

**STATE LOTTERY DEPARTMENT
RICHMOND, VIRGINIA**

**REPORT ON AUDIT
FOR THE YEARS ENDED
JUNE 30, 1999 AND JUNE 30, 2000**

***AUDITOR OF
PUBLIC
ACCOUNTS***



COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the State Lottery Department for the years ended June 30, 2000 and 1999, found:

- the financial statements are presented fairly, in all material respects;
- no internal control matters that we consider material weaknesses; and
- no instances of noncompliance required to be reported under Government Auditing Standards.

- TABLE OF CONTENTS -

	<u>Pages</u>
AUDIT SUMMARY	
INDEPENDENT AUDITOR’S REPORT:	
Report on Financial Statements	1
Report on Compliance and on Internal Control Over Financial Reporting	2
FINANCIAL STATEMENTS:	
Balance Sheet	4
Statement of Revenues, Expenses and Changes in Retaining Earnings	5
Statement of Cash Flows	6
Notes to Financial Statements	8-13
AGENCY OFFICIALS	14

August 24, 2000

The Members of the Virginia State Lottery Board
900 East Main Street
Richmond, Virginia

We have audited the accounts and records of the **State Lottery Department** as of and for the years ended June 30, 2000 and 1999, and submit herewith our complete reports on financial statements and compliance and internal controls.

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the balance sheet of the State Lottery Department as of June 30, 2000 and 1999, and the related statement of revenues, expenses and changes in retained earnings, and the statement of cash flows for the years then ended. The financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Lottery Department as of June 30, 2000 and 1999, and the results of its operations and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON
INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit of the financial statements of the State Lottery Department as of and for the years ended June 30, 2000 and 1999, we considered internal controls over financial reporting and tested compliance with certain provisions of laws, regulations, and contracts in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in Governmental Auditing Standards.

Compliance

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal controls over financial reporting and its operation that we consider to be material weaknesses.

The "Independent Auditor's Report on Compliance and on Internal Control Over Financial Reporting" is intended solely for the information and use of the Governor and General Assembly of Virginia, the Virginia State Lottery Board and Lottery management, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

EXIT CONFERENCE

We discussed this report with management at an exit conference held on September 20, 2000.

AUDITOR OF PUBLIC ACCOUNTS

KKH:whb
whb:32

FINANCIAL STATEMENTS

STATE LOTTERY DEPARTMENT
BALANCE SHEET
As of June 30, 2000 and 1999

	2000	1999
ASSETS		
Current assets:		
Cash and cash equivalents (Note 2)	\$ 16,187,052	\$ 10,795,785
Cash held as collateral: (Note 2)		
Treasury securities lending	1,025,487	585,163
Accounts receivable	27,171,760	35,302,436
Due from the General Fund of the Commonwealth (Note 4)	58,113	-
Instant ticket inventory (Note 3)	2,364,598	1,811,494
Deferred expenses	1,909,785	2,533,212
Short-term investments (Note 2)	58,683,433	64,623,875
Total current assets	107,400,228	115,651,965
Investments (Note 2)	443,902,533	518,196,615
Fixed assets:		
Furniture, fixtures and equipment	49,082,018	48,185,365
Less: Accumulated depreciation	(39,068,831)	(36,415,931)
Net fixed assets	10,013,187	11,769,434
Total assets	\$ 561,315,948	\$ 645,618,014
LIABILITIES AND RETAINED EARNINGS		
Current liabilities:		
Accounts payable	\$ 10,152,052	\$ 9,332,923
Treasury loan (Note 8)	-	12,000,000
Due to the General Fund of the Commonwealth (Note 4)	-	782,671
Obligations under securities lending: (Note 2)		
Treasury	1,025,487	585,163
Prizes payable: (Note 5)		
Jackpot prizes payable	58,683,433	64,623,875
Other	43,825,020	36,742,834
Deferred revenue	2,172,836	2,004,099
Total current liabilities	115,858,828	126,071,565
Long-term liabilities:		
Jackpot prizes payable (Note 5)	443,902,533	518,196,615
Compensated absences (Note 7)	1,554,587	1,349,834
Total liabilities	561,315,948	645,618,014
Retained earnings	-	-
Total liabilities and retained earnings	\$ 561,315,948	\$ 645,618,014

The accompanying notes to financial statements are an integral part of this statement.

