



**VIRGINIA LOTTERY
RICHMOND, VA**

ANNUAL FINANCIAL REPORT

FOR THE YEAR ENDED

JUNE 30, 2004

AUDIT SUMMARY

Our audit of the State Lottery Department of the Commonwealth of Virginia for the year June 30, 2004 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.

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Management's Discussion and Analysis (Unaudited)

The Virginia Lottery's management discussion and analysis (MD&A) is designed to assist the reader in focusing on significant financial issues and provides an overview of financial activity. All Lottery net income is transferred to the Commonwealth each year in accordance with requirements in the Appropriation Act and the Code of Virginia. Therefore, the Lottery's MD&A focuses primarily on an overview of the financial results of operations. Please read it in conjunction with the accompanying financial statements.

Financial Highlights

Virginia Lottery ticket sales totaled more than \$1.262 billion for fiscal year 2004, the highest total ever for Lottery sales in Virginia. Net proceeds totaling \$408.1 million were transferred to the Lottery Proceeds Fund, all of which are constitutionally mandated to support local K-12 public education. Highlights of the fiscal year include:

- Sales increased by \$126.6 million (11 percent) over last year to a record \$1.262 billion.
- Net income was a record \$408.1 million – an increase of \$32.9 million (9 percent) from 2003 and \$23.0 million over budget. Nearly one-third of every sales dollar went to profit.
- Prize expense increased by \$82.0 million (13 percent) to a record \$720.2 million. Prize expense increases directly with increased sales. Prizes increased at a higher rate than sales because the scratch product which has a higher prize expense rate than the other products grew to one-half of total sales.
- Retailers earned \$7.6 million (12 percent) more in 2004 with compensation totaling a record \$70.7 million. Retailers earned on average 5.6 cents on each dollar sold.
- Although, by law, the Lottery may spend up to 10 percent of sales on operating costs (all expenses except prizes and retailer compensation), these costs were only 5.4 percent of sales – exceeding the old record of 6.1 percent set in the prior year.

Overview of the Financial Statements

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

This annual report consists of a series of financial statements, along with explanatory notes to the financial statements. The report includes the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows. The Statement of Net Assets and the Statement

of Revenues, Expenses, and Changes in Net Assets report the Lottery's net assets and changes in them. By law, the Lottery transfers all of its net income to the Commonwealth of Virginia, specifically to the Lottery Proceeds Fund, each year. As a result, the net assets of the Lottery consist largely of capital assets (equipment) and investments held to fund future payments on annuitized lottery prizes as shown in the Statement of Net Assets. To assess the Lottery's financial position and financial health, the reader of these statements should pay particular attention to changes in operating revenues, expenses, and transfers to the Lottery Proceeds Fund as shown in the Statement of Revenues, Expenses, and Changes in Net Assets. The Statement of Cash Flows presents information related to cash inflows and outflows summarized by operating, capital, financing, and investing activities.

Statement of Net Assets

Table 1 reflects the condensed Statement of Net Assets compared to the prior year.

Table 1
Statement of Net Assets
(in millions)

	<u>2004</u>	<u>2003</u>	<u>Change</u>
Current Assets:	\$ 411.05	\$ 337.90	\$ 73.15
Investments	340.55	364.44	(23.89)
Fixed assets (net of accumulated depreciation)	<u>11.91</u>	<u>17.42</u>	<u>(5.51)</u>
Total Assets	<u>\$ 763.51</u>	<u>\$ 719.76</u>	<u>\$ 43.75</u>
Current Liabilities:	\$ 418.38	\$ 347.79	\$ 70.59
Long-term liabilities	<u>345.13</u>	<u>371.97</u>	<u>(26.84)</u>
Total liabilities	<u>\$ 763.51</u>	<u>\$ 719.76</u>	<u>\$ 43.75</u>
Net Assets:			
Invested in capital assets	\$ 5.26	\$ 7.95	\$ (2.69)
Unreserved	<u>(5.26)</u>	<u>(7.95)</u>	<u>2.69</u>
Total Net Assets	-	-	-
Total Liabilities and Net Assets	<u>\$ 763.51</u>	<u>\$ 719.76</u>	<u>\$ 43.75</u>

The increase of \$43.75 million in assets and liabilities is mostly attributable to the change in securities lending collateral. According to Governmental Accounting Standards Board (GASB) Statement Number 28, *Accounting and Financial Reporting for Securities Lending Transactions*, cash received as collateral on securities lending transactions and investments made with that cash should be reported on the Statement of Net Assets as assets and liabilities resulting from these transactions. At June 30, 2003, of the investment account securities on loan, \$228.8 million (market value) was secured in cash deposits. At June 30, 2004, of the investment account securities on loan, \$282.4 million was secured in cash deposits.

