drawings are currently held twice daily, seven days-a-week.

Lotto!

***Fiscal Year 2006 Statistics:
\$20.0 million in net sales
1.3% of total net sales
\$14.1 million decrease from fiscal year 2005 Lotto net sales***

LOTTO was an on-line jackpot game that was introduced in October 1983. Players chose or requested the computer to generate six numbers from a field of 49. Players matching all six numbers, in any order, won the jackpot, which typically started at \$1 million and increased after each drawing, if not won. If there were multiple winners, the jackpot was divided by the number of winners. Players also won fixed prizes ranging from \$2 to \$1,500. Lotto drawings were held on Wednesday and Saturday evenings. The lottery industry as a whole has seen a decline in its traditional Lotto games as the jackpots for these games can not compete with the jackpots offered by the multi-state games of Mega Millions and Powerball. As a result, the Lotto game was discontinued in February 2006.



*Fiscal Year 2006 Statistics:
\$15.8 million in net sales
1.0% of total net sales*

MULTI-MATCH is an on-line jackpot game that was introduced in February 2006. Players receive three lines of six numbers. Players choose or request the computer to generate the first line of numbers from a field of 43. The computer then generates the remaining two lines of numbers. Players matching all six numbers in a single line, in any order, win the jackpot, which typically starts at \$500,000 and increases after each drawing, if not won. If there are multiple winners, the jackpot is divided by the number of winners. Players can also win fixed prizes ranging from \$2 to \$3,000 by matching three or more numbers in a single line or five or more numbers in the combined lines. Multi-Match drawings are held on Wednesday and Saturday evenings. Additional information concerning this game can be found on page 14 under highlights of fiscal year 2006.



*Fiscal Year 2006 Statistics:
\$22.4 million in net sales
1.4% of total net sales
\$509.1 thousand increase from fiscal year 2005 Bonus Match 5 net sales*

BONUS MATCH 5 is an on-line game that was originally introduced in September 1995. The game was discontinued in January 1998 and re-introduced in February 2002. Players select or request the computer to generate five numbers from a field of 39. Players matching all five numbers, in any order, win \$50,000. In the event that there are more than twelve \$50,000 winners in one drawing, each winner will receive an equal share of the \$600,000 prize pool. Players may also win prizes ranging from \$2 to \$600. Drawings are held seven nights a week.

Keno. Keno.

Fiscal Year 2006 Statistics:

\$436.3 million in net sales

28.0% of total net sales

\$19.7 million increase over fiscal year 2005 KENO/KENO Bonus net sales

KENO/KENO BONUS is an on-line game that is predominantly sold in a social atmosphere as drawings are held every four minutes. KENO was introduced in January 1993. The Lottery's computer continuously generates random sets of 20 numbers. These numbers are then displayed on a KENO monitor. Players can select from 1 to 10 numbers from a field of 80 numbers and win prizes ranging from \$2 to \$100,000 by matching anywhere from no numbers to 10 numbers.

KENO BONUS was introduced statewide in April 1999 and is sold in conjunction with KENO. By matching their KENO wager, players have an opportunity to multiply their winnings by 3, 4, 5, or 10. The multiplier is determined by a computer-generated wheel that is spun prior to each drawing. The maximum prize that can be won per game on any one KENO ticket when KENO Bonus is played is \$1 million.



Fiscal Year 2006 Statistics:

\$116.2 million in net sales

7.5% of total net sales

\$16.5 million increase over fiscal year 2005 Mega Millions net sales

MEGA MILLIONS, formally known as THE BIG GAME, is an on-line jackpot multi-state lottery game. The Lottery joined THE BIG GAME in September 1996 and remained a member of THE BIG GAME when it became MEGA MILLIONS in May 2002 when Ohio and New York joined the game. Twelve states, Maryland, California, Georgia, Illinois, Massachusetts, Michigan, New York, New Jersey, Ohio, Texas, Virginia and Washington are currently members.

Players choose or request the computer to generate a total of six numbers from two different fields. Players pick five numbers from a field of 56 and one MEGA ball number from a field of 46. Players matching all numbers and the MEGA ball win the jackpot. If there are multiple winners, the jackpot prize is divided evenly among all the winners. Jackpots start at \$12 million and increase each drawing for which there is no jackpot winner(s). Players may also win prizes ranging from \$2 to \$250,000. Drawings are held every Tuesday and Friday.



***Fiscal Year 2006 Statistics:
\$268,000 in net sales
less than 1.0% of total net sales***

RACETRAX™ was an on-line promotional game offered by the Lottery to a limited number of retailers during the period December 2004 through July 2005. This game was a computer animated monitor game that offered the thrill of horseracing with advanced 3-D graphic animation that made the horses and races appear realistic. Races were run every 5 minutes and players could select from 1 to 12 horses to win prizes ranging from \$1.20 to \$28,716. Additional information concerning this game can be found on page 17 under future projects.



***Fiscal Year 2006 Statistics:
\$415.3 million in net sales
26.6% of total net sales
\$24.4 million increase over fiscal year 2005 Instant Tickets net sales***

INSTANT TICKETS, also known as scratch offs, were first introduced in 1976. Similar to today's instant ticket games, the first instant ticket game launched in Maryland provided players the opportunity to win by scratching a latex play area. Players were also provided with an additional opportunity to win by tearing off the stub of the ticket, which contained a letter. Players collecting enough letters to spell Maryland or Instant won additional cash prizes. From 1976 to 1985, the Lottery launched a limited number of instant tickets games, however, by 1986 instant games were launched on a frequent basis. Today, instant tickets have become one of the fastest growing products in Maryland as well as the lottery industry. During fiscal year 2006, the Lottery launched 47 different instant ticket games.

HIGHLIGHTS OF FISCAL YEAR 2006

Fiscal year 2006 was another successful year for the Lottery as it was the seventh consecutive year that record sales and income from operations were achieved. Fiscal year 2006 sales totaled an all time high of \$1.561 billion an increase of \$75.2 million or 5.1% over fiscal year 2005. Income from operations transferred to the State of Maryland during fiscal year 2006 totaled \$501.0 million, an increase of \$23.9 million or 5.0% over fiscal year 2005 transfers. Additional financial information can be found in the Management's Discussion and Analysis Section of this report, which begins on page 26.

Aside from another record breaking year in sales and income, the most significant accomplishment of the Lottery during fiscal year 2006 entailed preparing for the conversion of its on-line gaming system. The conversion occurred during the first few weeks of fiscal year 2007; however, substantially all of the planning, documenting, testing and installation of the infrastructure occurred during fiscal year 2006. As a result of the conversion, the Lottery will benefit from the following major enhancements:

- a new technologically advanced on-line system that is easily upgraded to meet the evolving needs of the lottery industry;
- upgraded lottery terminals with retailer friendly touch screens, full monitor video training module, and thermal printers;
- an upgraded telecommunications network that utilizes satellite technology which allows the Lottery to easily expand its existing retailer network without the costly and time consuming wired line technology that was previously used;
- the latest technology for processing instant ticket orders, including a telemarketing staff that is responsible for contacting the retailer network to determine instant ticket orders, packing the orders by Lottery personnel and ability to ship the product to retailers the next day.

In addition to preparing for conversion, the Lottery continued to enhance its game portfolio. On February 2, 2006, the Lottery replaced its original classic Lotto game with Multi-Match. Multi-Match is a \$2.00 Lotto-style game that gives players a new play style and more chances to win. The change came about as a result of extensive player research and a continued decline in Lotto sales. The decline in traditional Lotto games has been seen throughout the lottery industry, as a whole, as the jackpots for these games can not compete with the jackpots offered by the multi-state games of Mega Millions and Powerball. During fiscal year 2006, Multi-Match sales outperformed Lotto sales for the same period of time in fiscal year 2005. Multi-Match sales exceeded Lotto sales by \$1.0 million or 6.9%.

The Lottery introduced its first \$20 instant ticket, \$20 Million Mania. The ticket, which included over \$20 million in prizes, was launched on January 30, 2006 and quickly became a top selling ticket. Sales for the first week exceeded \$2.6 million, surpassing the first week's launch of any other instant ticket in the Lottery's history. Additionally, in June 2006, the Lottery entered into a new 4-year contract with its primary instant ticket vendor and two additional contracts with secondary vendors. These contracts will allow the Lottery to offer its players the latest innovative scratch off games from each of the vendors.

FINANCIAL INFORMATION

ACCOUNTING SYSTEMS AND POLICIES

The Lottery operates only enterprise activities. These activities are sales of lottery tickets to the public and all necessary supporting functions, including, but not limited to personnel, finance and administration, marketing, security and licensing. No general government functions or operations are managed by the Lottery or included in this report. The Lottery, like a private business, utilizes the full accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Under the accrual basis of accounting, revenues are recognized when earned and expenses are recognized at the time the related liabilities are incurred.

BUDGETARY SYSTEMS AND CONTROLS

Budgetary control for all state agencies is maintained through the Governor's approval and the enactment of the State's budget by the General Assembly. Each year, the Lottery submits its budget to the Governor for approval. The budget includes all costs to operate the Lottery with the exception of prizes paid to winners and commissions paid to retailers. Prizes and commissions are funded from the sale of Lottery tickets and are not included as part of the annual budget submitted for approval.

The Governor, in turn, submits the budget for the entire State (including the Lottery's) to the General Assembly for enactment. The Lottery's official budget, as enacted by the General Assembly, is divided among the various divisions within the Maryland Lottery. These divisions are responsible for monitoring expenditures within their division in order to ensure expenditures do not exceed the amount budgeted. Encumbrance accounting is utilized whereby purchase orders, contracts and other commitments are treated as expenditures for budgetary purposes. The Lottery's Budget Department is responsible for monitoring the entire budget of the Lottery, including the budgeted funds allocated to the various divisions, in order to ensure that the total expenditures of the Lottery (including encumbrances) does not exceed the approved budget without first obtaining the approval of the Governor and the General Assembly.

DEBT ADMINISTRATION

The Lottery's long-term liabilities are primarily payments owed to Lotto jackpot and lifetime winners and capital lease obligations. The payments due to winners are fully funded by amounts invested primarily in United States Government Agency Obligations (coupon bonds). Some investments are also held in annuity contracts. Capital lease obligations are for gaming equipment primarily leased through the State Treasurer's Office.

CASH MANAGEMENT

The Lottery collects cash due for instant and on-line sales from its approximately 3,700 retailers on a weekly basis. Funds are collected electronically from the retailers' designated bank accounts. The Treasury of the State of Maryland invests cash primarily in overnight repurchase agreements, United States Government Obligations and money market mutual funds.

RISK MANAGEMENT

The Lottery is exposed to various levels of risk associated with theft, damage, or destruction of assets, torts and game liability. To manage the related risks, the Lottery participates in the State's insurance program, which provides general liability, personal and casualty and workers' compensation insurance. The Lottery is assessed an annual premium by the State to fund such coverage.

To manage the risks associated with games liabilities, the Lottery has established aggregate payout limits for each game type.

INTERNAL CONTROL ENVIRONMENT

Management of the Lottery is responsible for establishing and maintaining an internal control structure designed to ensure that assets are protected from loss, theft or misuse and to ensure that the accounting system allows compilation of accurate and timely financial information. The structure is designed to provide reasonable assurance that these objectives are met.

To enhance controls over accounting procedures, the Lottery has segregated the following functions: personnel, payroll, purchasing and accounts payable and general ledger and accounts receivable accounting. Data input and processing are separate from system programming with management providing approval and oversight. In addition, an internal auditor reviews all areas of the Lottery and reports jointly to the Director of the Lottery and to the Chairman and Vice-Chairman of the Lottery Commission.

Since the Lottery manages a valuable instant ticket inventory and controls the disbursement of prizes, the following steps have been taken to ensure the operations remain secure and meet the highest ethical standards:

- Employing specialized security staff.
- Maintaining secure lottery facilities and limiting access to them.
- Performing background checks on retailers, vendors and employees.
- Printing lottery tickets with special security features.
- Performing unannounced inspections at the drawing studio to ensure compliance with established operating procedures.
- Processing daily transaction data of all vendor activity by Lottery personnel using the Lottery's internal control system programs and reconciling transactions to reports generated by the on-line gaming vendor.
- Providing a variety of access and other controls in our computer systems.

The Lottery currently has 179 employees, most of whom are located at the Lottery's headquarters in Baltimore. The drawings are conducted at the broadcast facility of the television station, which produces the drawings; except for, the Sunday midday drawings, which are conducted at the Lottery's headquarters and are not broadcast on television.

FUTURE PROJECTS

During fiscal year 2007, the Lottery will be undertaking the introduction of two new on-line games to the general public. The first game, Racetrax, is a monitor-style game that simulates horse races. This will be the second monitor-style game available to Marylanders. Keno/Keno Bonus, the Lottery's first monitor-style game, has been extremely successful and has become Maryland's best selling on-line game. During fiscal year 2006, sales exceeded \$436 million, an increase of nearly \$59 million since 2003. Monitor-style games are generally offered in a social atmosphere and allow players to experience an enhanced interaction with the game and immediate gratification of the prizes won. The Lottery originally offered Racetrax on a limited basis as part of a pilot program in October 2005. The response to the game was very favorable and, depending on sales, could result in additional monitor-style games in the future.

The second game to be offered will be Countdown to Millions, a \$20 raffle-style game. Raffle-style games are new to the industry but are beginning to capture the interest of players across the country. Unlike other lottery and jackpot games that seldom sell out, Countdown to Millions will only offer a limited number of tickets. The game will include several \$1 million prizes and numerous other prizes. The game will provide players with the Lottery's best odds of winning \$1 million.

INDEPENDENT AUDIT

The Lottery has contracted with an independent certified public accounting firm to perform an annual audit of the Lottery. The independent auditors' opinion on the Lottery's financial statements is included in the financial section of this report.

GFOA CERTIFICATE OF ACHIEVEMENT

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Lottery for its CAFR for the fiscal year ended June 30, 2005. This was the second year the Lottery has received this prestigious national award. In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized CAFR. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current CAFR continues to meet Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

ACKNOWLEDGEMENTS

The preparation of this report could not have been accomplished without the efficient and dedicated services of Deborah Sharpless, Controller. A special note of thanks is also given to the Lottery's Creative Services Division for assisting us in the layout of this report and providing us with the demographic information contained in the statistical section of this report, David Roose, Director of the State's Bureau of Revenue Estimates for his assistance in providing us information concerning the Maryland economy and our independent auditors for their assistance in the development of this report.

This Comprehensive Annual Financial Report reflects our commitment to maintain the Maryland Lottery's financial statements and record keeping systems in conformance with the highest standards of accountability.