STATE LOTTERY DEPARTMENT
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN RETAINED EARNINGS
For the Years Ended June 30, 2000 and 1999

	2000	1999
Revenue:		
Ticket sales	\$ 972,971,875	\$ 934,521,236
Less:		
Prize expense	537,306,306	506,899,594
Retailer compensation	55,177,099	52,129,611
Instant ticket printing	4,827,512	3,677,388
Gross margin	375,660,958	371,814,643
Operating expenses:		
Advertising and promotion	17,457,216	21,494,987
General and administration	44,949,036	43,657,575
Total operating expenses	62,406,252	65,152,562
Income from operations	313,254,706	306,662,081
Non-operating revenue:		
Interest income	8,870,097	9,012,206
Other income	1,350,206	1,200,569
Total non-operating income	10,220,303	10,212,775
Net income	323,475,009	316,874,856
Transfer to the General Fund of the Commonwealth	(323,533,122)	(321,092,185)
Due from (to) the General Fund of the Commonwealth	58,113	(782,671)
Retained earnings at July 1	-	5,000,000
Retained earnings at June 30	\$ -	\$ -

The accompanying notes to financial statements are an integral part of this statement.

STATE LOTTERY DEPARTMENT
STATEMENT OF CASH FLOWS
For the Years Ended June 30, 2000 and 1999

	2000	1999
Cash flows from operating activities:		
Cash received from ticket sales	\$ 981,271,288	\$ 925,382,352
Cash payments for prizes	(648,496,061)	(561,068,418)
Discounts for retailer compensation	(55,177,099)	(52,129,611)
Cash payments to supplier of instant tickets	(5,380,616)	(4,471,747)
Cash payments to suppliers of other goods and services	(28,610,851)	(33,682,476)
Cash payments to employees for services	(17,058,840)	(16,840,220)
Cash payments to the Literary Fund for unclaimed prizes (Note 9)	(10,881,724)	(9,348,632)
Net cash provided by operating activities	215,666,097	247,841,248
Cash flows from noncapital financing activities:		
Proceeds from other income	1,350,206	1,200,569
Proceeds from (Repayment of) Treasury loan (Note 8)	(12,000,000)	12,000,000
Transfers to the General Fund of the Commonwealth	(324,315,793)	(321,967,043)
Net cash used by noncapital financing activities	(334,965,587)	(308,766,474)
Cash flows from capital financing activities:		
Acquisition of capital assets	(2,451,281)	(4,872,888)
Net cash used for capital financing activities	(2,451,281)	(4,872,888)
Cash flows from investing activities:		
Purchase of investment securities	(32,738,552)	(11,870,538)
Sale of investment securities	89,062,493	-
Proceeds from maturing securities	61,948,000	66,380,000
Interest proceeds from cash balances	8,870,097	9,012,206
Net cash provided by investing activities	127,142,038	63,521,668
Net (decrease) in cash and cash equivalents	5,391,267	(2,276,446)
Cash and cash equivalents at July 1	10,795,785	13,072,231
Cash and cash equivalents at June 30	\$ 16,187,052	\$ 10,795,785
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	\$ 313,254,706	\$ 306,662,081
Adjustments to reconcile operating income to net cash:		
Depreciation	4,207,528	4,956,594
Accreted interest on investment securities	(38,037,417)	(41,910,073)
Changes in assets and liabilities:		
(Increase) decrease in accounts receivable	8,130,676	(8,610,555)
(Increase) in instant ticket inventory	(553,104)	(794,359)
(Increase) decrease in deferred expenses	623,427	(2,180,210)
Increase in accounts payable	819,129	2,432,102
Increase in current prizes payable	1,141,744	1,258,870
Increase (decrease) in deferred revenue	168,737	(528,329)
Increase in accrued compensated absences	204,753	72,748
(Decrease) in noncurrent prizes payable	(74,294,082)	(13,517,621)
Net cash provided by operating activities	\$ 215,666,097	\$ 247,841,248

The accompanying notes to financial statements are an integral part of this statement.