Investments (current and long-term) consist of U.S. Treasury STRIPS purchased to fund individual jackpot and "For Life" prizes. Long-term liabilities consist mainly of prize liabilities for prizes paid in installments over several years. Investments and Long-term Prize Liability both decreased because most recent jackpot winners chose to take a one-time cash payment rather than the annuity payments.

There was no major capital asset activity in fiscal year 2004. In fiscal years 2001 and 2002, the Lottery obtained new online terminals (ISYS) through a five-year installment purchase agreement. The original book value of equipment capitalized under this agreement totals \$14,248,000. Footnotes 3 and 7 in the Financial Statements provide more detailed information regarding capital asset and long term debt activity.

Since the Lottery transfers all net income to the Commonwealth at the end of each fiscal year, changes in assets do not reflect the results of the Lottery's operating activities. Those results are discussed later in this document.

Statement of Revenues, Expenses, and Changes in Net Assets

Sales

Lottery products fall into two major categories: scratch games and on-line games. Scratch games - those games in which players scratch off tickets to see whether or not they have won - include \$1, \$2, \$5, and \$10 games. On-line games - in which players buy tickets that are issued by a lottery terminal and the winning numbers are drawn randomly by the Lottery - include Pick 3, Pick 4, Cash 5, Lotto South, and Mega Millions.

Table 2
Lottery Sales
(in millions)

	<u>2004</u>	<u>2003</u>	<u>Percent Change</u>
Scratch Sales	\$ 630.93	\$ 543.45	16.1
Online Sales:			
Pick 3	\$ 241.43	\$ 240.42	0.4
Pick 4	156.93	146.85	6.9
Cash 5	28.04	28.43	(1.4)
Lotto South	73.00	71.61	2.0
Mega Millions	<u>132.03</u>	<u>104.96</u>	<u>25.8</u>
Total online sales	631.43	\$ 592.27	6.6
Total sales	<u>\$1,262.36</u>	<u>\$1,135.72</u>	<u>11.2</u>

Table 2 compares sales for each Lottery game, 2004 versus 2003. Total sales revenue for FY04 broke the prior sales record set in FY03. Mega Millions, Pick 4, and scratch ticket sales set individual records for those products.

Total daily game sales (Pick 3, Pick 4, and Cash 5) represent 34 percent of total product sales, and this category grew by 2.5 percent over the prior year. This growth continues to be significant because FY04 continues a growth trend started in FY02 after several years of flat sales for this product line.

Lotto South sales (6 percent of total sales) were up \$1.4 million over the prior year. Sales in this product are dependent on the amount of the advertised jackpot. Lotto South experienced longer jackpot rolls in FY04, meaning that players had additional opportunities to play for higher jackpots. The game experienced jackpot progressions in line with statistical expectations for the 2004 fiscal year.

Mega Millions sales (10 percent of total sales) were up \$27.1 million over last year, also due to more favorable jackpot rolls in 2004. This product is a lotto game with long odds of winning the top prize. Sales in this product are extremely dependent on the amount of the advertised jackpot, with sales increasing significantly as jackpots exceed \$200 million. During fiscal year 2004, there were five separate jackpot rolls ending with jackpots won over \$100 million and 17 separate drawings for jackpots of \$100 million or more, with one drawing for an advertised jackpot of over \$200 million. Conversely, in 2003, while there were four jackpot rolls ending with jackpots won over \$100 million, there were only 9 drawings for jackpots of over \$100 million and no drawings for jackpots of \$200 million or more.