Respectfully Submitted,

MARYLAND STATE LOTTERY



Gina M. Smith, CPA
Assistant Director and Chief Financial Officer



Buddy Roogow
Director

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Maryland State Lottery Agency

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
June 30, 2005

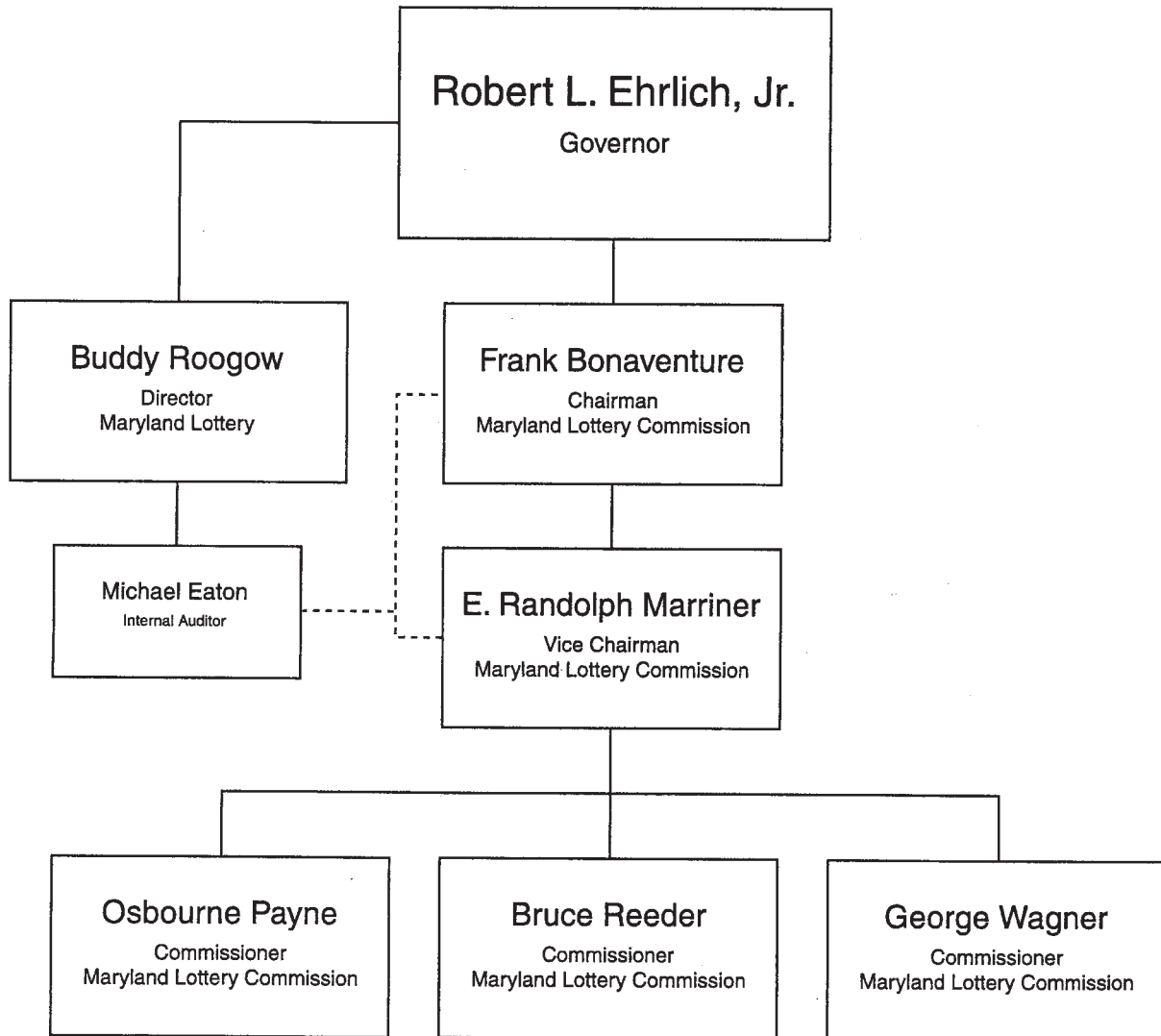
A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



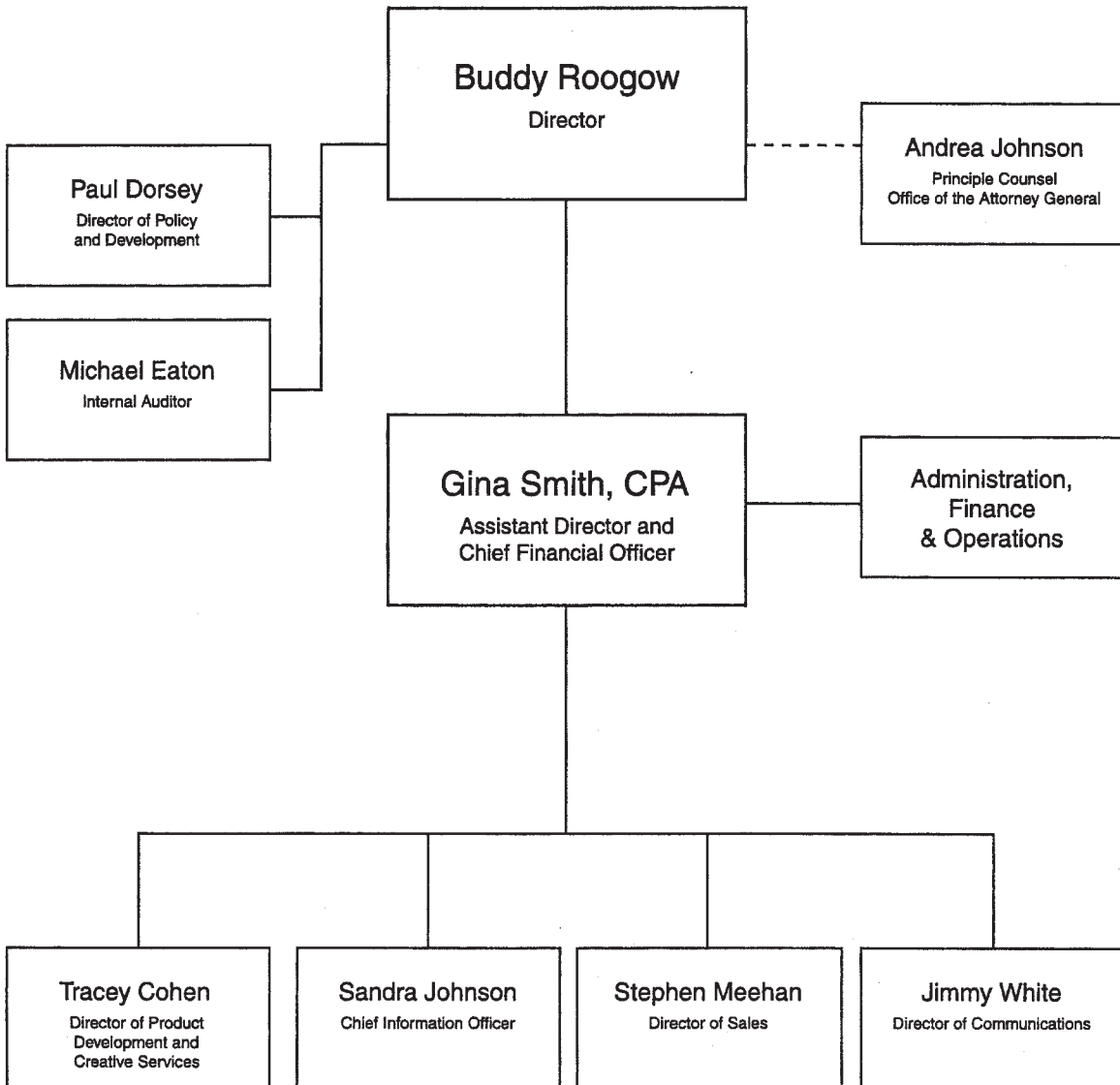
President

Executive Director

**Maryland State Lottery Agency
Principal Officials**



Maryland State Lottery Agency Organizational Chart





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Financial Section



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STOUT, CAUSEY &
HORNING, P.A.

910 Ridgebrook Road
Sparks, MD 21152

INDEPENDENT AUDITORS' REPORT

To the Maryland State Lottery Agency:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Maryland State Lottery Agency (an agency of the State of Maryland), as of and for the years ended June 30, 2006 and 2005, as shown on pages 38 through 41. These financial statements are the responsibility of the Maryland State Lottery Agency'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 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 Maryland State Lottery Agency, are intended to present the financial position, and the changes in financial position and cash flows, where applicable, of only that portion of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State of Maryland that is attributable to the transactions of the Maryland State Lottery Agency. They do not purport to, and do not, present fairly the financial position of the State of Maryland, as of June 30, 2006 and 2005, and the changes in its 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 respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the Maryland State Lottery Agency, as of June 30, 2006 and 2005, and the respective changes in financial position and cash flows, where applicable, thereof 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 26 through 36 are not a required part of the basic statements but are supplementary information required by accounting principles 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 supplementary information. However, we did not audit the information and express no opinion on it.

The introductory section and statistical section have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, according, we express no opinion thereon.

Stout, Causey & Horning, P.A.

September 20, 2006

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Maryland State Lottery Agency Management's Discussion and Analysis

The following Management's Discussion and Analysis (MD&A) provides an overview of the Maryland State Lottery Agency (Lottery) performance for the fiscal years ended June 30, 2006 and 2005. As you read the MD&A, 2006 refers to the fiscal year ended June 30, 2006, 2005 refers to the fiscal year ended June 30, 2005 and 2004 refers to the fiscal year ended June 30, 2004. The information contained in the MD&A should be read in conjunction with the information contained in the financial statements and notes to the financial statements, which begins on page 38.

FINANCIAL HIGHLIGHTS

- Net sales were a record \$1.561 billion in 2006, an increase of \$75.2 million or 5.1% as compared to 2005, which increased \$90.3 million or 6.5% as compared to 2004.
- Cost of sales increased \$54.6 million or 5.6% in 2006 as compared to 2005, which increased \$74.5 million or 8.3% as compared to 2004.
 - Commissions paid to Lottery retailers in 2006 totaled \$102.7 million, an increase of \$5.1 million or 5.2% as compared to 2005, which increased \$6.3 million or 6.9% as compared to 2004.
 - Prizes paid to winners in 2006 totaled \$904.1 million, an increase of \$47.8 million or 5.6% as compared to 2005, which increased \$69.4 million or 8.8% as compared to 2004.
 - Gaming vendor and data processing fees along with instant ticket printing and delivery costs in 2006 totaled \$21.8 million, an increase of \$1.7 million or 8.2% as compared to 2005, which decreased \$1.2 million or 5.6% as compared to 2004.
- Operating expenses increased in 2006 by \$1.5 million or 4.7% as compared to 2005, which increased by \$1.0 million or 3.3% as compared to 2004.
- Transfers to the State of Maryland, in 2006, were a record \$501.0 million, an increase of \$23.9 million or 5.0% as compared to 2005, which increased \$18.7 million or 4.1% as compared to 2004.

FINANCIAL STATEMENTS

The Lottery is an independent agency of the State of Maryland that was created to generate revenue for the State through the operation of a lottery. The Lottery is accounted for as a proprietary-type enterprise fund using the accrual basis of accounting, similar to a private business entity.

Maryland State Lottery Agency Management's Discussion and Analysis

The financial statements included in this report are: statements of net assets; statements of revenues, expenses, and changes in net assets; and statements of cash flows. The statements of net assets present the assets and liabilities of the Lottery with the difference between the two being reported as net assets. The statements of revenues, expenses, and changes in net assets report the revenues and expenses of the Lottery and are used to measure the success of the Lottery's operations for a given period of time as it relates to contributions to the State of Maryland. The statements of cash flows reconcile the changes in cash and cash equivalents with the activities of the Lottery for the periods presented. The activities are classified as operating, noncapital financing, capital and related financing and investing.

The notes to the financial statements provide additional information that is essential to the full understanding of the data provided in the financial statements. The notes to the financial statements can be found on pages 42 to 55 of this report.

FINANCIAL ANALYSIS

Table 1 is a summarized version of the statements of net assets for 2006, 2005 and 2004. The table reflects the Lottery's overall change in financial resources and claims on those resources. The majority of the Lottery's assets consists of cash held by the State Treasury, investments and accounts receivable. The Lottery's investments and accounts receivable, as well as the majority of cash held by the State Treasury, are used to pay Lottery winners or are transferred as income to the State of Maryland. Most liabilities represent prize awards payable and amounts due to the State of Maryland.

Table 1
Net Assets
(in thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Current Assets	\$ 131,697	\$ 133,798	\$ 138,326
Non-Current Assets	171,619	214,836	244,261
Capital Assets, net	1,549	2,109	3,509
Total Assets	<u>\$ 304,865</u>	<u>\$ 350,743</u>	<u>\$ 386,096</u>
Current Liabilities	\$ 117,947	\$ 118,495	\$ 126,913
Non-Current Liabilities	159,906	186,902	214,961
Total Liabilities	<u>\$ 277,853</u>	<u>\$ 305,397</u>	<u>\$ 341,874</u>
Net Assets			
Invested in Capital Assets	\$ 293	\$ 436	\$ 377
Unrestricted	26,719	44,910	43,845
Total Net Assets	<u>\$ 27,012</u>	<u>\$ 45,346</u>	<u>\$ 44,222</u>

Maryland State Lottery Agency Management's Discussion and Analysis

Current Assets

The Lottery's current assets decreased by \$2.1 million or 1.6% in 2006 as compared to 2005, which decreased \$4.5 million or 3.3% as compared to 2004. The majority of these changes occurred in the Lottery's current portion of investments for annuity payments, accounts receivable, instant ticket inventory, cash held by the State Treasury and cash and cash equivalents.

The current portion of investments for annuity payments decreased by \$3.4 million or 7.6% in 2006 as compared to 2005, which decreased \$3.1 million or 6.4% as compared to 2004. The decrease in 2006 and 2005 resulted from fewer jackpot winners selecting to receive their prize in the form of an annuity compared to the number of annuities that expired.

The accounts receivable increased by \$2.1 million or 10.0% in 2006 as compared to 2005, which decreased by \$887,000 or 4.0% as compared to 2004. Accounts receivable represents the amount due from Lottery retailers from the sale of Lottery tickets. On a weekly basis, amounts due from retailers are collected electronically from the retailers' bank accounts. In 2006, 5 days of sales activity were waiting to be collected, compared to 4 days in 2005 and 3 days in 2004. The accounts receivable balance as of June 30, 2005 decreased as compared to 2004 because the June 29, 2004 Mega Millions jackpot reached \$220 million which caused sales to increase by approximately \$2.6 million on that day compared to an average day.

The instant ticket inventory decreased by \$85,000 or 2.6% in 2006 as compared to 2005, which increased by \$2.0 million or 149.4% as compared to 2004. In 2005, the Lottery began to increase the volume of tickets warehoused as well as to purchase certain games in larger quantities to support the demand for its instant ticket products. As a result, inventory levels remained relatively constant in 2006 compared to 2005 and increased significantly in 2005 compared to 2004. Additionally, in late June 2005, several high price-point tickets, which are more expensive than standard tickets due to the size of the ticket and enhanced printing features were received and therefore included in the 2005 year-end inventory.

The cash held by the State Treasury decreased by \$1.8 million or 2.9% in 2006 as compared to 2005, which decreased \$1.2 million or 1.9% as compared to 2004. The cash and cash equivalents increased by \$1.2 million or 207.9% in 2006 as compared to 2005, which decreased \$1.2 million or 68.7% as compared to 2004. Cash held by the State Treasury and cash and cash equivalents primarily represent income waiting to be transferred to the State of Maryland, unpaid prizes and unclaimed prizes. Changes in accounts receivable, the payables for unpaid and unclaimed prizes and amounts due to the State of Maryland have a corresponding effect on the Lottery's cash position. The transfers due to the State of Maryland General Fund represent income to be transferred and are discussed more fully on page 29 of this analysis. Changes in cash held by the State Treasury were affected by a decrease in the balance of unclaimed prizes in 2006 and increase in 2005 as more fully explained on page 30 of this analysis. Cash held by the State Treasury in 2005 was also affected as a result of the prize awards payable decreasing by \$3.5 million as compared to 2004 due to the Mega Millions jackpot prize being substantially less as of June 30, 2005 as compared to June 30, 2004. Cash and cash equivalents fluctuations are caused by the timing of transfers from cash held by the State Treasury.

Maryland State Lottery Agency Management's Discussion and Analysis

Non-Current Assets

The Lottery's investments for annuity payments, net of current portion, decreased by \$43.2 million or 20.1% in 2006 as compared to 2005, which decreased \$29.4 million or 12.1% as compared to 2004. These decreases resulted from fewer jackpot winners selecting to receive their prize in the form of an annuity compared to the number of annuities that have expired. Additionally, the decrease was caused by a decline in the fair value of the investments held to satisfy the Lottery's obligation to its annuitants.