NOTES TO FINANCIAL STATEMENTS

STATE LOTTERY DEPARTMENT

NOTES TO FINANCIAL STATEMENTS

AS OF JUNE 30, 2000 AND 1999

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The State Lottery Department (Virginia Lottery) was established by Chapter 531 of the 1987 Acts of Assembly and operates as an independent agency in accordance with the provisions of Chapter 40 of Title 58.1 of the Code of Virginia.

A separate report is prepared for the Commonwealth of Virginia which includes all agencies, boards, commissions, and authorities over which the Commonwealth exercises or has the ability to exercise oversight authority. The Virginia Lottery is an agency of the Commonwealth of Virginia and is included in the general purpose financial statements of the Commonwealth.

B. Basis of Accounting

The basis of accounting is an accrual basis where revenues are recognized when earned and expenses when incurred. Instant ticket revenue is recognized when tickets are sold to retailers. On-line ticket revenue is recognized as corresponding drawings are held.

C. Fund Accounting

The activities of the Virginia Lottery are accounted for in an enterprise fund, which is used to account for governmental operations that are financed and operated in a manner similar to private business enterprises. Enterprise fund accounting is used where the governing body has decided that periodic determination of revenues earned, expenses incurred, and net income is appropriate.

2. CASH AND CASH EQUIVALENTS AND INVESTMENTS

Cash and cash equivalents represent cash with the Treasurer of Virginia, deposits and overnight repurchase agreements. Cash with the Treasurer of Virginia is held pursuant to Section 2.1-177, et seq., Code of Virginia. These funds are held in pooled accounts and, accordingly, are not categorized as to credit risk as defined by Statement 3 of the Governmental Accounting Standards Board. Cash on deposit is held in demand deposit accounts maintained for prize payments and is covered by federal depository insurance with the balance in excess of this insurance collateralized in accordance with the Virginia Security for Public Deposits Act. Under that Act, banks holding public deposits in excess of the amounts insured by FDIC pledge collateral in the amount of 50 percent of deposits in excess of FDIC insurance coverage to a collateral pool held in the name of the State Treasury Board.

Investments (current and long-term) consist of U.S. Treasury STRIPS purchased to fund individual jackpot and "For Life" prizes. Investments are valued at cost plus accrued interest.

Market values are reported for informational purposes as it is management's intention to hold these securities to maturity.

Statutes authorize the investment of funds held by the Virginia Lottery in obligations of the Commonwealth, Federal Government, other states or political subdivisions thereof, the International Bank for Reconstruction and Development, the Asian Development Bank, and the African Development Bank. In addition, the Virginia Lottery may invest in prime quality commercial paper rated prime 1 by Moody's Investment Service or A-1 by Standard and Poor's Incorporated, overnight term or open repurchase agreements, and money market funds comprised of investments which are otherwise legal investments of the Virginia Lottery.

Cash on deposit, short-term investments, and investments are categorized below to give an indication of the level of credit risk assumed by the Virginia Lottery. Credit risk is the risk that the Virginia Lottery may not be able to obtain possession of its investment instruments or collateral at maturity. Risk category 1 includes investments which are insured or registered or for which the securities are held by the Virginia Lottery or its safekeeping agent in the Virginia Lottery's name. Risk category 2 includes uninsured or unregistered investments for which the securities are held by the broker's or dealer's trust department or safekeeping agent in the Virginia Lottery's name. There are no accounts or investments in this category. Risk category 3 includes uninsured or unregistered investments for which the securities are held by the broker or dealer, or by its trust department or safekeeping agent but not in the Virginia Lottery's name.

Securities Lending

As authorized by Section 2.1-328.6 of the Code of Virginia, the Virginia Lottery, through its master custodian, BankersTrust, New York, N.Y., N.A., lends securities to various security brokers and lenders on a temporary basis for a fee. Up to 100 percent of the securities may be available for loan. All security loan agreements are collateralized at loan inception at 102 percent of market value by cash or U.S. Government obligations and adjusted to market daily to cover market value fluctuations; therefore, management believes there is no assumed credit risk. For the year ended June 30, 2000, the market value of investment account securities on loan was \$182,320,895 secured by \$185,967,313 in market value securities that cannot be pledged or loaned. For the year ended June 30, 1999, the market value of investment account securities on loan was \$19,689,213 secured by \$20,082,997 in market value securities that cannot be pledged or loaned.