Scratch game sales (50 percent of total sales) continue along a strong growth trend, up \$87.5 million from FY03 record levels. Growth in scratch game sales resulted from continuing efforts to produce a variety of games with different themes and price points to appeal to many types of players and improve distribution at retail locations.

Expenses

A summary of Lottery expenses for fiscal years ending June 30, 2004 and June 30, 2003 is shown in Table 3.

Table 3
Expenses
(in millions)

	<u>2004</u>		<u>2003</u>		<u>Change</u>	
	<u>Amount</u>	<u>Percent of Total</u>	<u>Amount</u>	<u>Percent of Total</u>	<u>Amount</u>	<u>Percent Change</u>
Prize expense	\$ 720.21	83.9	\$ 638.18	82.9	\$ 82.03	12.9
Retailer compensation	70.65	8.2	63.01	8.2	7.64	12.1
Operating expenses	58.57	6.8	60.76	7.9	(2.19)	(3.6)
Scratch ticket printing	<u>9.51</u>	<u>1.1</u>	<u>8.01</u>	<u>1.0</u>	<u>1.50</u>	<u>18.7</u>
Total	<u>\$ 858.94</u>	<u>100.0</u>	<u>\$ 769.96</u>	<u>100.0</u>	<u>\$ 88.98</u>	<u>11.6</u>

Prizes are the largest expense for the Lottery, and they vary with sales fluctuations. The FY04 prize payout rate (percent of sales paid out in prizes) was 57.1 percent which was close to the statistically expected rate. The amount of prizes paid increased because of the higher sales, higher payout rates for the daily games, and a slightly higher payout rate for the scratch product as players continue the trend toward the purchase of higher price-point tickets with higher prize payouts.

The change in retailer compensation was due to the commission earned on the additional \$126.6 million in sales and increased participation in retailer incentive programs. Total retailer compensation was in line with the expected 5.6 percent of total sales.

Scratch ticket printing costs increased \$1.5 million (18.7 percent), relatively consistent with the 16.1 percent increase in total scratch ticket sales.

Operating expenses decreased 3.6 percent from 2003, due to the continuation of savings resulting from a variety of efficiency measures implemented over the past several years. The most significant spending decrease occurred in the information systems and telecommunications category, with \$3.5 million savings realized through changes in equipment leases, maintenance, and the consolidation of retailer equipment.

Other Income

Table 4
Other Income
(in millions)

	<u>2004</u>	<u>2003</u>	<u>Percent Change</u>
Interest income	\$ 4.0	\$ 8.7	(54.0)
Net other income	<u>1.0</u>	<u>1.2</u>	<u>(16.7)</u>
Total	<u>\$ 5.0</u>	<u>\$ 9.9</u>	<u>(49.5)</u>

Interest income is earned primarily on cash balances held and invested by the Virginia Department of Treasury on behalf of the Virginia Lottery. As Table 4 shows, interest income was down 54 percent in 2004 due to a decrease in the earnings yield on collected Lottery revenue. This decline is reflective of the overall general decline in interest rates in 2004. The average annual rate was 2.34 percent in 2004, a 51.7 percent decline from the 4.85 percent average in 2003.

Net other income is derived from securities lending income, as well as various fees assessed to retailers for licensing and administrative fees and penalties for failure to remit monies owed when due. In 2004, other income was down nearly 17 percent, primarily due to decreased securities lending income. As the total portfolio of securities available for inclusion in this program decreases (down 12 percent in 2004), so does the income derived from lending the securities.

Net Income

In 2004, the Lottery generated \$408.1 million in profits. As shown in Table 5, profits surpassed the prior record of \$375.2 million earned in 2003 by \$32.9 million or 8.8 percent. Estimated net income of \$407.7 million was transferred to the Commonwealth prior to the year-end; the residual income will be transferred during 2005.

Table 5
Lottery Net Income
(in millions)

	<u>2004</u>		<u>2003</u>		<u>Change</u>	
	<u>Amount</u>	<u>Percent of Sales</u>	<u>Amount</u>	<u>Percent of Sales</u>	<u>Amount</u>	<u>Percent of Sales</u>
Net Income	\$ 408.05	32.3	\$ 375.20	33.0	\$ 32.85	(0.7)

Statement of Cash Flows

The Statement of Cash Flows, summarized in Table 6, presents the detailed information pertaining to the cash activity of the Lottery during the year. The first part of the statement deals with operating cash flows and shows the net cash provided by operating activities of the Lottery. Receipts from the sale of tickets and related services totaled over \$1.24 billion. Uses of cash include payment of prizes to winners (\$773 million) and payments to retailers, suppliers, and employees for goods and services (\$117 million). The net cash provided by operating activities of \$351 million represents a 12 percent increase, consistent with the 11 percent increase in overall sales.

