



**VIRGINIA LOTTERY
RICHMOND, VA**

ANNUAL FINANCIAL REPORT
FOR THE YEAR ENDED
JUNE 30, 2003

AUDIT SUMMARY

Our audit of the State Lottery Department of the Commonwealth of Virginia for the years ended June 30, 2003 and 2002, 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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August 15, 2003

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 years ended June 30, 2003 and 2002, 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 years ended June 30, 2003 and 2002, 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, 2003, 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, 2003 and 2002, and changes in its financial position and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

The management discussion and analysis on pages four through nine 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 years ended June 30, 2003 and 2002, 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 October 28, 2003.

AUDITOR OF PUBLIC ACCOUNTS

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MANAGEMENT'S DISCUSSION AND ANALYSIS

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 of Virginia 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.

General Overview

Lottery net income is transferred to the General Fund of the Commonwealth of Virginia at the end of each fiscal year. The Appropriation Act specifies how the Lottery funding will be distributed to localities and the Virginia Department of Education transfers the funds. In November 2000, Virginia voters approved a constitutional amendment directing the General Assembly to establish a Lottery Proceeds Fund. The amendment states that proceeds shall be appropriated from the Fund to the Commonwealth's counties, cities and towns, and the school divisions, to be expended for the purposes of public education. In the 2002 General Assembly Session, the Lottery Proceeds Fund was established effective July 1, 2002.

Financial Highlights

- Sales increased by \$27.7 million (2.5 percent) over last year to a record \$1.135 billion.
- Net income was a record \$375.2 million – an increase of \$7.5 million (2 percent) from 2002 and \$11.5 million over budget. One-third of every sales dollar went to profit.
- Retailers earned almost \$765,000 (1 percent) more in 2003 with compensation totaling a record \$63.0 million. Retailers earned on average 5.5 cents on each dollar sold.
- Although by law the Lottery may spend up to 10 percent of sales on operating costs, operating expenses were only 6.1 percent of sales – exceeding the old record of 6.6 percent.

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 where 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 report consists of a series of financial statements, along with explanatory notes to the financial statements and supplemental schedules. 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 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 General Fund of the Commonwealth as shown in the Statements 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 for fiscal year 2003 compared to fiscal year 2002.

Table 1
Net Assets as of June 30 2003 and 2002
(in millions)

	Fiscal Year 2003	Fiscal Year 2002	Change
Current assets	\$ 337.90	\$ 241.73	\$ 96.17
Investments	364.44	392.54	(28.10)
Fixed assets (net of accumulated depreciation)	<u>17.42</u>	<u>20.85</u>	<u>(3.43)</u>
Total assets	<u>\$ 719.76</u>	<u>\$ 655.12</u>	<u>\$ 64.64</u>
Current liabilities	\$ 347.79	\$ 252.26	\$ 95.53
Long-term liabilities	<u>371.97</u>	<u>402.86</u>	<u>(30.89)</u>
Total liabilities	<u>\$ 719.76</u>	<u>\$ 655.12</u>	<u>\$ 64.64</u>
Net assets:			
Invested in capital assets	\$ 7.95	\$ 8.68	\$ (0.73)
Unrestricted	<u>(7.95)</u>	<u>(8.68)</u>	<u>0.73</u>
Total net assets	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

The increase of \$64.64 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, 2002, of the investment account securities on loan, \$133.3 million (market value) was secured in cash deposits. At June 30, 2003, of the investment account securities on loan, \$228.8 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 2003. 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. Notes to the financial statement number three and seven 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.

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

Table 2
Lottery Sales
(in millions)

	Fiscal Year 2003	Fiscal Year 2002	Percent Change
Scratch sales	\$ 543.45	\$ 492.46	10.4
Online sales:			
Pick 3	240.42	243.12	(1.1)
Pick 4	146.85	141.17	4.0
Cash 5	28.43	27.28	4.2
Lotto South	71.61	86.77	(17.5)
Mega Millions	104.96	117.26	(10.5)
Total online sales	592.27	615.60	(3.8)
Total ticket sales	\$ 1,135.72	\$ 1,108.06	2.5

Table 2 compares sales for each Lottery game for fiscal year 2003 and 2002. Total sales revenue for fiscal year 2003 broke the prior sales record set in fiscal year 2002. Within product lines, scratch game and Pick 4 sales set records for those products.