In accordance with Statement No. 28 of the Governmental Accounting Standards Board, balances for "Cash held as collateral" and "Obligations under securities lending," reflect the recommended reporting. There were no Lottery security lending transactions at June 30, 2000, secured by cash deposits.

Cash held as collateral from treasury security lending represents the Lottery's share of cash collateral received for security lending transactions held in the General Account of the Commonwealth. Information related to the credit risk of these securities lending transactions is available on a statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

At June 30, 2000				
	Category		Carrying Amount	Market Value
	1	3		
<u>Cash and Cash Equivalents</u>				
Cash on deposit	\$ (220,670)	\$ -	\$ (220,670)	\$ (220,670)
Repurchase agreements	-	3,902,808	3,902,808	3,902,808
Cash with Treasurer of Virginia	-	-	12,500,374	12,500,374
Petty cash	-	-	4,540	4,540
Total cash and cash equivalents	<u>\$ (220,670)</u>	<u>\$ 3,902,808</u>	<u>\$ 16,187,052</u>	<u>\$ 16,187,052</u>
<u>Cash held as collateral</u>				
Treasury securities lending	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,025,487</u>	<u>\$ 1,025,487</u>
<u>Investments</u>				
U. S. Government Securities	<u>\$502,585,966</u>	<u>\$ -</u>	<u>\$502,585,966</u>	<u>\$533,387,868</u>
At June 30, 1999				
	Category		Carrying Amount	Market Value
	1	3		
<u>Cash and Cash Equivalents</u>				
Cash on deposit	\$ (7,036,195)	\$ -	\$ (7,036,195)	\$ (7,036,195)
Repurchase agreements	-	10,861,954	10,861,954	10,861,954
Cash with Treasurer of Virginia	-	-	6,965,086	6,965,086
Petty cash	-	-	4,940	4,940
Total cash and cash equivalents	<u>\$ (7,036,195)</u>	<u>\$ 10,861,954</u>	<u>\$ 10,795,785</u>	<u>\$ 10,795,785</u>
<u>Cash held as Collateral</u>				
Treasury securities lending	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 585,163</u>	<u>\$ 585,163</u>
<u>Investments</u>				
U. S. Government Securities	<u>\$582,820,490</u>	<u>\$ -</u>	<u>\$582,820,490</u>	<u>\$ 624,758,375</u>

3. INSTANT TICKET INVENTORY

Inventories are valued at cost and are expensed over the life of each game as it is sold to retailers.

4. DUE FROM/(TO) THE GENERAL FUND OF THE COMMONWEALTH

The amount due from/(due to) the General Fund of the Commonwealth represents Virginia Lottery net income receivable/(payable) from/(to) the Commonwealth of Virginia's General Fund in accordance with Section 31.01(G) of Chapter 1072, 2000 Acts of Assembly, and Section 58.1-4022(D), Code of Virginia.

	Year Ended June 30, 2000	Year Ended June 30, 1999
Net Income	\$ 323,475,009	\$ 316,874,856
Special Prize Reserve	-	5,000,000
Less:		
Transfer of net income through June 30	<u>323,533,122</u>	<u>321,092,185</u>
Balance due from/(due to) General Fund of the Commonwealth	<u>\$ 58,113</u>	<u>\$ (782,671)</u>

5. PRIZES PAYABLE

Jackpot prizes are paid in 20, 25, or 26 installments. The first installment is paid on the day the prize is claimed. The subsequent annual payments are funded with U.S. Treasury STRIPS purchased by the Virginia Lottery. Jackpot prizes payable also includes "For Life" estimated prizes payable monthly, quarterly, or annually for the life of the winner based on life expectancy tables from the Virginia Bureau of Insurance, and funded with a pool of U.S. Treasury STRIPS.

Jackpot prizes payable represent the future annual prize payments valued at cost plus accrued interest (present value) of the investment securities funding the payments.