The cash flows from noncapital financing activities portion of the statement reflects the \$406.8 million used for noncapital financing activities, the major portion being the \$407.8 million in total transfers from the Lottery during the year. This amount represents the initial estimate of FY2004 Lottery profits transferred to the Lottery Proceeds Fund prior to July 1, 2004. Cash flows from capital financing activities reflect the payment of principal and interest on a financing agreement for capital equipment (\$3.2 million), plus the net cost of capital assets acquired during the period (\$0.5 million). The \$57 million cash flows from investing activities reflect investment income on cash balances (\$4 million), purchases of investments to fund win-for-life prizes due to Lottery winners (\$7 million), and the proceeds from maturing investments previously purchased to fund Lottery prizes payable (\$60 million). The net decrease in cash from activities totaled \$2.68 million.

Table 6
Statement of Cash Flows
(in millions)

	2004	2003
Cash flows from:		
Operating activities	\$ 350.70	\$ 312.62
Noncapital financing activities	(406.80)	(373.85)
Capital financing activities	(3.65)	(6.30)
Investing activities	57.07	67.62
Net change in cash	\$ (2.68)	\$ 0.09
Ending cash and cash equivalents	\$ 7.70	\$ 10.38

Potentially Significant Factors Impacting Next Year

Two major changes that may impact sales and operating expenses will be fully implemented in 2005. First, the Lottery will change to consignment sales for scratch tickets where a retailer is not billed for tickets until a pack is activated for sale. Also, under a new contract with Oberthur Gaming Technologies, scratch ticket printing and related services will now be paid on a percentage of sales basis rather than the past method of paying separately for ticket inventory and distribution. This change will result in significant operational savings over the multi-year contract period.

Contacting the Virginia Lottery

This financial report is designed to provide the legislative and executive branches of government, the public, and other interested parties with an overview of the financial results of the Virginia Lottery's activities, and to demonstrate the Virginia Lottery's accountability for its revenues. If there are any questions about this report or about any Virginia Lottery financial issue, please contact the Director of Finance at the Virginia Lottery, 900 East Main Street, Richmond, Virginia, 23219.

FINANCIAL STATEMENTS

STATE LOTTERY DEPARTMENT
STATEMENT OF NET ASSETS
For Fiscal Year Ended June 30, 2004 with Comparative Information for 2003

	2004	2003
ASSETS		
Current assets:		
Cash and cash equivalents (Note 2)	\$ 7,696,761	\$ 10,381,734
Cash held as collateral (Note 2)	282,432,968	228,793,959
Accounts receivable	57,944,471	34,738,207
Due from the Lottery Proceeds Fund (Note 5)	-	-
Instant ticket inventory (Note 4)	3,594,998	4,357,745
Deferred expenses	1,737,285	2,353,994
Short-term investments (Note 2)	57,646,124	57,281,492
Total current assets	411,052,607	337,907,131
Noncurrent assets:		
Investments (Note 2)	340,549,132	364,439,461
Fixed assets: (Note 3)		
Furniture, fixtures and equipment	42,729,802	42,802,825
Less: Accumulated depreciation	(30,823,091)	(25,381,239)
Net fixed assets	11,906,711	17,421,586
Total noncurrent assets	352,455,843	381,861,047
Total assets	\$ 763,508,450	\$ 719,768,178
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	\$ 11,408,322	\$ 9,695,425
Due to the Lottery Proceeds Fund (Note 5)	351,586	100,774
Compensated absences (Note 8)	642,099	780,770
Obligations under securities lending (Note 2)	282,432,968	228,793,959
Prizes payable: (Note 6)		
Jackpot prizes payable	57,646,124	57,281,492
Other	58,774,117	45,286,885
Deferred revenue	4,172,611	3,027,582
Installment notes payable (Note 7)	2,948,268	2,822,180
Total current liabilities	418,376,095	347,789,067
Long-term liabilities:		
Installment notes payable (Note 7)	3,695,685	6,643,952
Jackpot prizes payable (Note 6)	340,549,132	364,439,461
Compensated absences (Note 8)	887,538	895,698
Total liabilities	763,508,450	719,768,178
Net Assets:		
Invested in capital assets, net of related debt	5,262,758	7,955,454
Unreserved	(5,262,758)	(7,955,454)
Total net assets	-	-
Total liabilities and net assets	\$ 763,508,450	\$ 719,768,178