Total daily game sales (Pick 3, Pick 4, and Cash 5) grew by one percent over the prior year. This growth continues to be significant, not only because it represents an increase over a strong growth year in fiscal year 2002, but also because fiscal year 2003 continues this growth trend after several years of flat sales for this product line.

Lotto South sales (six percent of total sales) were down 17.5 percent over the prior year. Sales in this product are dependent on the amount of the advertised jackpot. In fiscal year 2002, there were ten drawings for jackpots higher than \$20 million, while in fiscal year 2003 there was only one advertised jackpot over \$20 million.

Similarly, Mega Millions sales (nine percent of total sales) were 10.5 percent lower than last year due to overall lower jackpot levels. This product is a lotto game with long odds of winning the top prize. The game was designed with the potential to generate record jackpots. Sales in this product are extremely dependent on the amount of the advertised jackpot, with sales increasing significantly as jackpots exceed \$200 million. In fiscal year 2002, two draws were for jackpots over \$200 million. In fiscal year 2003, the highest advertised jackpot reached only \$180 million.

Scratch game sales (48 percent of total sales) continue along a strong growth trend, up 10.4 percent from fiscal year 2002 record levels. Growth in scratch game sales resulted from continuing efforts to create and introduce a variety of games with different themes and price points to appeal to many types of players.

Expenses

A summary of Lottery expenses for fiscal years ending June 30, 2003 and June 30, 2002 is shown in Table 3.

Table 3
Summary of Expenses as of June 30 2003 and 2002
(in millions)

	Fiscal Year 2003		Fiscal Year 2002		Change	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent Change
Prize Expense	\$ 638.18	82.9	\$ 613.73	81.8	\$ 24.45	4.0
Retailer Compensation	63.01	8.2	62.24	8.3	0.77	1.2
Operating Expenses	60.76	7.9	67.71	9.0	(6.95)	(10.3)
Instant Ticket Printing	<u>8.01</u>	<u>1.0</u>	<u>7.00</u>	<u>0.9</u>	<u>1.01</u>	<u>14.5</u>
Total	<u>\$ 769.96</u>	<u>100.00</u>	<u>\$ 750.68</u>	<u>100.0</u>	<u>\$ 19.28</u>	<u>2.6</u>

Prizes are the largest expense for the Lottery, and they vary with sales fluctuations. The fiscal year 2003 prize payout rate (percent of sales paid out in prizes) was 56.2 percent which was close to the statistically expected rate. The amount of prizes paid increased because of the higher sales and a slightly higher payout rate for the scratch product.

The change in retailer compensation was due to the commission earned on the additional \$27.7 million in sales. Total retailer compensation was less than anticipated, however, due to lower retailer earnings from incentive programs offered throughout the year.

Scratch ticket printing costs increased \$1.0 million (14.5 percent), relatively consistent with the 10.4 percent increase in total scratch ticket sales. Another factor in the increased ticket printing costs was the increase in contract printing rates beginning in fiscal year 2002. Ticket expense in fiscal year 2002 included lower-cost games as warehouse ticket inventory was depleted.

General and administrative (operating) spending decreased just over ten percent from fiscal year 2002, due to a variety of efficiency measures implemented. The most significant spending decrease occurred in the information systems and telecommunications category, with \$2.7 million savings realized through changes in equipment leases, maintenance, and the consolidation of retailer equipment.

Other Income

Table 4
Other Income
(in millions)

	Fiscal Year 2003	Fiscal Year 2002	Percent Change
Interest income	\$ 8.70	\$ 9.60	(9.4)
Net other income	1.20	1.20	-
Total other income	\$ 9.90	\$ 10.80	8.3

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 over 9.4 percent in fiscal year 2003 due to a decrease in the composite earnings yield. This decline is reflective of the overall general decline in interest rates in 2003. The average annual composite earnings rate was 5.12 percent in 2003, a 9.5 percent decline from the 5.66 percent average in 2002.