Capital Assets, Net

Net capital assets decreased by \$560,000 or 26.6% in 2006 as compared to 2005, which decreased by \$1.4 million or 39.9% as compared to 2004. The decreases are the result of depreciation of technology property and Lottery-specific equipment. Details of capital assets, additions and depreciation are included in Note 4 to the financial statements, on page 49.

Current Liabilities

Current liabilities decreased by \$548,000 or 0.5% in 2006 as compared to 2005, which decreased by \$8.4 million or 6.6% as compared to 2004. The majority of these decreases are attributable to the current portion of annuity prizes payable, transfers due to the State of Maryland General Fund and prize awards payable.

The current portion of annuity prizes payable decreased by \$3.0 million or 6.8% in 2006 as compared to 2005, which decreased \$2.6 million or 5.6% as compared to 2004. The transfer due to the State of Maryland General Fund increased by \$3.4 million or 8.9% in 2006 as compared to 2005, which decreased \$1.5 million or 3.9% as compared to 2004. Prize awards payable decreased by \$20,500 or 0.1% in 2006 as compared to 2005, which decreased \$3.5 million or 11.4% as compared to 2004. These changes are the result of similar changes in the current portion of investments for annuity payments and cash held by the State Treasury as discussed on page 28.

Non-Current Liabilities

Non-current liabilities decreased by \$27.0 million or 14.4% in 2006 as compared to 2005, which decreased \$28.1 million or 13.0% as compared to 2004. The primary reason for these decreases is fewer jackpot winners selecting to receive their prize in the form of an annuity compared to the number of annuities that expired. A similar decrease in non-current investments for annuity payments is discussed above.

Additional information on the Lottery's non-current liabilities may be found in Notes 5, 6 and 7 to the financial statements, beginning on page 50.

Maryland State Lottery Agency Management's Discussion and Analysis

Total Net Assets

Total net assets decreased by \$18.3 million or 40.4% in 2006 as compared to 2005, which increased by \$1.1 million or 2.5% as compared to 2004. The majority of these fluctuations occurred as a result of changes in the fair value of investments held to fund obligations to annuitants, funds retained in the unclaimed prize account and instant ticket inventory. Because the Lottery is required by law to transfer its entire budgetary basis net income to the State of Maryland, changes in net assets do not reflect the results of the Lottery's operating activities. Rather, changes in net assets reflect differences between budgetary basis net income and net income in accordance with accounting principles generally accepted in the United States and the unclaimed prize account. The unclaimed prize account represents prizes not claimed by players within 182 days of the drawing, or at the end of an instant game. The funds in the account are given back to players in the form of prizes through promotions and supplementing jackpot prizes.

The Lottery recognized an unrealized loss on investments in the amount of \$17.0 million during 2006 as compared to \$2.2 million during 2005. The unrealized losses on investments are the result of an increase in interest rates which has an inverse effect on the fair value of the Lottery's fixed rate investments. Additionally, in 2006, the unclaimed prize account decreased by \$1.5 million or 14.0% as compared to 2005. In 2005, the unrealized loss was offset by an increase in the instant ticket inventory in the amount of \$2.0 million or 149.4% as compared to 2004 coupled with an increase in the unclaimed prize account in the amount of \$1.4 million or 15.1% as compared to 2004.

Maryland State Lottery Agency Management's Discussion and Analysis

Results of Operations

Table 2 is a summarized version of the statements of revenues, expenses, and changes in net assets for the years ended 2006, 2005 and 2004.

Table 2
Revenues, Expenses, and Changes in Net Assets
(in thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Sales			
On-line games	\$1,145,574	\$1,094,764	\$ 1,040,392
Instant games	415,332	390,969	355,016
	<u>1,560,906</u>	<u>1,485,733</u>	<u>1,395,408</u>
Total sales	1,560,906	1,485,733	1,395,408
Cost of sales	<u>1,028,621</u>	<u>974,007</u>	<u>899,487</u>
Gross profit	532,285	511,726	495,921
Operating expenses	<u>32,630</u>	<u>31,178</u>	<u>30,174</u>
Income from operations	499,655	480,548	465,747
Non-operating revenues (expenses)			
Unrealized loss on investments	(16,974)	(2,237)	(25,411)
Interest expense	(44)	(90)	(118)
Payments to State of Maryland General Fund and Stadium Authority	<u>(500,971)</u>	<u>(477,098)</u>	<u>(458,373)</u>
Total non-operating revenues (expenses)	(517,989)	(479,425)	(483,902)
Change in Net Assets	(18,334)	1,123	(18,155)
Total Net Assets – beginning of year	45,346	44,223	62,378
Total Net Assets – end of year	<u>\$ 27,012</u>	<u>\$ 45,346</u>	<u>\$ 44,223</u>

Maryland State Lottery Agency Management's Discussion and Analysis

Sales

Net sales were a record \$1.561 billion in 2006, an increase of \$75.2 million or 5.1% as compared to 2005, which increased \$90.3 million or 6.5% as compared to 2004.

Lottery sales are categorized as on-line or instant games. On-line games consist of Pick 3, Pick 4, Keno and Keno Bonus, Mega Millions, Multi-Match, Bonus Match 5 and other on-line games. Other on-line games consist of those games that were offered for a short promotional period or have been discontinued within the past 3 years, unless otherwise indicated.

On-line sales increased by \$50.8 million or 4.6% in 2006, as compared to 2005, which increased \$54.4 million or 5.2% as compared to 2004. The growth in on-line sales is attributable primarily to Pick 4, Keno and Keno Bonus and Mega Millions as shown in Table 3.

Table 3
Net Sales of Selected Games
(in thousands)

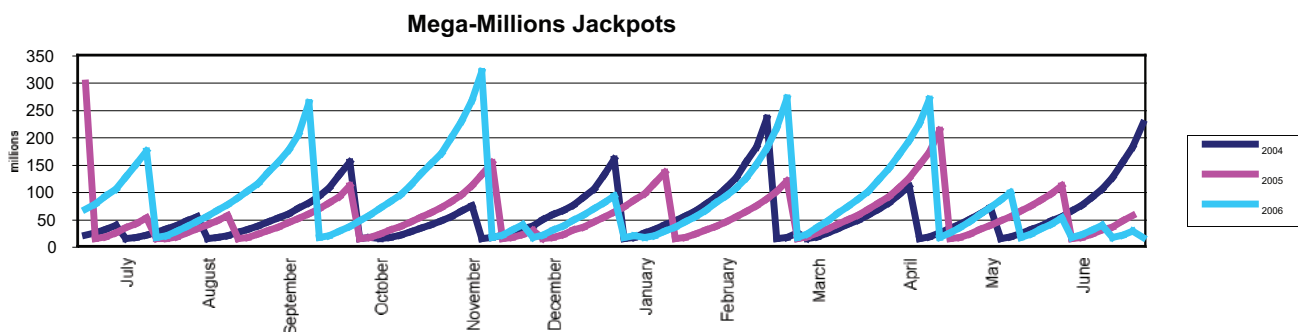
	2006	2005	2004
Pick 4	\$236,503	\$225,453	\$209,214
Keno and Keno Bonus	436,259	416,514	389,796
Mega Millions	116,250	99,738	90,312
Total	\$789,012	\$741,705	\$689,322

Pick 4 sales increased by \$11.1 million or 4.9% in 2006 as compared to 2005, which increased \$16.2 million or 7.8% as compared to 2004. The increase in Pick 4 sales is attributable to players seeking a higher payout in a daily game. The Lottery offers two daily games, Pick 3 and Pick 4. The top prize for Pick 3 is \$500 compared to a top prize of \$5,000 for Pick 4.

Keno and Keno Bonus sales increased by \$19.7 million or 4.7% in 2006 as compared to 2005, which increased \$26.7 million or 6.9% as compared to 2004. The increase in Keno and Keno Bonus sales is attributable to the Lottery conducting various Keno and Keno Bonus specific promotions. The promotions were well received by players and led to an overall increase in the popularity of monitor-style games. Monitor games are generally enjoyed in a social atmosphere and allow players to experience an enhanced game interaction and receive immediate gratification of the prizes won.

Maryland State Lottery Agency Management's Discussion and Analysis

Mega Millions sales increased by \$16.5 million or 16.6% in 2006 as compared to 2005, which increased \$9.4 million or 10.4% as compared to 2004. A direct relationship exists between higher jackpots and higher sales. In 2006, the average jackpot was \$79.5 million as compared to \$52.3 million and \$53.1 million in 2005 and 2004, respectively. The increase is attributable to 8 jackpots in excess of \$200 million in 2006 as compared to a combined 4 jackpots in 2005 and 2004. Sales growth was also achieved as a result of players preferring games with higher jackpots and longer odds. Mega Millions' starting jackpot is several million dollars higher than other jackpot-style games.

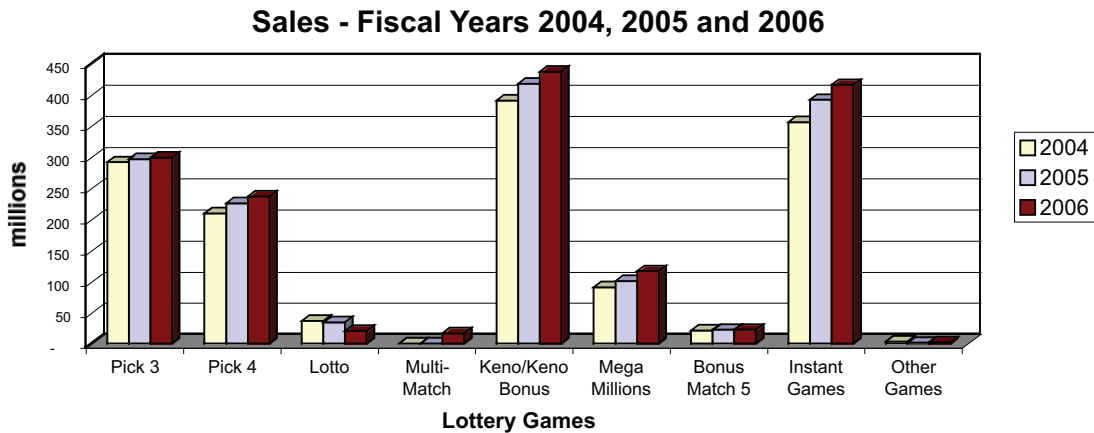


Moderate growth was also achieved in all other on-line games in 2005 and 2006 with the exception of Lotto. The lottery industry as a whole has experienced a decline in this game, as it was the original jackpot game. As seen with the increase in Mega Millions sales, jackpot players generally prefer games that offer extremely large jackpots with longer odds. The Lottery discontinued its Lotto game in February 2006 and replaced the game with Multi-Match, a game that offers a modest jackpot and multiple winning combinations.

Instant games are the second type of Lottery game offered to the public. Instant game sales increased by \$24.4 million or 6.2% in 2006 as compared to 2005, which increased \$36.0 million or 10.1% as compared to 2004. The instant ticket sales continue to grow due to the implementation of the results of research, monitoring the mix of play styles, colors and payouts and providing the players a wide variety of tickets from which to choose. The sales increases have been further fueled by players' desire for higher price point tickets. To further accommodate player preferences, the Lottery introduced its first \$20 instant ticket in 2006. The average price-points for instant tickets in 2006, 2005, and 2004 were \$3.46, \$2.83 and \$2.61, respectively.

Maryland State Lottery Agency Management's Discussion and Analysis

The following graph depicts the Lottery's on-line and instant sales for 2004, 2005 and 2006. Keno and Keno Bonus sales have been combined.



Cost of Sales

Cost of sales consists of prize expense, retailer commissions, costs paid to vendors to operate and maintain the on-line system and costs paid for the printing and delivery of instant games. Cost of sales increased by \$54.6 million or 5.6% in 2006 as compared to 2005, which increased \$74.5 million or 8.3% as compared to 2004. These increases are attributable to higher sales, which correspond to higher prize expense and retailer commissions. Gross profit percentages have remained relatively consistent. Gross profit percentages were 34.1%, 34.4% and 35.6% for 2006, 2005 and 2004, respectively.

Prize Expense and Retailer Commissions

The Lottery's most significant expenses (prize expense and retailer commissions) are predictable because they have a direct correlation to sales. Prize expense increased by \$47.8 million or 5.6% in 2006 as compared to 2005, which increased \$69.4 million or 8.8% as compared to 2004. In general, as sales increase, prize expense increases at a proportional rate. Prize expense for instant games is controllable by designing and printing a predetermined number and value of winning tickets. Prize expense for on-line games is impacted by the luck of the draw. Over time, such prize payouts generally reflect the design of the game and the odds of winning.

Commissions paid to Lottery retailers increased by \$5.1 million or 5.2% in 2006 as compared to 2005, which increased \$6.3 million or 6.9% as compared to 2004. Retailers licensed by the Lottery to sell on-line and/or instant tickets are paid a commission of 5% of net sales and an additional 3% of the value of the prizes they redeem. Consequently, as sales and prize expense increase, the amounts paid to Lottery retailers also increase.

Maryland State Lottery Agency Management's Discussion and Analysis

Operating Expenses

Operating expenses increased by \$1.5 million or 4.7% in 2006 as compared to 2005, which increased by \$1.0 million or 3.3% as compared to 2004. Fluctuations in operating expenses are primarily due to changes in the Lottery's budgetary appropriation or the timing of liquidating prior year encumbrances. The Lottery's operating expenses have remained stable since the Lottery's budgetary appropriation and outstanding encumbrances have remained constant for the past several years.

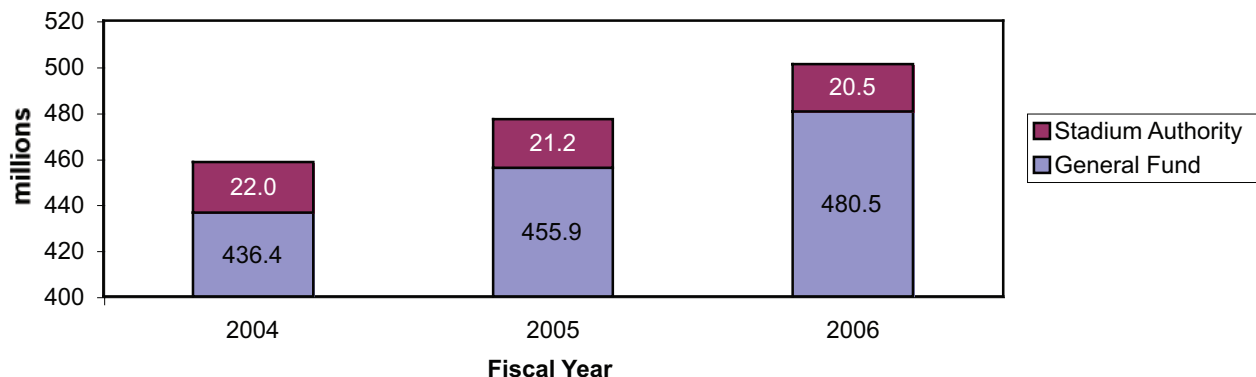
Non-operating Expenses

Non-operating expenses increased by \$38.6 million or 8.0% in 2006 as compared to 2005, which decreased by \$4.5 million or 0.9% as compared to 2004. Non-operating expenses primarily consist of unrealized losses on investments held to fund obligations to annuitants and payments to the State of Maryland General Fund and Maryland Stadium Authority.

The Lottery expects to realize the face value of its investments, since it intends to hold these investments until maturity. Therefore, any interim unrealized losses on investments will reverse. The decrease in fair value of the investments held by the Lottery is discussed in more detail on page 30.