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

STATE LOTTERY DEPARTMENT
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For Fiscal Year Ended June 30, 2004 with Comparative Information for 2003

	2004	2003
Operating revenues:		
Ticket sales	\$ 1,262,358,367	\$ 1,135,729,104
Less:		
Prize expense	720,214,601	638,175,549
Retailer compensation	70,654,708	63,005,680
Instant ticket printing and services	9,510,249	8,009,561
Gross margin	461,978,809	426,538,314
Operating expenses:		
Advertising and promotion	18,988,122	18,828,296
General and administration	33,599,414	35,388,741
Depreciation	5,986,603	6,545,950
Total operating expenses	58,574,139	60,762,987
Income from operations	403,404,670	365,775,327
Non-operating revenue (expenses):		
Interest income	4,005,359	8,654,703
Interest expense	(355,671)	(481,040)
Other income	997,228	1,251,784
Total non-operating income	4,646,916	9,425,447
Net income	408,051,586	375,200,774
Transfer to the Lottery Proceeds Fund	(407,700,000)	(375,100,000)
Available for transfer from (to) the Lottery Proceeds Fund	(351,586)	(100,774)
Net assets--July 1	-	-
Net assets--June 30	\$ -	\$ -

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

STATE LOTTERY DEPARTMENT
STATEMENT OF CASH FLOWS
For Fiscal Year Ended June 30, 2004 with Comparative Information for 2003

	2004	2003
Cash flows from operating activities:		
Cash received from ticket sales	\$ 1,240,297,132	\$ 1,137,379,684
Cash payments for prizes	(759,788,459)	(695,059,495)
Discounts for retailer compensation	(70,654,708)	(63,005,680)
Cash payments to supplier of instant tickets	(8,747,502)	(8,821,932)
Cash payments to suppliers of other goods and services	(17,554,451)	(27,242,009)
Cash payments to employees for services	(19,815,328)	(18,324,066)
Cash payments to the Literary Fund for unclaimed prizes (Note 10)	(13,034,982)	(12,304,583)
Net cash provided by operating activities	<u>350,701,702</u>	<u>312,621,919</u>
Cash flows from noncapital financing activities:		
Proceeds from other income	997,228	1,251,784
Transfers to the Lottery Proceeds Fund	(407,800,774)	(375,102,719)
Net cash used by noncapital financing activities	<u>(406,803,546)</u>	<u>(373,850,935)</u>
Cash flows from capital financing activities:		
Acquisition of capital assets	(654,535)	(3,117,404)
Disposal of capital assets	182,807	
Principal payments on installment notes	(2,822,179)	(2,701,495)
Interest payment on installment notes	(355,671)	(481,040)
Net cash used for capital financing activities	<u>(3,649,578)</u>	<u>(6,299,939)</u>
Cash flows from investing activities:		
Purchase of investment securities	(6,862,150)	-
Sale of investment securities	471,240	-
Proceeds from maturing securities	59,452,000	58,966,000
Interest proceeds from cash balances	4,005,359	8,654,703
Net cash provided by investing activities	<u>57,066,449</u>	<u>67,620,703</u>
Net (decrease) increase in cash and cash equivalents	(2,684,973)	91,748
Cash and cash equivalents at July 1	<u>10,381,734</u>	<u>10,289,986</u>
Cash and cash equivalents at June 30	<u>\$ 7,696,761</u>	<u>\$ 10,381,734</u>
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	\$ 403,404,670	\$ 365,775,327
Adjustments to reconcile operating income to net cash:		
Depreciation	5,986,603	6,545,950
Accreted interest on investment securities	(29,535,393)	(30,992,988)
Changes in assets and liabilities:		
(Increase) in accounts receivable	(23,206,264)	1,456,872
(Increase) in instant ticket inventory	762,747	(812,371)
Decrease in deferred expenses	616,709	(1,058,065)
Increase (decrease) in accounts payable	1,712,897	(2,686,653)
Increase (decrease) in current prizes payable	13,851,864	2,212,092
Increase in deferred revenue	1,145,029	193,708
Increase (decrease) in accrued compensated absences	(146,831)	91,097
(Decrease) in noncurrent prizes payable	(23,890,329)	(28,103,050)
Net cash provided by operating activities	<u>\$ 350,701,702</u>	<u>\$ 312,621,919</u>