	Year Ended June 30, 2000	Year Ended June 30, 1999
Jackpot Prizes Payable:		
Due within one year	\$ 58,683,433	\$ 64,623,875
Due in subsequent years	<u>443,902,533</u>	<u>518,196,615</u>
Total (present value)	502,585,966	582,820,490
Add: Interest to maturity	<u>276,454,034</u>	<u>346,865,510</u>
Jackpot prizes payable at maturity	<u>\$ 779,040,000</u>	<u>\$ 929,686,000</u>

Other prizes payable represent unclaimed prizes from drawings or games which have ended and are redeemable up to 180 days after the drawing or game end. The "For Life" bonds that have not been purchased are reported as other prizes payable.

6. OPERATING LEASE COMMITMENTS

The Virginia Lottery is committed under various operating lease agreements. Rent expense under operating lease agreements were \$5,499,648 and \$5,493,952 as of June 30, 2000 and 1999, respectively. A summary of future obligations under these agreements as of June 30, 2000 follows:

Year Ending June 30,	Operating Lease Obligations
2001	\$ 5,457,469
2002	350,988
2003	76,930
2004	79,193
Future Years	<u>251,845</u>
Total commitments and gross minimum payments	<u>\$ 6,216,425</u>

7. COMPENSATED ABSENCES

Compensated absences represent the amounts of vacation, sick, and compensatory leave earned by employees of the Virginia Lottery but not taken at June 30, 2000 and 1999. The amounts reflect all earned leave payable under the Commonwealth of Virginia's leave pay-out policy upon employment termination. Compensated absences were calculated in accordance with Governmental Accounting Standards Board (GASB) Statement No. 16 Accounting for Compensated Absences. This statement requires the accrual of the following: sick leave earned by employees who, while not currently vested for payment, will probably attain the five years of service required to vest for payment; and social security and Medicare taxes to be paid by the Virginia Lottery on all accrued compensated absences.

8. LINE OF CREDIT

The State Comptroller has provided the Virginia Lottery with an interest-free line of credit not to exceed \$25,000,000 in accordance with Section 3-2.03 of Chapter 1072, 2000 Acts of Assembly, to fund administrative and operating expenses in the event unreserved cash is insufficient to cover these short-term costs. There were no borrowings as of June 30, 2000. There was a \$12,000,000 loan payable under this arrangement as of June 30, 1999 (repaid on July 27, 1999).

9. LITERARY FUND AND SET-OFF DEBT COLLECTION PAYMENTS

Prizes unclaimed after 180 days are paid to the Literary Fund of the Commonwealth. Payments to the Literary Fund by the Virginia Lottery totaled \$10,881,724 and \$9,348,632 for the years ended June 30, 2000 and 1999, respectively.

The Virginia Lottery participates in the Setoff Debt Collection Act whereby certain prize payments are withheld to set-off state obligations the prize winner owes. The Virginia Lottery collected \$789,241 and \$745,527 for the years ended June 30, 2000 and 1999, respectively.

10. PENSION PLAN AND OTHER POST RETIREMENT BENEFITS

Employees of the Lottery are employees of the Commonwealth of Virginia. The employees participate in a defined benefit retirement plan administered by the Virginia Retirement System (VRS). The VRS also administers life insurance and health related plans for retired employees. Information relating to these plans is available at the statewide level only in the Commonwealth of Virginia's Comprehensive Annual Financial Report (CAFR). The Commonwealth of Virginia, not the Lottery, has the overall responsibility for contributions to these plans.

11. RISK MANAGEMENT

In order to cover its exposures to various risks of loss, the Virginia Lottery, an independent agency of the Commonwealth of Virginia, participates in the Commonwealth's self-insurance plans for state employee health care and risk management insurance. The latter includes worker's compensation, property, general (tort) liability, medical malpractice and automobile plans. Information relating to the Commonwealth's self-insurance plans is available at the statewide level in the Commonwealth's Comprehensive Annual Financial Report.

STATE LOTTERY DEPARTMENT
Richmond, Virginia

STATE LOTTERY BOARD
As of June 30, 2000

Stuart C. Siegel, Chairman

Stephen C. Fogleman, Vice Chairman

Virginia D. Hall

Paul J. Lanteigne

Enoch W. Love, Jr.

Penelope W. Kyle, Director