The Lottery is required by State law to transfer its budgetary basis net income to the State of Maryland (General Fund and Stadium Authority). Accordingly, the Lottery's success can be measured by the income it transfers to the State. The Lottery continued its overall sales growth during 2006, resulting in record transfers to the State that totaled \$501.0 million, an increase of \$23.9 million or 5.0% as compared to 2005, which increased \$18.7 million or 4.1% as compared to 2004. The graph below depicts the payments made to the State of Maryland for 2004, 2005 and 2006.

Payments to the State of Maryland - 2004, 2005 and 2006



Maryland State Lottery Agency Management's Discussion and Analysis

Contacting the Lottery's Financial Management

The financial report is designed to provide a general overview of the Lottery's financial activity for those interested in the Lottery's operations. Questions concerning any of the information provided in this report or requests for additional financial information should be addressed to Gina Smith, Assistant Director/CFO, Maryland Lottery, 1800 Washington Boulevard, Suite 330, Baltimore, Maryland 21230.



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Maryland State Lottery Agency Statements of Net Assets

	As of June 30	
	2006	2005
Assets:		
Current assets:		
Cash and cash equivalents	\$ 1,715,749	\$ 557,336
Cash held with State Treasury	61,925,092	63,761,994
Accounts receivable	23,196,063	21,082,415
Instant ticket inventory	3,196,849	3,282,054
Prepaid commissions	31,506	43,311
Current portion of investments for annuity payments	41,632,037	45,071,195
Total current assets	131,697,296	133,798,305
Non-current assets:		
Capital assets, net of accumulated depreciation	1,548,587	2,108,844
Investments for annuity payments, net of current portion	171,619,401	214,835,631
Total non-current assets	173,167,988	216,944,475
Total assets	\$ 304,865,284	\$ 350,742,780
Liabilities and Net Assets:		
Current liabilities:		
Current portion of annuity prizes payable	\$ 40,968,014	\$ 43,977,701
Current portion of employee related payables	892,398	824,320
Current portion of capital lease obligation	439,639	460,969
Transfer due to State of Maryland General Fund	41,717,340	38,307,178
Prize awards payable	27,265,356	27,285,894
Accounts payable and accrued expenses	3,572,336	3,987,704
Unearned revenue	2,474,640	3,237,401
Taxes and other liabilities	617,565	413,817
Total current liabilities	117,947,288	118,494,984
Non-current liabilities:		
Annuity prizes payable, net of current portion	158,553,792	185,225,621
Employee related payables, net of current portion	535,875	464,862
Capital lease obligation, net of current portion	816,074	1,211,646
Total non-current liabilities	159,905,741	186,902,129
Total liabilities	277,853,029	305,397,113
Net Assets:		
Invested in capital assets, net of related debt	292,874	436,229
Unrestricted	26,719,381	44,909,438
Total net assets	27,012,255	45,345,667
Total liabilities and net assets	\$ 304,865,284	\$ 350,742,780

The accompanying notes are an integral part of these financial statements.

Maryland State Lottery Agency
Statements of Revenues, Expenses, and Changes in Net Assets

	Years ended June 30	
	2006	2005
Sales:		
On-line games	\$ 1,145,573,957	\$ 1,094,764,156
Instant games	415,331,827	390,968,694
Total sales	<u>1,560,905,784</u>	<u>1,485,732,850</u>
Cost of sales:		
Prize expense	904,077,713	856,231,700
Retailer commissions	102,704,705	97,592,346
Gaming vendor and data processing fees	15,638,778	15,243,781
Instant ticket printing and delivery	6,199,964	4,938,585
Total cost of sales	<u>1,028,621,160</u>	<u>974,006,412</u>
Gross profit	532,284,624	511,726,438
Operating expenses:		
Salaries, wages and benefits	11,402,287	10,583,585
Advertising and promotions	15,859,308	14,889,419
Depreciation and amortization	560,257	1,500,135
Other general and administrative expenses	4,807,627	4,205,133
Total operating expenses	<u>32,629,479</u>	<u>31,178,272</u>
Income from operations	499,655,145	480,548,166
Non-operating revenues (expenses):		
Investment revenue (loss)	(1,437,548)	16,033,132
Amortization of discount for annuity prize liabilities	(15,536,326)	(18,269,821)
Interest expense	(44,066)	(89,863)
Payments to State of Maryland General Fund	(480,470,617)	(455,863,363)
Payments to State of Maryland Stadium Authority	(20,500,000)	(21,235,000)
Total non-operating revenues (expenses)	<u>(517,988,557)</u>	<u>(479,424,915)</u>
Change in net assets	(18,333,412)	1,123,251
Total net assets - beginning of year	45,345,667	44,222,416
Total net assets - end of year	<u>\$ 27,012,255</u>	<u>\$ 45,345,667</u>

The accompanying notes are an integral part of these financial statements.

Maryland State Lottery Agency Statements of Cash Flows

	Years ended June 30	
	2006	2005
Cash flows from operating activities:		
Receipts from customers	\$ 1,558,029,375	\$ 1,486,270,479
Payments to suppliers	(42,841,732)	(39,905,785)
Payments to employees	(11,263,196)	(10,395,544)
Payments to agents	(102,687,007)	(97,485,678)
Prize payments/awards to players	(903,243,909)	(860,641,834)
Net cash provided by operating activities	497,993,531	477,841,638
Cash flows from noncapital financing activities:		
Transfers to the State of Maryland General Fund and Stadium Authority	(497,560,457)	(478,645,887)
Payments of annuity prize obligations	(45,868,438)	(48,562,532)
Net cash used in noncapital financing activities	(543,428,895)	(527,208,419)
Cash flows from capital and related financing activities:		
Payments of capital lease obligations	(416,902)	(1,458,951)
Interest payments	(44,066)	(89,863)
Acquisition of equipment	-	(100,531)
Net cash used in capital and related financing activities	(460,968)	(1,649,345)
Cash flows from investing activities:		
Coupon bonds purchased	(650,595)	-
Proceeds from matured annuities and bonds	45,868,438	48,562,532
Net cash provided by investing activities	45,217,843	48,562,532
Net decrease in cash and cash equivalents	(678,489)	(2,453,594)
Cash and cash equivalents, beginning of year	64,319,330	66,772,924
Cash and cash equivalents, ending of year	<u>\$ 63,640,841</u>	<u>\$ 64,319,330</u>
Noncash investing and financing activities:		
Change in fair value of investments	<u>\$ (16,973,874)</u>	<u>\$ (2,236,689)</u>

Maryland State Lottery Agency
Statements of Cash Flows - (continued)

	<u>Years ended June 30</u>	
	<u>2006</u>	<u>2005</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$499,655,145	\$480,548,166
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	560,257	1,500,135
Deferred prize payments	650,595	-
Effect of changes in operating assets and liabilities:		
Accounts receivable	(2,113,648)	887,149
Inventory	85,205	(1,965,839)
Prepaid commissions	11,805	49,446
Accounts payable and accrued expenses	(415,368)	1,393,445
Employee related payables	139,091	188,042
Taxes and other liabilities	203,748	(910,462)
Prize awards payable	(20,538)	(3,498,924)
Unearned revenue	(762,761)	(349,520)
Net cash provided by operating activities	<u>\$497,993,531</u>	<u>\$477,841,638</u>

The accompanying notes are an integral part of these financial statements.

Maryland State Lottery Agency Notes to the Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Legislative Enactment

The Maryland State Lottery Agency (Lottery) was established by the Maryland General Assembly enactment of Chapter 365 of Laws of Maryland of 1972, and the voter's approval that same year of a constitutional amendment to allow the Lottery. The amendment was ratified on November 7, 1972 and the Lottery commenced operations on January 2, 1973. The Lottery is a part of the primary government of the State of Maryland and is reported as a proprietary fund and business-type activity within the State of Maryland's financial statements.

The mandate of the Lottery law was to establish a State-operated lottery, under the immediate supervision of a Director and the guidance of a Commission, for the purpose of producing revenue for the General Fund of the State. The Governor, with the advice and consent of the Senate of Maryland, appoints the Director and five Commission members.

The State of Maryland prepares a comprehensive annual financial report (CAFR). The Lottery is an enterprise fund of the State of Maryland and is included in the basic financial statements of the CAFR of the State of Maryland.

Basis of Accounting and Presentation

The Lottery is accounted for as a proprietary fund special purpose government engaged in business-type activities. In accordance with Governmental Accounting Standards Board (GASB) Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments," and with accounting principles generally accepted in the United States of America, the financial statements are prepared on the accrual basis of accounting which requires recognition of revenue when earned and expenses when incurred. As permitted by GASB No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Units That Use Proprietary Fund Accounting," the Lottery has elected to not adopt Financial Accounting Standard Board (FASB) statements and interpretations issued after November 30, 1989, unless the GASB specifically adopts such FASB statements or interpretations.

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 in the financial statements and accompanying notes. Actual results may differ from those estimates.

Maryland State Lottery Agency Notes to the Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)

Lottery Game Operations – Revenue Recognition and Prize Obligations

The Lottery originates its revenue from two product lines: on-line and instant games. The Lottery develops multiple game themes and prize structures to comply with its enabling legislation and customer demand. Independent and corporate retailers comprised principally of grocery and convenience stores, package goods stores and restaurants serve as the primary distribution channel for on-line and instant lottery sales to the general public. Retailers receive a sales commission of five percent of net sales and cashing commission of three percent of prizes redeemed.

Licensed Lottery agents sell on-line lottery tickets to the public through the use of computerized terminals. On-line games include Numbers (Pick 3 and Pick 4), Lotto, Keno, Keno Bonus, Bonus Match 5, Racetrax™, Multi Match and Mega Millions. On-line revenue is recognized in the month in which the related drawings are held. Revenue from the sale of tickets and commissions paid for future drawings are deferred until the drawings are held. Revenue from instant games is recognized when the retailer activates the book of tickets.

Prize obligations for on-line games are determined and recognized after each drawing is held. For all games, winners are paid a certain amount depending upon the number of winners and the order of the winning numbers drawn. Prize obligations are recognized monthly for instant games based on the books activated by retailers and the related prize expense based on the specific game's prize structure.

Operating and Non-Operating Revenues and Expenses

Operating revenues and expenses for proprietary funds such as the Lottery are revenues and expenses that result from providing services and producing and delivering goods and/or services. Operating revenues for the Lottery are derived from providing various types of lottery games. Operating expenses include the costs to operate the various games, pay prize winners, and administrative expenses. All revenues and expenses not meeting this definition are reported as non-operating revenues and expenses.

Cash and Cash Equivalents

Cash and cash equivalents include cash deposited with financial institutions, deposits with the Maryland State Treasury and overnight investments in repurchase agreements.

Accounts Receivable

Accounts receivable represent the amounts due from Lottery retailers from the sale of Lottery tickets. The Lottery utilizes the allowance method to provide for doubtful accounts based on management's evaluation of the collectibility of accounts receivable. The Lottery determines accounts receivable to be delinquent when greater than 10 days past due. Receivables are written off when it is determined that amounts are uncollectible. As of June 30, 2006 and 2005, management believes all accounts receivable are collectible, and as such, no allowance for doubtful accounts has been recorded.

Maryland State Lottery Agency Notes to the Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)

Inventory

Inventory consists of instant game books available for sale to licensed Lottery retailers and is carried at cost (as determined by specific identification method). The cost of tickets is charged to operations upon the recognition of revenue under the procedures described above. The Lottery analyzes inventory for impairment on a periodic basis. As of June 30, 2006 and 2005, the Lottery determined no inventory was impaired and, as such, no allowance was recorded.

Capital Assets and Leasehold Improvements

The Lottery has adopted a policy of capitalizing assets with individual amounts exceeding \$25,000 and all leased assets. These assets are comprised principally of technology equipment necessary to administer lottery games. The purchased assets are recorded at cost and depreciation is computed using the straight-line method over three to five year useful lives. Assets acquired through capital leases are initially recorded at the lower of fair value at the date of the lease or the net present value of the minimum lease payments. Assets acquired under capital leases are amortized over the lesser of the lease term or the estimated useful life of the leased asset.

Investments

Investments consist of United States Government Treasury Bonds and annuity contracts. The investments in United States Government Treasury Bonds are purchased in the name of the Lottery and stated at fair value based on quoted market prices. Investments in annuity contracts are purchased in the name of the Lottery and stated at present value, which approximates fair value.

Compensated Absences

The Lottery accrues compensated absences in accordance with GASB No. 16, "Accounting for Compensated Absences." All full-time Lottery employees except contractual employees accrue annual leave at variable rates based on the number of years employed by the State of Maryland. The maximum annual leave an employee can earn per calendar year is 25 days. At the end of each calendar year, an employee's accrued annual leave may not exceed 50 days. The current portion of the accrued annual leave is included in the employee related payables in the accompanying statements of net assets. All full-time Lottery employees except contractual employees also accrue sick pay benefits. However, the Lottery does not record a liability for accrued sick pay benefits as neither the State of Maryland nor the Lottery has a policy to pay unused sick leave when employees terminate from State service.

Maryland State Lottery Agency Notes to the Financial Statements

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES – (continued)

Payments to the State of Maryland

The State of Maryland law requires the Lottery to transfer its revenue in excess of funds allocated to prize awards, operating expenses and the Maryland Stadium Authority to the State of Maryland General Fund. These payments are recorded as a non-operating expense in the accompanying statements of revenues, expenses, and changes in net assets.

Restricted Assets

State law restricts the Lottery's assets in their entirety. The Lottery's assets are not reported as restricted on the statements of net assets since the restriction created by State law is as broad as the Lottery operations.

Net Assets

Net assets are presented as either unrestricted or invested in capital assets, net of related debt. Net assets invested in capital assets, net of related debt, represents the difference between capital assets and the related capital lease obligations. Unrestricted net assets represent the net assets available for future operations including outstanding encumbrances as of year-end and unrealized gains or losses on investments. Market gains or losses represent temporary fluctuations and are not recognized in the calculation of the amount due to the Maryland Stadium Authority or State of Maryland General Fund.

New Accounting Pronouncements

The Lottery has implemented GASB Statement No. 46, "Net Assets Restricted by Enabling Legislation," and GASB Statement No. 47, "Accounting for Termination Benefits" effective for the fiscal year ended June 30, 2006. Implementation of these standards had no impact on the Lottery's financial position.

In April 2004, GASB issued Statement No. 43, "Financial Reporting for Postemployment Benefit Plans Other than Pension Plans." This Statement will be effective for the Lottery for the fiscal year ended June 30, 2007. In June 2004, GASB issued Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions." This statement will be effective for the Lottery for the fiscal year ended June 30, 2008. The Lottery is in the process of assessing the impact of these statements and will implement them as of the effective dates.

Maryland State Lottery Agency Notes to the Financial Statements

2. CASH AND CASH EQUIVALENTS

As of June 30, 2006 and June 30, 2005, the carrying amounts of deposits with financial institutions were \$1,715,749 and \$557,336, respectively. The corresponding bank balances were \$1,694,574 and \$665,689 as of June 30, 2006 and June 30, 2005, respectively.

As of June 30, 2006 and June 30, 2005, the amount on deposit with the Maryland State Treasury was \$61,925,092 and \$63,761,994, respectively. The State Treasury has statutory responsibility for the daily cash management activities of the State's agencies, departments, boards, and commissions. The deposits with the State Treasury are part of the State of Maryland's internal investment pool and are not separately identifiable as to specific types of securities. The Treasury maintains these and other Maryland State agency funds on a pooled basis in accordance with State statute. The Lottery does not obtain interest on funds deposited with the State Treasury. As of June 30, 2006 and 2005, the Lottery's deposits with the State Treasury were less than 2% of the total deposits with the State Treasury.