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, 2004

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.

The Virginia Lottery participates in two multi-state games, Lotto South and Mega Millions. Lotto South member lotteries include Virginia, Georgia, and Kentucky. Mega Millions Member lotteries include Virginia, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas and Washington. The financial activity included in the financial statements reflects only Virginia's portion of these multi-state games. Separate agreed-upon procedures reports are issued for Lotto South and Mega Millions.

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 basic 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. On-line ticket revenue is recognized as corresponding drawings are held. Instant ticket revenue is recognized when tickets are sold to retailers.

C. Revenue and Expense Classifications

Operating revenues and expenses include activities related to the sale of lottery tickets. Operating expenses include prizes to winners, compensation to retailers, and instant ticket printing costs. Nonoperating revenues and expenses include activities that have the characteristics of investing transactions and capital and noncapital financing activities as defined by GASB Statement 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, and GASB Statement 34.

Nonoperating revenues include interest income from its cash balances held with the Treasurer of Virginia. Nonoperating expenses include interest on debt related to the purchase of capital assets and losses on the disposal of capital assets.

D. Fund Accounting

The activities of the Virginia Lottery are accounted for in an enterprise fund, 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.

E. Cash, Cash Equivalents, and Investments

The Lottery's cash and cash equivalents are considered to be cash on hand, cash with the Treasurer of Virginia, deposits, and overnight repurchase agreements.

Statutes authorize the Lottery to invest 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.

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.

F. Property, Plant, and Equipment

Fixed assets are capitalized and depreciated on a straight-line basis over their useful lives. Fixed assets are valued at historical cost or estimated historical cost. Donated fixed assets are capitalized at estimated market value at the date of contribution. The Virginia Lottery capitalizes all property, plant, and equipment that have a cost or value equal to and greater than \$3,000 and an expected useful life of at least three years.

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 2.2-1800, 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.

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 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 2.2-4506 of the Code of Virginia, the Virginia Lottery, through its master custodian, JP Morgan Chase Bank, 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.

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. For the year ended June 30, 2004, the market value of investment account securities on loan was \$277,234,328 secured by \$281,550,302 in cash deposits, and \$52,112,490 secured by \$53,154,740 in market value securities that cannot be pledged or loaned.

Cash held as collateral from treasury security lending represents the Lottery's share of cash collateral received on security lending transactions associated with their investment of Lottery cash 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, 2004			
	Category		Carrying Amount	Market Value
	1	3		
<u>Cash and Cash Equivalents</u>				
Cash on deposit	\$ (112,611)	\$ -	\$ (112,611)	\$ (112,611)
Repurchase agreements	-	4,514,383	4,514,383	4,514,383
Cash with Treasurer of Virginia	-	-	3,291,829	3,291,829
Petty cash	-	-	<u>3,160</u>	<u>3,160</u>
Total cash and cash Equivalents	<u>\$ (112,611)</u>	<u>\$ 4,514,383</u>	<u>\$ 7,696,761</u>	<u>\$ 7,696,761</u>
<u>Cash held as collateral</u>				
Lottery securities lending	\$ -	\$ -	\$ 281,550,302	\$ 281,550,302
Treasury securities lending	-	-	<u>882,666</u>	<u>882,666</u>
Total cash collateral			<u>\$282,432,968</u>	<u>\$282,432,968</u>
<u>Investments</u>				
U. S. Government Securities	<u>\$398,195,256</u>	<u>\$ -</u>	<u>\$398,195,256</u>	<u>\$449,812,385</u>

3. FIXED ASSETS

The following schedule presents the changes in Fixed Assets by category.