Custodial credit risk – Custodial credit risk is the risk that in the event of a bank failure, the Lottery's deposits will not be returned to it. The Lottery's deposit policy requires that it comply with the State law that governs the State Treasury deposits. Specifically, unexpended or surplus money may be deposited in a financial institution in the State, if the deposit is interest bearing; the financial institution provides collateral that has a market value that exceeds the amount by which a deposit exceeds the deposit insurance; and the custodian holds the collateral.

Federal depository insurance covers \$100,000 of the Lottery's deposits with a financial institution and the remaining balance is collateralized with securities that are held by the State of Maryland's agent in the State's name. These deposits are invested in overnight repurchase agreements. As of June 30, 2006 and 2005, the collateral for the repurchase agreements were FNMA Mortgage-Backed Securities which are not rated; however, are implicitly guaranteed by the United States government.

Interest rate risk – The State Treasury investment policy states that to the extent possible, it will attempt to match its investments with anticipated cash flow requirements. Unless matched to a specific cash flow, the State Treasury will not directly invest in securities maturing more than five years from the date of purchase.

Credit risk – State law requires that the State Treasury investments in repurchase agreements be collateralized by United States Treasury and Agency Obligations. In addition, investments must be made directly in United States Agency Obligations. State law also requires that money market mutual funds contain only United States Treasuries or Agency Obligations or repurchase agreements secured by such investments.

Maryland State Lottery Agency Notes to the Financial Statements

2. CASH AND CASH EQUIVALENTS – (continued)

Concentration of credit risk – The State Treasury’s investment policy limits the amount of repurchase agreements to be invested with a particular institution to 30% of the portfolio. There is no other limit on the amount that may be invested in any one issuer. More than 5% of government funds investments are in the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Federal Home Loan Bank. These investments are 53.54%, 35.52% and 5.25% of the State of Maryland’s internal investment pool total investments, respectively.

3. INVESTMENTS

It is the Lottery’s policy to fund jackpot and lifetime prize awards through the purchase of United States Government Treasury Bonds. Furthermore, it is the policy of the Lottery to hold these investments to maturity. The investment maturities approximate the annuity prizes payable installment due dates.

The Lottery has purchased long-term investments to fund jackpot and lifetime prize awards. The majority of these investments are United States Government Treasury Bonds, which carry a yield to maturity of approximately 2.2% to 10.5%. As of June 30, 2006 and June 30, 2005, the Lottery’s United States Government Treasury Bonds totaled \$212,766,843 and \$259,388,700, respectively. The investments in United States Government Treasury Bonds are carried at fair value based on quoted market prices on the accompanying statements of net assets and the related unrealized gains and interest income are recorded as investment revenue (loss) on the accompanying statements of revenues, expenses, and changes in net assets.

Certain investments are held in annuity contracts that return guaranteed interest ranging from 7.6% to 12.1%. As of June 30, 2006 and June 30, 2005, the annuity contracts totaled \$484,595 and \$518,126, respectively. The annuity contracts were purchased in 1976 to satisfy the Lottery’s obligation for certain lifetime prizes. The value of the annuity contracts and related annuity prizes payable were adjusted in fiscal year 2005 based on revised actuarial life expectancy tables.

Interest rate risk is the risk that an investment’s fair value decreases as market interest rates increase. Typically, this risk is higher in debt securities with longer maturities. The Lottery is not subject to interest rate risk because it is our policy to hold the investments until maturity, unless an annuitant through a court order forces the sale of an investment to settle the Lottery’s obligation to the annuitant at which time the annuitant would be paid the proceeds received from the sale of the investments.

For an investment, custodial risk is the risk that in the event of the failure of the counterparty, the Lottery will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Lottery is not subject to custodial risk because the United States Government Treasury Bonds are held in the Lottery’s name by its custodian and annuity contracts are not evidenced by securities that exist in physical or book entry form.

Maryland State Lottery Agency Notes to the Financial Statements

3. INVESTMENTS – (continued)

As of June 30, 2006, the Lottery had the following investments:

Investment Type	Fair Value	Credit Quality Rating	% of Investments	Investment Maturities (In Years)				
				Less than 1	1-5	6-10	11-20	21-30
<u>Investments in prize annuities:</u>								
United States Treasury Bonds	\$212,766,843	1	99.8%	\$41,583,369	\$109,402,528	\$48,325,139	\$12,801,704	\$654,103
Annuity Contracts	484,595	2	.2%	48,668	216,092	155,780	57,590	6,465
Total Investments	\$213,251,438		100.0%	\$41,632,037	\$109,618,620	\$48,480,919	\$12,859,294	\$660,568

- 1 Credit quality ratings not required for U.S. government and agency securities that are explicitly guaranteed by the U.S. government.
- 2 Annuity contracts not rated.

Maryland State Lottery Agency
Notes to the Financial Statements

4. CAPITAL ASSETS

A summary of capital asset activity for the years ended June 30, 2006 and 2005 is as follows:

	2005	Increases	Decreases	2006
Capital Assets-Depreciated				
Machinery and Equipment	\$ 11,078,605	\$ -	\$ 2,280,145	\$ 8,798,460
Leasehold Improvements	613,240	-	-	613,240
Total Capital Assets-Depreciated	11,691,845	-	2,280,145	9,411,700
Less Accumulated Depreciation				
Machinery and Equipment	9,424,580	498,933	2,280,145	7,643,368
Leasehold Improvements	158,421	61,324	-	219,745
Total Accumulated Depreciation	9,583,001	560,257	2,280,145	7,863,113
Net Capital Assets	<u>\$ 2,108,844</u>	<u>\$ (560,257)</u>	<u>\$ -</u>	<u>\$ 1,548,587</u>

	2004	Increases	Decreases	2005
Capital Assets-Depreciated				
Machinery and Equipment	\$ 10,978,074	\$ 100,531	\$ -	\$ 11,078,605
Leasehold Improvements	613,240	-	-	613,240
Total Capital Assets-Depreciated	11,591,314	100,531	-	11,691,845
Less Accumulated Depreciation				
Machinery and Equipment	7,985,770	1,438,810	-	9,424,580
Leasehold Improvements	97,096	61,325	-	158,421
Total Accumulated Depreciation	8,082,866	1,500,135	-	9,583,001
Net Capital Assets	<u>\$ 3,508,448</u>	<u>\$ (1,399,604)</u>	<u>\$ -</u>	<u>\$ 2,108,844</u>

Maryland State Lottery Agency Notes to the Financial Statements

5. ANNUITY PRIZE OBLIGATIONS

The Lottery carries long-term annuity prize obligations at present value. Presented below is a summary of long-term annuity prize payment requirements for annuities payable to maturity:

<u>Fiscal Year</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007	\$ 40,968,014	\$ 1,684,052	\$ 42,652,066
2008	33,909,072	4,064,924	37,973,996
2009	27,979,433	5,679,563	33,658,996
2010	22,871,810	6,628,186	29,499,996
2011	18,036,336	6,759,660	24,795,996
2012-2016	43,292,695	25,539,285	68,831,980
2017-2021	7,785,927	8,409,237	16,195,164
2022-2026	4,048,233	6,723,747	10,771,980
2027-2031	630,286	1,371,694	2,001,980
Total	<u>\$199,521,806</u>	<u>\$66,860,348</u>	<u>\$266,382,154</u>

This debt represents annual payments owed to jackpot and lifetime winners. Annuity prizes are paid over a period of time ranging from 20 to 25 years depending on the time period in which the prize was won. The Lottery has purchased United States Government Treasury Bonds or annuity contracts that fully fund these obligations.

Long-term liability activity of annuity prize payments for the years ended June 30, 2006 and 2005 was as follows:

<u>Fiscal Year</u>	<u>Beginning</u>			<u>Ending</u>	<u>Due Within</u>
<u>Ending</u>	<u>Balance</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance</u>	<u>One Year</u>
June 30, 2006	\$229,203,033	\$16,186,922	\$ 45,868,438	\$199,521,806	\$ 40,968,014
June 30, 2005	\$259,496,033	\$18,269,521	\$ 48,562,532	\$229,203,322	\$ 43,977,701

Maryland State Lottery Agency Notes to the Financial Statements

6. EMPLOYEE RELATED PAYABLES

Changes in long-term employee related payables were as follows for the years ended June 30, 2006 and 2005. The employee related payables due within one year are included in the current portion of the employee related payables on the accompanying statements of net assets, which also includes salaries payable in the amount of \$326,208 and \$258,749 as of June 30, 2006 and 2005, respectively.

	2006		
	Compensated Absences	Workers' Compensation	Combined
Beginning Balance	\$ 736,433	\$ 294,000	\$ 1,030,433
Additions	593,188	28,935	622,123
Reductions	(525,556)	(24,935)	(550,491)
Ending Balance	<u>\$ 804,065</u>	<u>\$ 298,000</u>	<u>\$ 1,102,065</u>

Amount Due Within One Year	\$ 520,000	\$ 46,190	\$ 566,190
Non-Current Portion	284,065	251,810	535,875
	<u>\$ 804,065</u>	<u>\$ 298,000</u>	<u>\$ 1,102,065</u>

	2005		
	Compensated Absences	Workers' Compensation	Combined
Beginning Balance	\$ 697,080	\$ 171,000	\$ 868,080
Additions	565,687	149,476	715,163
Reductions	(526,334)	(26,476)	(552,810)
Ending Balance	<u>\$ 736,433</u>	<u>\$ 294,000</u>	<u>\$ 1,030,433</u>

Amount Due Within One Year	\$ 520,000	\$ 45,571	\$ 565,571
Non-Current Portion	216,433	248,429	464,862
	<u>\$ 736,433</u>	<u>\$ 294,000</u>	<u>\$ 1,030,433</u>

7. COMMITMENTS AND CONTINGENCIES

Leases

The Lottery leases office space, warehouse facilities, and on-line and instant product equipment over periods extending through November 2012. Rent expense for the years ended June 30, 2006 and 2005 totaled \$924,109, respectively. Certain leases contain a bargain purchase option and are accounted for as capital leases.

**Maryland State Lottery Agency
Notes to the Financial Statements**

7. COMMITMENTS AND CONTINGENCIES-- (continued)

Leases – (continued)

The assets acquired under capital leases include:

	<u>June 30, 2006</u>	<u>June 30, 2005</u>
Machinery and Equipment	\$ 2,002,139	\$ 3,377,891
Accumulated amortization	<u>(1,027,595)</u>	<u>(1,999,540)</u>
	<u>\$ 974,544</u>	<u>\$ 1,378,351</u>

The following is a schedule of future minimum lease payments under these leases:

<u>Year Ending June 30:</u>	<u>Operating Leases</u>	<u>Capital Leases</u>
2007	\$ 924,109	\$ 439,639
2008	924,109	439,434
2009	924,109	439,223
2010	924,109	-
2011	924,109	-
2012 - 2013	1,309,153	-
Total	\$ 5,929,698	1,318,296
Less amount representing interest		62,583
Present value of minimum lease payments		1,255,713
Less current maturities		439,639
Long-term portion of capital lease obligations		<u>\$ 816,074</u>

Liability activity for capital leases was as follows for the years ended June 30,:

	<u>2006</u>	<u>2005</u>
Beginning Balance	\$ 1,672,615	\$ 3,131,566
Acquisitions	-	-
Payments	<u>(416,902)</u>	<u>(1,458,951)</u>
Ending Balance	<u>\$ 1,255,713</u>	<u>\$ 1,672,615</u>

Contracts

As of June 30, 2006, the Lottery has entered into various contracts totaling approximately \$125,817,000 for services to be rendered. These services relate principally to the operation of, and advertising for, the Lottery's games.

Maryland State Lottery Agency Notes to the Financial Statements

8. PARTICIPATION IN MULTI-STATE GAME MEGA MILLIONS

The Lottery is a member of the multi-state game Mega Millions. Mega Millions is a lottery game conducted as a cooperative venture by twelve states: Georgia, Illinois, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, Washington, California and Maryland. The Mega Millions states have agreed to a common set of game rules and share a common prize pool. The prize pool is shared on a percent of sales basis. Game accounting is conducted after each semi-weekly drawing. Settlements between the states occur immediately for jackpot winners; annually for all other prizes, unless a state's settlement amount exceeds \$1,500,000; annually for unclaimed non-jackpot prizes; and immediately for unclaimed jackpot prizes.

9. RETIREMENT BENEFITS

The Lottery and its employees contribute to the State Retirement and Pension System (the System). The System is an agent multiple-employer public employee retirement system established by the State to provide retirement allowances and other benefits for State employees and employees of participating entities within the State. The Lottery accounts for the plan as a cost sharing multiple-employer public employee retirement system because a separate valuation is not performed for the Lottery. The Lottery's only obligation to the System is its required annual contribution. The System is administered by a Board of Trustees in accordance with State Personnel and the Pension Article of the Annotated Code of Maryland. The System prepares a separately audited CAFR, which can be obtained from the State Retirement and Pension System of Maryland, 120 East Baltimore Street, Baltimore, Maryland 21202.

Plan Descriptions

Lottery employees are members of the Employees' Retirement and Pension Systems (two of several systems managed by the System's Board of Trustees). The Employees' Retirement System (the Retirement Plan) includes those employees hired prior to January 1, 1980 and who have not elected to transfer to the Employees' Pension System (the Pension Plan). Conversely, members of the Pension Plan include those employees hired after January 1, 1980 and prior employees who have elected to transfer from the Retirement Plan.

The Retirement Plan provides retirement, death and disability benefits to its members. Members of the Retirement Plan are generally eligible for full retirement benefits upon the earlier of attaining age 60 or accumulating 30 years of eligible service regardless of age. The annual retirement allowance equals 1/55 (1.8%) of the member's highest three year's average final salary (AFS) multiplied by the number of years of accumulated creditable service. A member may retire with reduced benefits after completing 25 years of eligible service. Benefits are reduced by .5% per month for each month remaining until the retiree

**Maryland State Lottery Agency
Notes to the Financial Statements**

9. RETIREMENT BENEFITS – (continued)

either attains age 60 or would have accumulated 30 years of eligible service, whichever is less. The maximum reduction for a member is 30%. Any member who terminates employment before attaining retirement age but after accumulating five years of eligible service is eligible for a vested retirement allowance.

The Pension Plan provides retirement, death and disability benefits to its members. Members of the Pension Plan are generally eligible for full retirement benefits upon the earlier of attaining age 62, with specified years of eligibility service, or accumulating 30 years of eligibility service regardless of age. Generally, the annual pension allowance for a member equals 1.2% of the member’s AFS, multiplied by the number of years creditable service accumulated prior to July 1, 1998, plus 1.4% of the member’s AFS, multiplied by the number of years of creditable service accumulated subsequent to June 30, 1998. A member may retire with reduced benefits upon attaining age 55 with at least 15 years of eligible service. Benefits are reduced by .5% per month for each month remaining until the retiree attains age 62. The maximum reduction for a member is 42%. Any member who terminates employment before attaining retirement age but after accumulating five years of eligible service is eligible for a vested retirement allowance.

Funding Policy

Active members and the employers of the members are required to contribute to the Employees’ Retirement and Pension Systems. The Lottery’s required contribution is established by annual actuarial valuations using the entry age normal cost method with projection and other actuarial assumptions adopted by the Board of Trustees. Members of the Employees’ Retirement System are required to contribute 5% or 7% of earnable compensation depending upon the retirement option selected. Members of the Employee’s Pension System are required to contribute 2% of earnable compensation.