	Balance as of <u>July 1, 2003</u>	<u>Additions</u>	<u>Reductions</u>	Balance as of <u>June 30, 2004</u>
Furniture, fixtures and equipment	\$ 42,802,825	\$ 654,535	\$ 727,558	\$ 42,729,802
Less: accumulated depreciation	<u>25,381,239</u>	<u>5,986,603</u>	<u>544,751</u>	<u>30,823,091</u>
Net fixed assets	<u>\$ 17,421,586</u>	<u>\$ (5,332,068)</u>	<u>\$ 182,807</u>	<u>\$ 11,906,711</u>

4. INSTANT TICKET INVENTORY

Inventories are valued at cost, using a weighted average basis, and are expensed over the life of each game as it is sold to retailers.

5. DUE FROM (TO) THE LOTTERY PROCEEDS FUND

The amount due from (to) the Lottery Proceeds Fund represents Virginia Lottery net income payable to the Commonwealth of Virginia's General Fund in accordance with Section 3-2.03 of Chapter 943, 2004 Acts of Assembly, and Section 58.1-4022, Code of Virginia. The Lottery Proceeds Fund is a special non-reverting fund established solely for the purpose of public education in the Commonwealth. For the year ended June 30, 2004, the net income was \$408,051,586, with a net income transfer through June 30th of \$407,700,000 and a balance due to the Lottery Proceeds Fund of \$351,586.

6. PRIZES PAYABLE

Jackpot prize annuities are paid in 20, 25, 26, or 30 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 on the first business day following the winning draw. Jackpot winners also have the option of accepting their winnings in a lump sum cash payout. When a winner selects this option, the securities purchased are sold and the winner receives the cash value. For Life prizes payable represent 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 securities held to maturity) of the investment securities funding the payments.

	<u>Jackpot</u>	<u>For Life</u>	<u>Total</u>
Jackpot Prizes Payable:			
Due within one year	\$ 56,121,612	\$ 1,524,512	\$ 57,646,124
Due in subsequent years	<u>321,235,498</u>	<u>19,313,634</u>	<u>340,549,132</u>
Total (present value)	377,357,110	20,838,146	398,195,256
Add: Interest to maturity	<u>145,516,890</u>	<u>20,373,854</u>	<u>165,890,744</u>
Jackpot prizes payable at maturity	<u>\$522,874,000</u>	<u>\$41,212,000</u>	<u>\$ 564,086,000</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. For Life prizes, for which bonds have not been purchased are reported as other prizes payable.

Prizes payable increases when Jackpot winners select annuities and securities are purchased. Prizes payable decreases when securities mature to pay prior jackpot winners. In FY 04 all jackpot winners selected cash, resulting in no new securities purchased for jackpot prize payments; however, securities were purchased for For Life winners.

The following schedule presents the changes in prizes payable.

Balance as of July 1, 2003	Increases	Decreases	Balance as of June 30, 2004
<u>\$421,720,953</u>	<u>\$6,862,150</u>	<u>\$30,387,847</u>	<u>\$398,195,256</u>

7. INSTALLMENT PURCHASE AND OPERATING LEASE COMMITMENTS

The Virginia Lottery is committed under various installment purchase agreements and operating lease agreements. The installment purchase agreement is for our new online terminals (ISYS). This is a five year installment loan with interest rates ranging from 3.94 percent to 4.483 percent. The operating leases are for regional offices and instant validation equipment. Original book value of equipment capitalized under installment purchase agreements totals \$14,248,000 at June 30, 2004. Expenses under operating lease agreements were \$1,731,639 as of June 30, 2004. A summary of future obligations under these agreements as of June 30, 2004 follows:

Year Ending <u>June 30,</u>	Operating Lease	Installment Purchase		
	<u>Obligation</u>	<u>Principal</u>	<u>Interest</u>	<u>Obligations</u>
2005	\$ 1,711,180	\$ 2,948,268	\$ 229,582	\$ 3,177,850
2006	284,368	3,080,004	97,846	3,177,850
2007	292,854	615,681	13,238	628,919
2008	<u>69,494</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total commitments and gross minimum payments	<u>\$ 2,357,896</u>	<u>\$ 6,643,953</u>	<u>\$ 340,666</u>	<u>\$ 6,984,619</u>

The following schedule presents the changes in installment purchases.

Balance as of July 1, 2003	Increases	Decreases	Balance as of June 30, 2004
<u>\$ 9,466,132</u>	<u>\$ -</u>	<u>\$ 2,822,179</u>	<u>\$ 6,643,953</u>

8. 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, 2004 and 2003. Compensated absences were calculated in accordance with Governmental Accounting Standards Board (GASB) Statement No. 16 "Accounting for Compensated Absences." The amount reflects all earned leave payable under the Commonwealth of Virginia's leave payout policies. Information on the Commonwealth's leave policy is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

Balance as of July 1, 2003	Increases	Decreases	Balance as of June 30, 2004	Due Within One Year
<u>\$1,676,467</u>	<u>\$936,117</u>	<u>\$1,082,947</u>	<u>\$1,529,637</u>	<u>\$642,099</u>

9. LINE OF CREDIT

The State Comptroller has provided the Virginia Lottery with a line of credit not to exceed \$25,000,000 in accordance with Section 3-2.03 of Chapter 943, 2004 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, 2004.

10. LITERARY FUND AND SETOFF DEBT COLLECTION PAYMENTS

Prizes unclaimed after 180 days are paid to the Literary Fund of the Commonwealth. Payments totaled \$13,034,982 for the year ended June 30, 2004.

The Virginia Lottery participates in the Setoff Debt Collection Act whereby certain prize payments are withheld to set-off state obligations the prizewinner owes. Payments totaled \$912,503 for the year ended June 30, 2004. The Literary Fund and state debt setoff payments are reported as prize expense on the financial statements.

11. PENSION PLAN AND OTHER POST RETIREMENT BENEFITS

Employees of the Virginia 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 Virginia Lottery, has the overall responsibility for contributions to these plans.

12. RISK MANAGEMENT

The Virginia Lottery is exposed to various risks of loss related to torts: theft or, damage to, and destruction of assets; errors and omissions; non-performance of duty; injuries to employees; and natural disasters. The Virginia Lottery participates in insurance plans maintained by the Commonwealth of Virginia. The state employee health care and worker's compensation plans are administered by the Department of Human Resource Management and the risk management insurance plans are administered by the Department of Treasury, Division of Risk Management. Risk management insurance includes property, general liability, medical malpractice, faithful performance of duty bond, automobile, and air and watercraft plans. The Virginia Lottery pays premiums to each of these Departments for its insurance coverage. Information relating to the Commonwealth's insurance plans is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

**Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218**

August 13, 2004

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** of the Commonwealth of Virginia as of and for the year ended June 30, 2004, 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 accompanying basic statements of the State Lottery Department as of and for the year ended June 30, 2004, as listed in the Table of Contents. These basic financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. 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.

As discussed in Note 1A, the basic financial statements of the Department are intended to present the financial position, and the changes in financial position and cash flows of only that portion of the business-type activities and the major enterprise fund of the Commonwealth of Virginia that is attributable to the transactions of the Department. They do not purport to, and do not, present fairly the financial position of the Commonwealth of Virginia as of June 30, 2004, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Lottery Department as of June 30, 2004, and changes in its financial position and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The management discussion and analysis on pages one through six is not a required part of the basic financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

INDEPENDENT AUDITOR'S REPORT 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 year ended June 30, 2004, we considered internal controls over financial reporting and tested compliance with certain provisions of laws, regulations, and contracts in accordance with auditing standards generally accepted in the United States of America 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 27, 2004.

AUDITOR OF PUBLIC ACCOUNTS

STATE LOTTERY DEPARTMENT
Richmond, Virginia

STATE LOTTERY BOARD
As of June 30, 2004

Paul J. Lanteigne, Chairperson

Stuart C. Siegel, Vice-Chairperson

Gilliam M. Cobbs, Sr.

Susan Smith Feaster

Stephen C. Fogleman, Esq.

Penelope W. Kyle, Director