The Lottery contributions, which equal 100% of the required contributions, for the three years ended June 30, 2006, 2005, and 2004 are as follows:

	2006	2005	2004
Lottery contribution	<u>\$459,000</u>	<u>\$360,000</u>	<u>\$359,000</u>
Percentage of payroll	4.34%	3.40%	3.49%

Maryland State Lottery Agency Notes to the Financial Statements

9. RETIREMENT BENEFITS – (continued)

Post-Employment Benefits

Members of the retirement systems and their dependents are provided post employment health care benefits. The State of Maryland subsidizes approximately 50% to 85% of covered medical and hospitalization costs, depending on the type of insurance plan. The State assesses a surcharge for post employment health care benefits, which is based on health care insurance charges for current employees. Costs for post retirement benefits are for State of Maryland retirees. The State does not distinguish employees by employer/State agency. Instead, the State allocates the post employment health care costs to all participating employers. The Lottery's share of these costs for years ended June 30, 2006, 2005, and 2004 was approximately \$425,000, \$332,000, and \$306,000, respectively. The cost of these benefits is expensed when paid.

10. RISK MANAGEMENT

The Lottery is exposed to various risks associated with the theft, damage, or destruction of assets, torts, and game liability. To manage the related risks, the Lottery participates in the State's insurance program, which provides general liability, personal & casualty and workers' compensation insurance. The program requires all agencies to submit premiums based upon proportionate payroll costs and/or claim history. This insurance covers related losses up to a maximum of \$1,000,000 per event. Settlements have not exceeded coverage for any of the past three fiscal years. The activity related to accrued workers' compensation costs is included in the schedule exhibited in Note 6.

To minimize risks associated with game liabilities, the Lottery has established aggregate payout limits for each game type. This approach discontinues sales of the daily numbers games once the potential liability limit is reached for a specific player selection. A maximum payout limit is established for those games with a first tier prize, which requires multiple first tier winners to split the related prize.

Maryland State Lottery Agency Supplementary Information

Schedule of Revenues, Expenses, and Changes in Net Assets - Budget and Actual

For the Year Ended June 30, 2006				
	Original Budget	Final Amended Budget	Actual Amounts	Variance with Budget positive (negative)
Revenues				
Ticket Sales	\$ 1,468,518,892	\$ 1,495,939,216	\$ 1,558,029,375	\$ 62,090,159
Expenses				
Gaming vendor and information technology fees	15,235,146	16,178,452	15,638,781	(539,671)
Instant ticket printing and delivery	5,951,130	6,489,202	6,114,759	(374,443)
Salaries, wages and benefits	10,925,461	10,925,461	11,330,655	405,194
Advertising and promotions	17,284,932	16,460,621	15,859,308	(601,313)
Other general and administrative expenses	4,938,530	5,308,496	5,253,357	(55,139)
Reversions	-	(12,481)	-	12,481
Total Expenses and Encumbrances	<u>54,335,199</u>	<u>55,349,751</u>	<u>54,196,860</u>	<u>(1,152,891)</u>
Excess of Revenues over Expenses	1,414,183,693	1,440,589,465	1,503,832,515	63,243,050
Other Uses of Financial Resources				
Transfers out				
Payments to Maryland Stadium Authority	(20,500,000)	(20,500,000)	(20,500,000)	-
Payments to the Maryland General Fund	(463,850,000)	(463,850,000)	(480,470,617)	(16,620,617)
Excess of Revenues over Expenses and Other Uses of Financial Resources	<u>\$ 929,833,693</u>	<u>\$ 956,239,465</u>	<u>\$ 1,002,861,898</u>	<u>\$ 46,622,433</u>
Reconciliation of Differences between Budgetary Inflows and Outflows and GAAP Revenues and Expenses				
Change in Net Assets (page 39)	\$ (18,333,412)			
Non-Budgetary Expenses				
Prize expense	904,077,713			
Retailer commissions	102,704,705			
Depreciation and amortization	560,257			
Bad debt recoveries	(5,893)			
Accounting Principle Differences				
Accounts receivable	(2,113,648)			
Unearned revenue	(762,761)			
Increase in fair value of investments	1,437,548			
Amortization of discount of prize liabilities	15,536,326			
Compensated absences	67,632			
Workers' compensation	4,000			
Instant ticket inventory	85,205			
Capital lease payments and related interest	(395,774)			
Excess of Revenues over Expenses and Other Uses of Financial Resources	<u>\$ 1,002,861,898</u>			

Maryland State Lottery Agency Notes to Supplementary Information

1. BUDGETING AND BUDGETARY CONTROL

The Maryland Constitution requires the Governor to submit to the General Assembly an annual balanced budget for the following fiscal year. Each year the Lottery prepares its annual budget and submits it to the Governor. The Governor then presents the State's annual budget (including the Lottery's) to the General Assembly in accordance with Constitutional requirements. The General Assembly is required to then enact a balanced budget.

The Maryland Lottery's official budget, as adopted by the Legislature, is based upon accounting for certain transactions on the basis of cash receipts and disbursements. Encumbrance accounting, under which purchase orders, contracts and other commitments for expenditures are recorded as expenditures when the purchase commitment is made, is employed for budgetary purposes. Unliquidated encumbrances are canceled at year-end if it is determined the funds will not be utilized in the future. Unencumbered appropriations lapse at the end of the fiscal year for which they were appropriated. The major difference between the budget basis and the Generally Accepted Accounting Principle (GAAP) basis of accounting are:

- Lottery player prize payments are not budgeted;
- Lottery retailer commissions are not budgeted;
- Revenues are recorded when received in cash (budget) as opposed to when earned (GAAP);
- Expenses (including deferred prizes) are recorded when paid or encumbered (budget) as opposed to when the liability is incurred (GAAP);
- The budget basis excludes depreciation and amortization.

The Maryland Lottery maintains budgetary control by not permitting the total expenditures to exceed appropriations without executive and legislative branch approval.



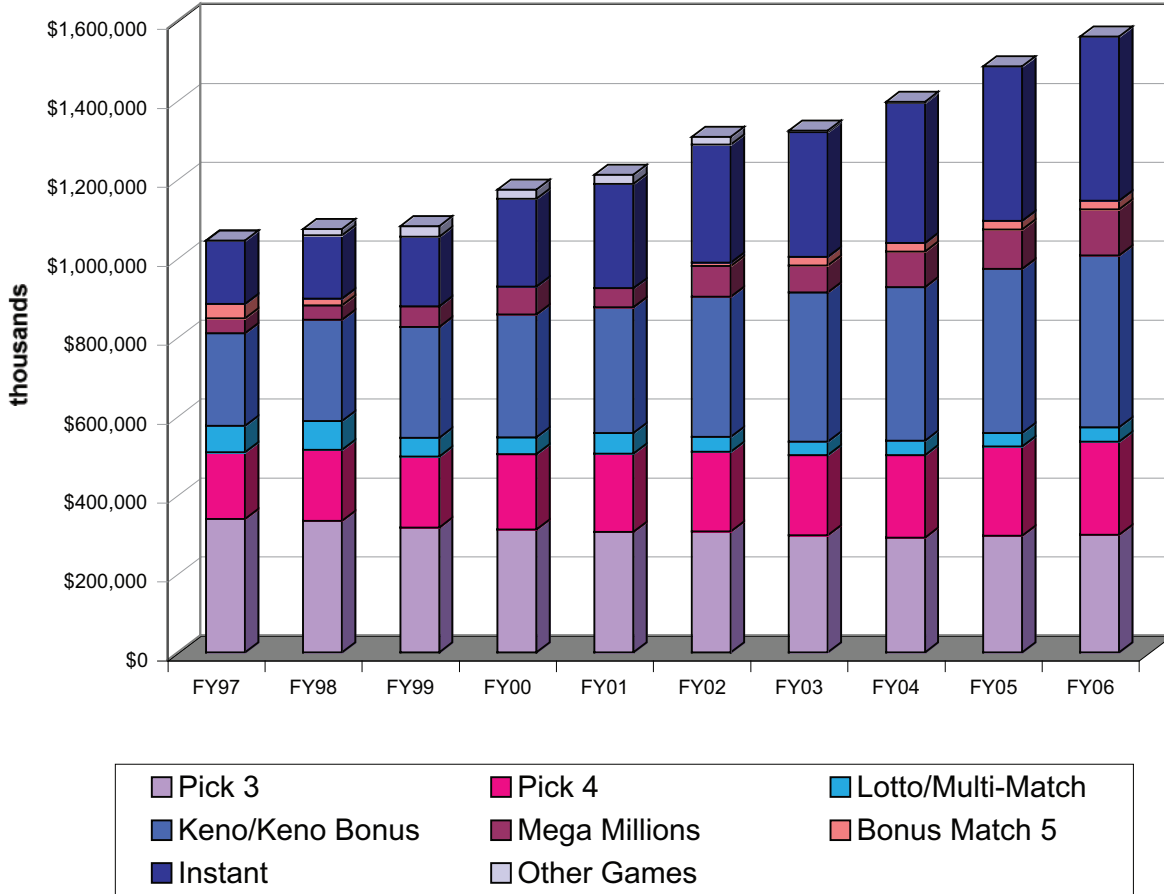
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Statistical Section

Maryland State Lottery Agency Sales - Fiscal Years 1997 through 2006

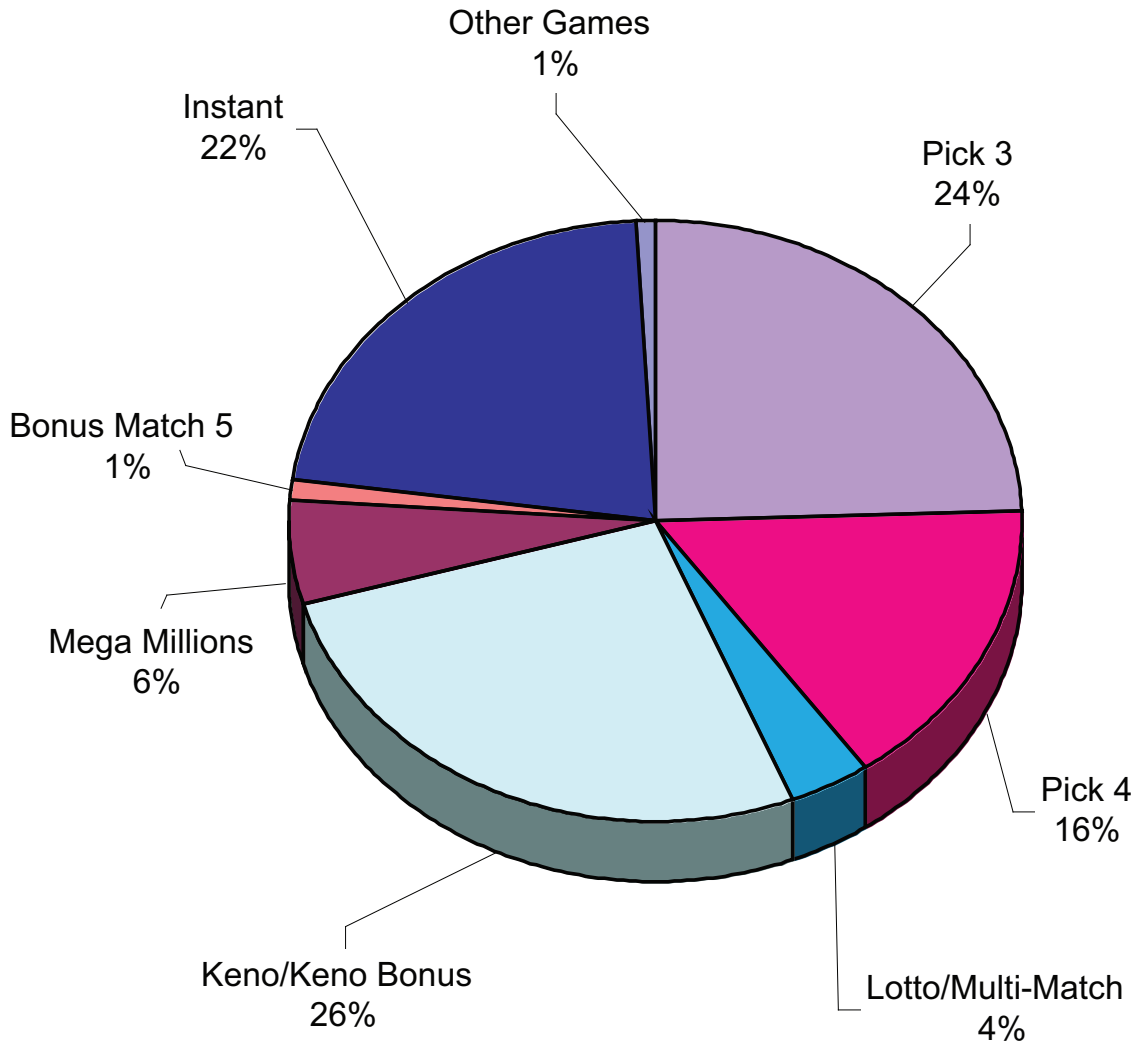
	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Pick 3	\$ 338,820,974	\$ 333,849,331	\$ 316,355,532	\$ 311,568,072	\$ 305,371,869	\$ 306,873,311	\$ 296,702,479	\$ 290,754,971	\$ 296,102,946	\$ 298,075,249
Pick 4	168,483,511	179,707,750	179,651,362	190,522,702	198,641,156	201,432,264	203,675,530	209,213,634	225,452,551	236,503,472
Lotto/Multi-Match	67,638,687	73,384,988	48,239,861	43,270,217	51,872,278	37,660,036	34,178,932	36,179,993	34,086,337	35,792,433
Keno/Keno Bonus	234,298,401	256,127,590	280,341,804	311,045,071	319,452,467	355,711,608	377,419,953	389,796,257	416,513,577	436,259,474
Mega Millions	38,131,394	36,057,236	52,410,091	71,020,464	47,568,280	77,912,406	69,153,072	90,312,228	99,737,552	116,249,659
Bonus Match 5	36,099,084	17,855,879	-	-	-	8,286,718	21,250,620	21,235,924	21,916,265	22,425,338
Instant	160,111,133	160,358,292	176,991,465	221,875,654	264,111,034	299,203,861	316,657,091	355,016,755	390,988,694	415,331,827
Other Games	-	15,290,997	26,038,795	23,579,918	23,599,146	19,478,293	3,201,875	2,898,696	944,928	268,332
Total Sales	\$ 1,043,583,184	\$ 1,072,632,063	\$ 1,080,028,910	\$ 1,172,882,098	\$ 1,210,616,230	\$ 1,306,538,497	\$ 1,322,239,552	\$ 1,395,408,458	\$ 1,485,732,850	\$ 1,560,905,784

**Maryland State Lottery Agency
Sales - Fiscal Years 1997 through 2006 - (continued)**



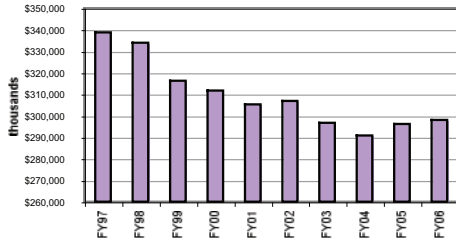
Maryland State Lottery Agency
Sales - Fiscal Years 1997 through 2006 - (continued)

Total Sales \$12,650,567,626



Maryland State Lottery Agency Sales - Fiscal Years 1997 through 2006 - (continued)

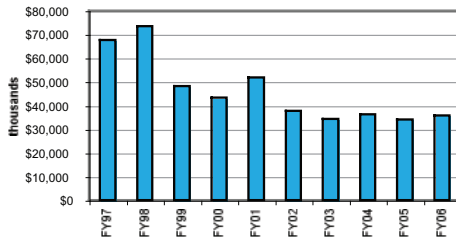
Pick 3



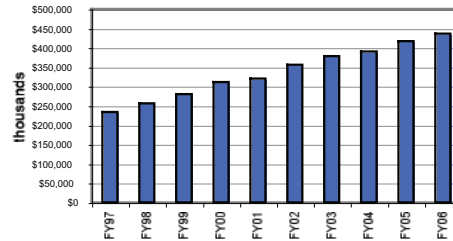
Pick 4



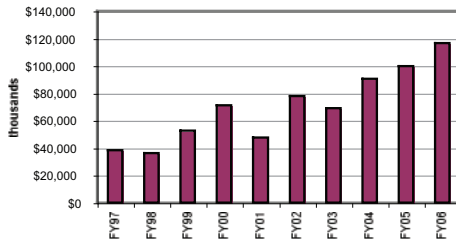
Lotto & Multi-Match



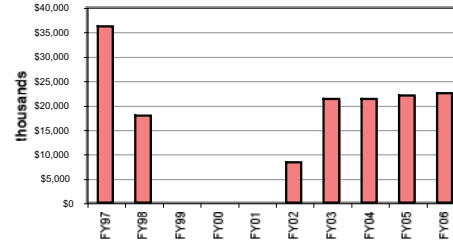
Keno/Keno Bonus



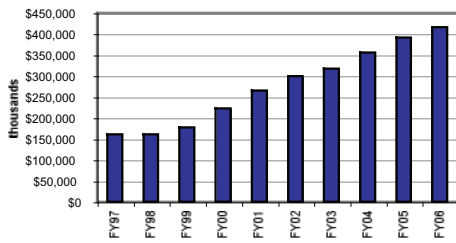
Mega Millions



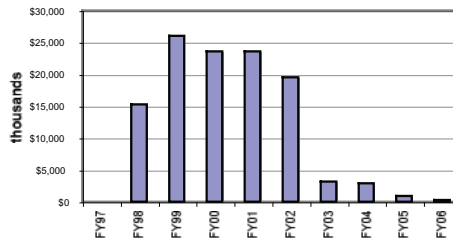
Bonus Match 5



Instant



Other Games



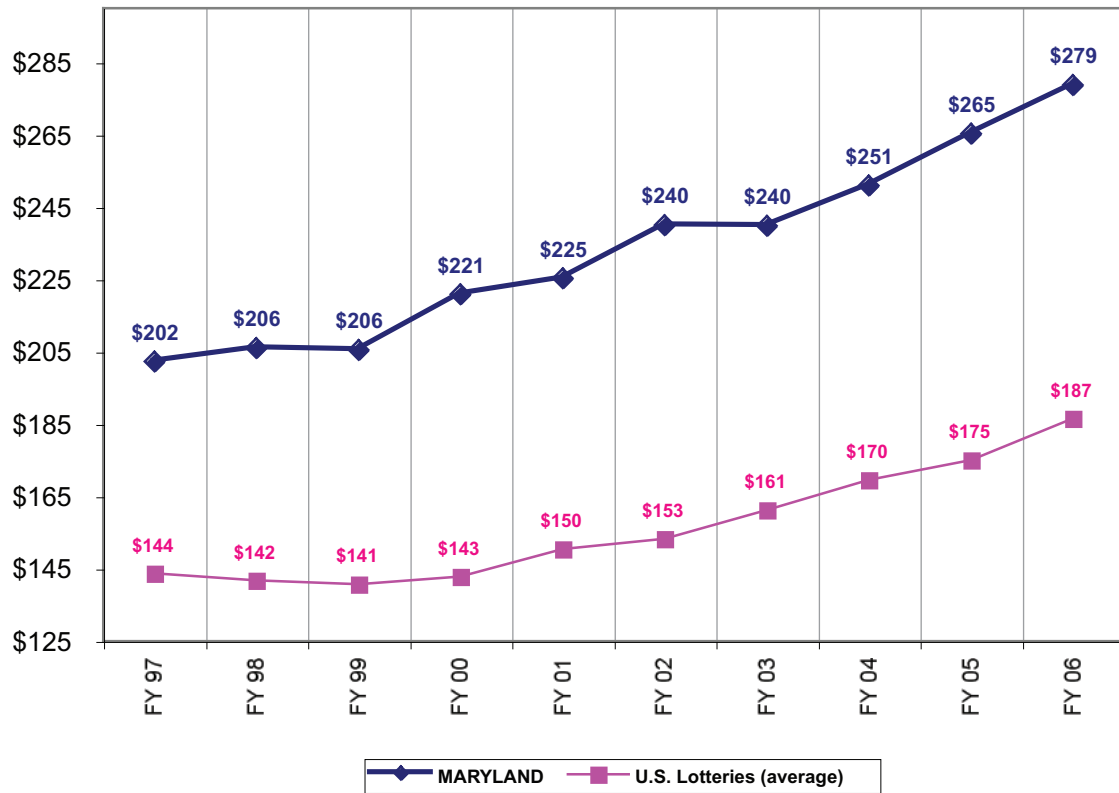
Maryland State Lottery Agency
U.S. Lotteries Per Capita Sales - Fiscal Year 2006

RANK	STATE	POPULATION (M)	TOTAL SALES (\$M)	PER CAPITA
1	Massachusetts	6.4	\$4,510.3	\$704.7
2	District of Columbia	0.6	258.6	431.0
3	Georgia	9.1	3,177.6	349.2
4	New York	19.3	6,487.1	336.1
5	Maryland	5.6	1,560.9	278.7
6	Connecticut	3.5	970.3	277.2
7	New Jersey	8.7	2,406.6	276.6
8	South Carolina	4.3	1,144.6	266.2
9	Pennsylvania	12.4	3,068.2	247.4
10	Rhode Island	1.1	261.3	237.5
11	Florida	17.8	4,030.1	226.4
12	Michigan	10.1	2,207.0	218.5
13	New Hampshire	1.3	262.3	201.8
14	Ohio	11.5	2,219.8	193.0
15	Virginia	7.6	1,365.3	179.6
16	Kentucky	4.2	742.3	176.7
17	Maine	1.3	229.7	176.7
18	Vermont	0.6	105.3	175.5
19	Texas	22.5	3,799.6	168.9
20	Tennessee	6.0	996.3	166.1
21	Missouri	5.8	915.7	157.9
22	Delaware	0.8	124.5	155.6
23	Illinois	12.8	1,989.2	155.4
24	Indiana	6.3	817.5	129.8
25	West Virginia	1.8	218.1	121.2
26	Oregon	3.6	363.2	100.9
27	Colorado	4.7	468.8	99.7
28	California	36.1	3,585.0	99.3
29	Idaho	1.4	131.3	93.8
30	Wisconsin	5.5	508.9	92.5
31	Kansas	2.7	243.9	90.3
32	Minnesota	5.1	449.7	88.2
33	New Mexico	1.9	154.7	81.4
34	Arizona	5.9	468.7	79.4
35	Washington	6.3	477.9	75.9
36	Louisiana	4.5	332.1	73.8
37	Nebraska	1.8	112.7	62.6
38	Oklahoma	3.5	207.3	59.2
39	South Dakota	0.8	39.2	49.0
40	Montana	0.9	39.9	44.3
41	North Dakota	0.6	22.4	37.3
42	North Carolina	8.7	225.8	26.0
43	Iowa			*
	TOTAL	275.4	\$51,699.7	\$187.7

* Information not available

Source: *La Fleur's Magazine* - Fiscal 2006 Report

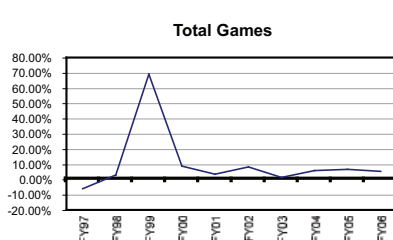
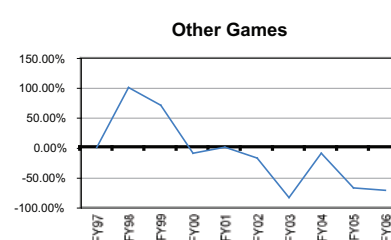
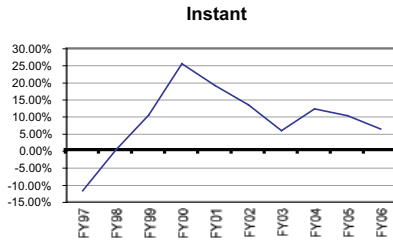
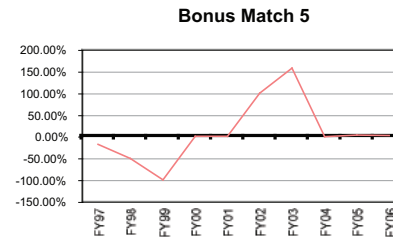
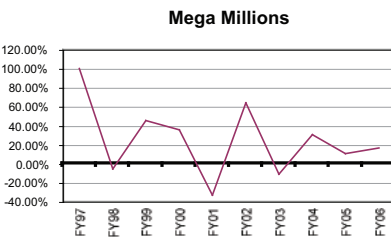
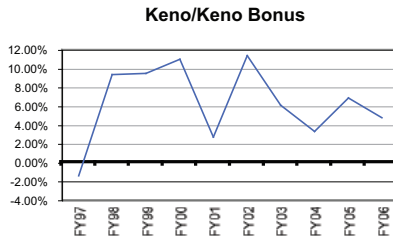
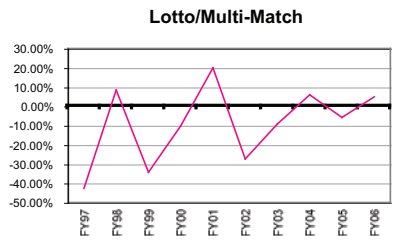
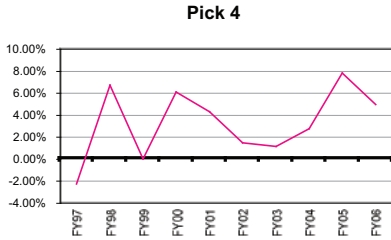
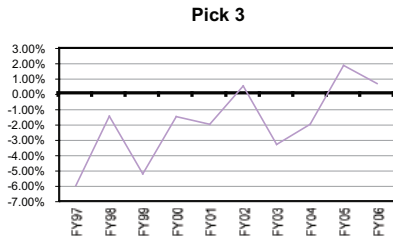
Maryland State Lottery Agency U.S. Lotteries Per Capita Sales - Fiscal Years 1997 through 2006



Sources: *LaFleur's 2005 Almanac*, *LaFleur's Magazine* - Fiscal 2006 Report, U.S. Census Bureau

Maryland State Lottery Agency Percentage Change in Sales - Fiscal Years 1997 through 2006

	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Pick 3	-5.99%	-1.47%	-5.24%	-1.51%	-1.99%	0.49%	-3.31%	-2.00%	1.84%	0.67%
Pick 4	-2.31%	6.66%	-0.03%	6.05%	4.26%	1.41%	1.11%	2.72%	7.76%	4.90%
Lotto/Multi-Match	-42.72%	8.50%	-34.26%	-10.30%	19.88%	-27.40%	-9.24%	5.85%	-5.76%	4.97%
Keno/Keno Bonus	-1.43%	9.32%	9.45%	10.95%	2.70%	11.35%	6.10%	3.28%	6.85%	4.74%
Mega Millions	100.00%	-5.44%	45.35%	35.51%	-33.02%	63.79%	-11.24%	30.60%	10.44%	16.56%
Bonus Match 5	-18.19%	-50.54%	-100.00%	0.00%	0.00%	100.00%	157.05%	-0.07%	3.20%	2.32%
Instant	-11.84%	0.15%	10.37%	25.36%	19.04%	13.29%	5.83%	12.11%	10.13%	6.23%
Other Games	0.00%	100.00%	70.29%	-9.44%	0.08%	-17.46%	-83.56%	-9.47%	-67.40%	-71.60%
Total Sales	-6.36%	2.78%	0.69%	8.60%	3.22%	7.92%	1.20%	5.53%	6.47%	5.06%



Maryland State Lottery Agency
U.S. Lotteries Percentage Change in Sales - Fiscal Year 2006

RANK	STATE	TOTAL SALES (\$M)	% CHANGE
1	South Carolina	\$ 1,144.6	20%
2	South Dakota	39.2	19%
3	Pennsylvania	3,068.2	19%
4	Montana	39.9	18%
5	Tennessee	996.3	18%
6	Arizona	468.7	18%
7	North Dakota	22.4	17%
8	Missouri	915.7	16%
9	Idaho	131.3	16%
10	New Hampshire	262.3	15%
11	Florida	4,030.1	14%
12	Vermont	105.3	14%
13	Kansas	243.9	13%
14	Wisconsin	508.9	13%
15	Nebraska	112.7	13%
16	Colorado	468.8	12%
17	West Virginia	218.1	12%
18	New Mexico	154.7	11%
19	Indiana	817.5	11%
20	Minnesota	449.7	10%
21	District of Columbia	258.6	10%
22	Maine	229.7	10%
23	Delaware	124.5	9%
24	Georgia	3,177.6	9%
25	Louisiana	332.1	8%
26	Illinois	1,989.2	8%
27	Rhode Island	261.3	8%
28	California	3,585.0	8%
29	New York	6,487.1	7%
30	Michigan	2,207.0	7%
31	New Jersey	2,406.6	6%
32	Maryland	1,560.9	5%
33	Kentucky	742.3	5%
34	Washington	477.9	4%
35	Connecticut	970.3	4%
36	Texas	3,799.6	4%
37	Ohio	2,219.8	3%
38	Virginia	1,365.3	2%
39	Massachusetts	4,510.3	1%
40	Oregon	363.2	1%
41	North Carolina	225.8	*
42	Oklahoma	207.3	*
43	Iowa		**
TOTAL		\$ 51,699.7	

* North Carolina and Oklahoma began selling lottery tickets in fiscal year 2006.

** Information not available

Source: *La Fleur's Magazine* - Fiscal 2006 Report

Maryland State Lottery Agency

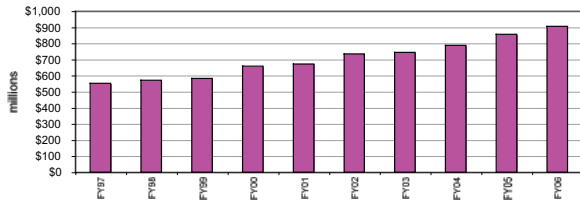
Expenses and Contributions - Fiscal Years 1997 through 2006

	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Expenses										
Prizes	\$ 551,706,866	\$ 571,137,201	\$ 582,192,056	\$ 656,720,362	\$ 671,196,364	\$ 733,196,055	\$ 743,416,525	\$ 786,801,576	\$ 856,231,700	\$ 904,077,713
Retailer Commissions	57,090,844	60,198,072	61,761,763	68,625,960	76,943,536	85,362,915	87,118,213	91,298,325	97,592,346	102,704,705
Administration	41,692,201	41,253,902	44,429,984	40,668,408	49,303,896	49,142,651	53,516,424	51,561,570	51,360,638	54,468,221
Total Expenses	\$ 650,489,911	\$ 672,589,175	\$ 688,383,803	\$ 766,014,730	\$ 797,443,796	\$ 867,701,621	\$ 884,051,162	\$ 929,661,471	\$ 1,005,184,684	\$ 1,061,250,639

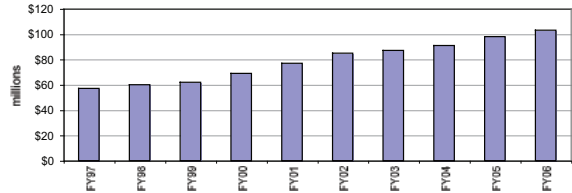
Note: Non-operating expenses are not included.

	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06
Contributions										
Maryland Stadium Authority	\$ 32,818,186	\$ 31,624,700	\$ 31,075,700	\$ 23,250,000	\$ 22,000,000	\$ 27,230,000	\$ 21,949,000	\$ 22,000,000	\$ 21,235,000	\$ 20,500,000
State of Maryland - General Fund	359,835,133	368,501,368	362,145,145	377,763,020	385,044,747	416,274,348	422,947,934	436,373,006	455,863,363	480,470,617
Total Contributions	\$ 392,653,319	\$ 400,126,068	\$ 393,220,845	\$ 401,013,020	\$ 407,044,747	\$ 443,504,348	\$ 444,896,934	\$ 458,373,006	\$ 477,098,363	\$ 500,970,617

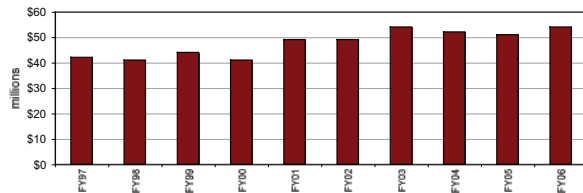
Prizes



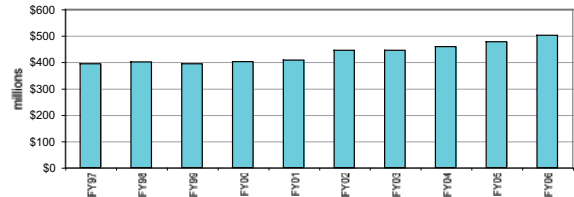
Retailer Commissions



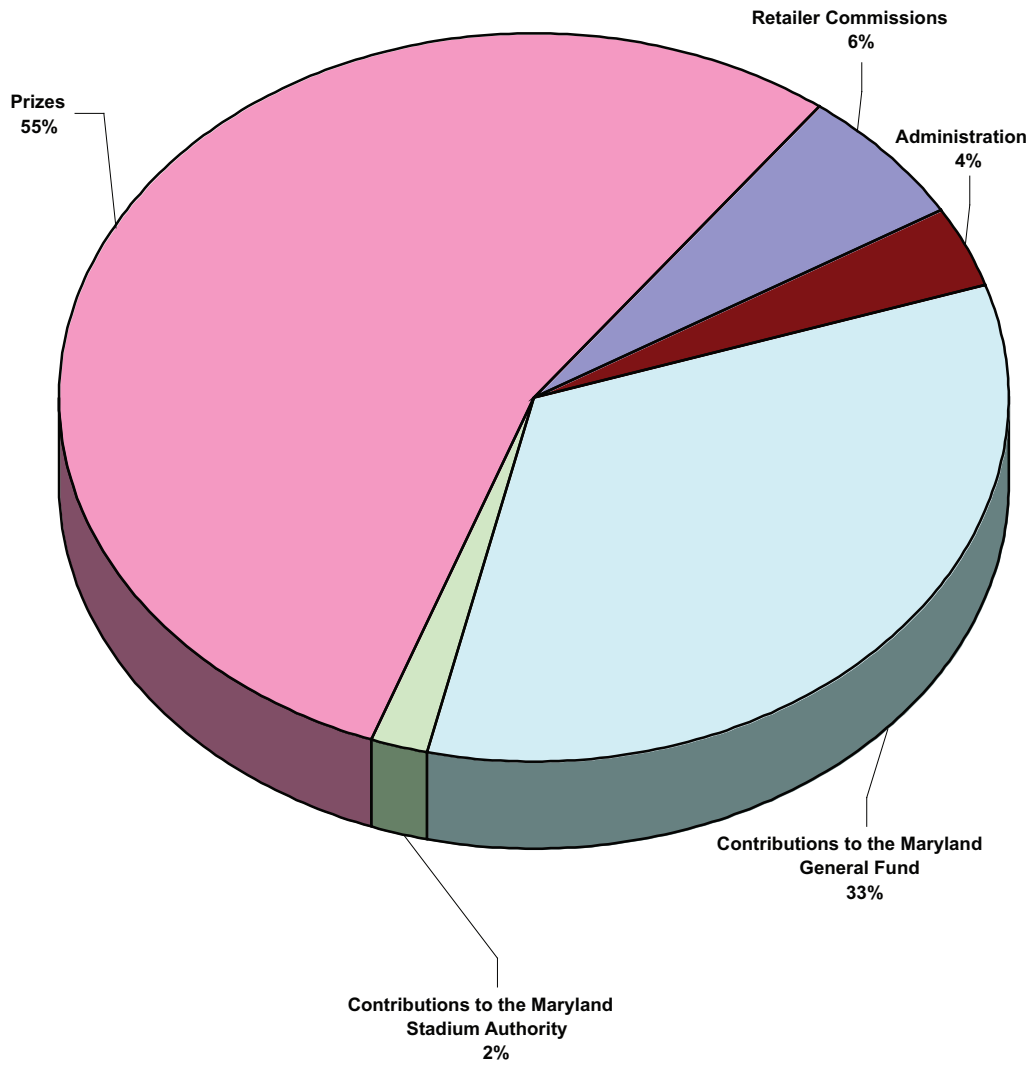
Administration



Contributions to the State of Maryland



**Maryland State Lottery Agency
Expenses and Contributions - Fiscal Years 1997 through 2006 -
(continued)**



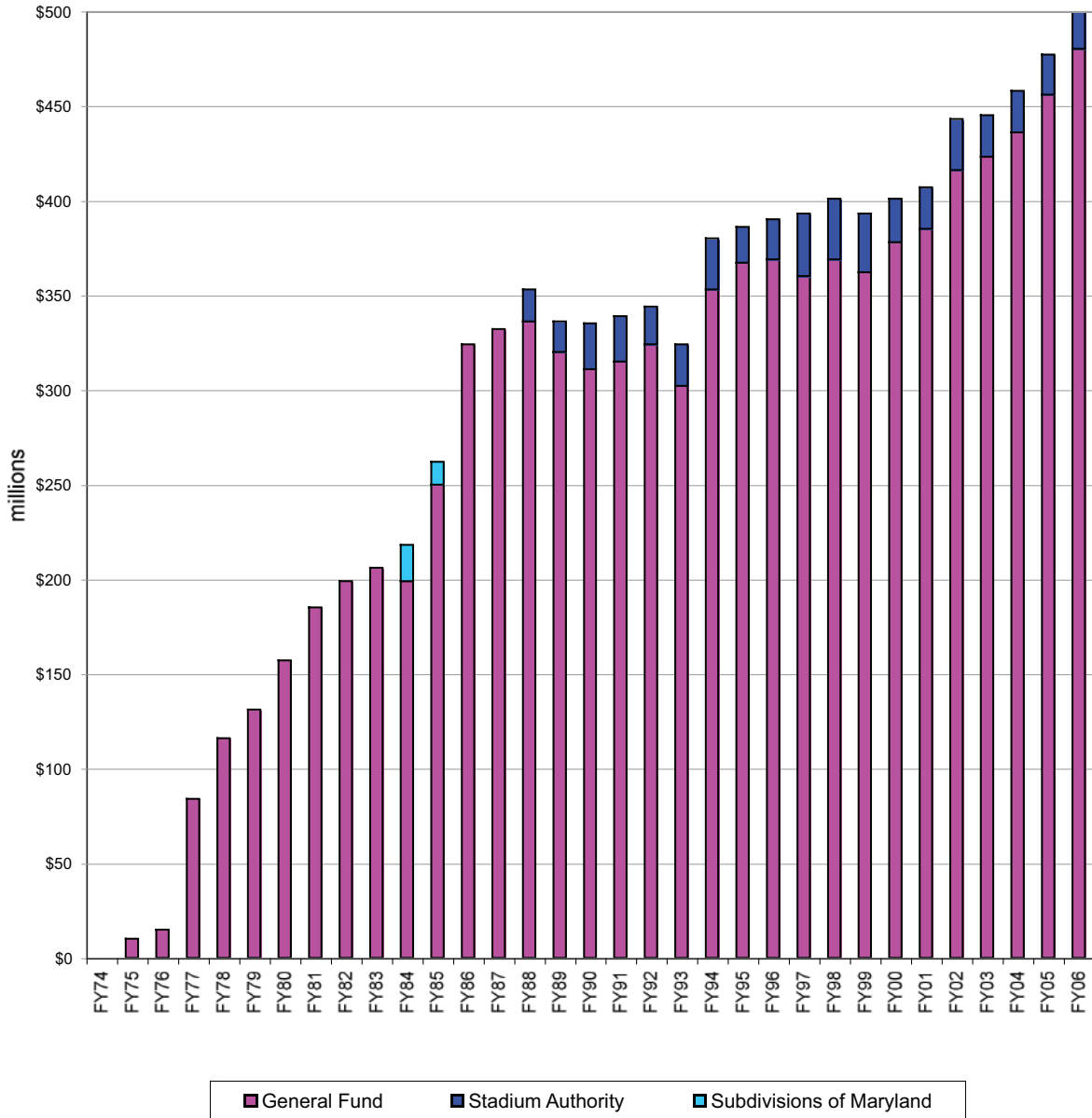
**Maryland State Lottery Agency
Contributions to the State of Maryland - Inception to Date**

FISCAL YEAR	THE STATE OF MARYLAND GENERAL FUND	THE MARYLAND STADIUM AUTHORITY	SUBDIVISIONS OF MARYLAND
1974	\$ -	\$ -	\$ -
1975	10,025,000*	-	-
1976	15,374,000	-	-
1977	83,928,000	-	-
1978	116,182,000	-	-
1979	131,271,000	-	-
1980	156,768,000	-	-
1981	185,224,000	-	-
1982	199,080,000	-	-
1983	206,236,000	-	-
1984	199,194,000	-	19,095,000
1985	250,123,000	-	12,158,000
1986	323,423,000	-	-
1987	332,366,000	-	-
1988	335,928,000	16,750,000	-
1989	319,605,000	16,221,000	-
1990	311,254,000	24,040,000	-
1991	315,247,000	24,004,000	-
1992	323,814,000	19,752,000	-
1993	301,563,000	21,612,000	-
1994	353,308,000	26,743,000	-
1995	366,577,000	19,077,000	-
1996	369,161,000	20,749,000	-
1997	359,835,000	32,818,000	-
1998	368,501,000	31,625,000	-
1999	362,145,000	31,076,000	-
2000	377,763,000	23,250,000	-
2001	385,045,000	22,000,000	-
2002	416,274,000	27,230,000	-
2003	422,948,000	21,949,000	-
2004	436,373,000	22,000,000	-
2005	455,863,000	21,235,000	-
2006	480,471,000	20,500,000	-
Total	\$9,270,869,000	\$442,631,000	\$31,253,000
TOTAL LIFETIME CONTRIBUTIONS			\$9,744,753,000

* Revenues generated from the inception of the Lottery were not transferred to the State of Maryland until fiscal year 1975.

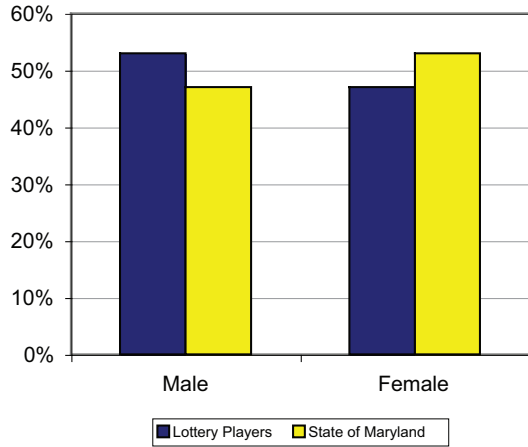
**Maryland State Lottery Agency
Contributions to the State of Maryland - Inception to Date - (continued)**

Total Lifetime Contributions \$9,744,753,000

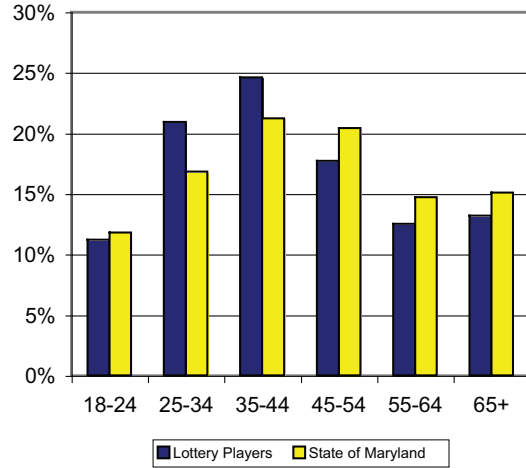


Maryland State Lottery Agency Demographics

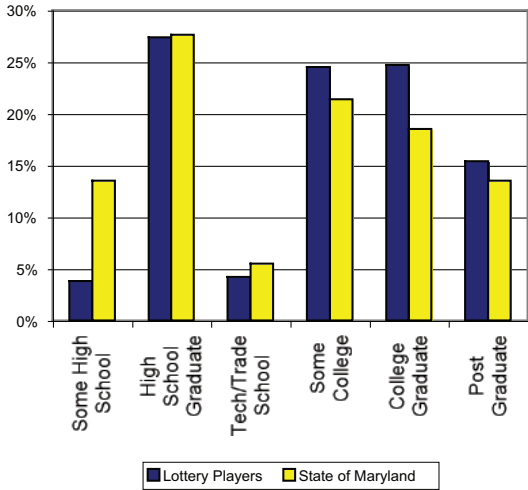
Gender



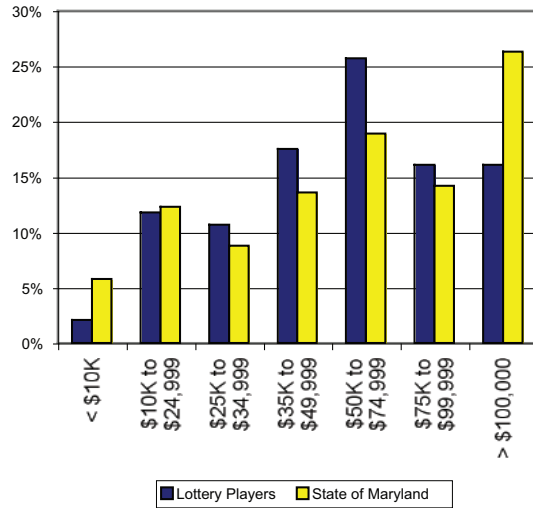
Age



Education



Household Income



Sources: Ipsos-Reid March 2006, U.S. Census Bureau: American Community Survey 2005

Maryland State Lottery Agency Operations

Number of Employees - as of June 30, 2006

<u>Department</u>	<u>Full-time Equivalents</u>
Agent Administration	6
Communications	19
Customer Service	13
Executive	5
Facilities	5
Finance, Budget and Procurement	16
Information Technology	24
Instant Ticket Warehouse	7
Legal Services	6
Personnel	4
Product Development and Creative Services	9
Sales	60
Security	5
Total	<u><u>179</u></u>

Percentage of Administrative Expenses to Sales - Fiscal Years 1997 through 2006

<u>Fiscal Year</u>	<u>Sales</u>	<u>Administration</u>	<u>Percentage of Administrative Expenses to Sales</u>
1997	\$1,043,583,184	\$41,692,201	4.00%
1998	1,072,632,063	41,253,902	3.85%
1999	1,080,028,910	44,429,984	4.11%
2000	1,172,882,098	40,668,408	3.47%
2001	1,210,616,230	49,303,896	4.07%
2002	1,306,538,497	49,142,651	3.76%
2003	1,322,239,552	53,516,424	4.05%
2004	1,395,408,458	51,561,570	3.70%
2005	1,485,732,850	51,360,638	3.46%
2006	1,560,905,784	54,468,221	3.49%



Maryland State Lottery Agency

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