Net other income is derived primarily from various fees assessed to retailers for licensing and administrative fees, and penalties for failure to remit monies owed when due. In fiscal year 2003, other income was relatively unchanged.

Net Income

In fiscal year 2003, the Lottery generated \$375.2 million in profits. As shown in Table 5, profits surpassed the prior record of \$367.7 earned in fiscal year 2002 by \$7.5 million or 2.5 percent. Estimated net income of \$375.1 million was transferred to the Commonwealth of Virginia prior to the year-end; the residual income will be transferred during fiscal year 2004. The 2003 Appropriation Act designated that \$1,053,670 of the transfer go to the Lottery Proceeds Fund for required operating costs savings, estimated cost efficiencies achieved through the Commonwealth's telecommunications contract initiative, and in support of the Commonwealth's electronic procurement initiative. The Act specifies that the remainder of the net income be dedicated to public education (K-12). The funding is distributed by the Virginia Department of Education to localities as determined by provisions in the Appropriation Act.

Table 5
Lottery Net Income
(in millions)

	Fiscal Year 2003		Fiscal Year 2002		Change	
	Amount	Percent of Sales	Amount	Percent of Sales	Amount	Percent of Sales
Net Income	\$ 375.20	33.0	\$ 367.69	33.2	\$ 7.51	(0.2)

As previously discussed, a strong scratch ticket portfolio, promotion and support for daily games, and a full year of sales for the new Mega Millions jackpot game provided the foundation for the record year experienced in fiscal year 2003.

Potentially Significant Factors Impacting Next Year

The Lottery does not expect all factors that influence sales to be better in fiscal year 2004 than they were in fiscal year 2003. Daily game prize payouts were slightly lower than anticipated in fiscal year 2003, causing profits on these products to be higher than anticipated. However, low prize payouts for these products can also negatively impact sales, so a continued low payout rate for daily games (in particular for Pick 3) would be detrimental to sales.

In fiscal year 2004, Texas will join the Mega Millions game. This enhancement to the product provides the potential to generate more revenue from the Mega Millions game.

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
As of June 30, 2003 and 2002

	2003	2002
ASSETS		
Current assets:		
Cash and cash equivalents (Note 2)	\$ 10,381,734	\$ 10,289,986
Cash held as collateral (Note 2)	228,793,959	133,254,399
Accounts receivable	34,738,207	36,195,079
Instant ticket inventory (Note 4)	4,357,745	3,545,374
Deferred expenses	2,353,994	1,295,929
Short-term investments (Note 2)	57,281,492	57,151,454
Total current assets	337,907,131	241,732,221
Noncurrent assets:		
Investments (Note 2)	364,439,461	392,542,511
Fixed assets: (Note 3)		
Furniture, fixtures and equipment	42,802,825	40,540,734
Less: Accumulated depreciation	(25,381,239)	(19,690,602)
Net fixed assets	17,421,586	20,850,132
Total noncurrent assets	381,861,047	413,392,643
Total assets	719,768,178	655,124,864
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable	9,695,425	12,382,078
Due to the Lottery Proceeds Fund (Note 5)	100,774	2,719
Compensated absences (Note 8)	780,770	731,392
Obligations under securities lending (Note 2)	228,793,959	133,254,399
Prizes payable: (Note 6)		
Jackpot prizes payable	57,281,492	57,151,454
Other	45,286,885	43,204,831
Deferred revenue	3,027,582	2,833,874
Installment notes payable (Note 7)	2,822,180	2,701,495
Total current liabilities	347,789,067	252,262,242
Long-term liabilities:		
Installment notes payable (Note 7)	6,643,952	9,466,132
Jackpot prizes payable (Note 6)	364,439,461	392,542,511
Compensated absences (Note 8)	895,698	853,979
Total liabilities	719,768,178	655,124,864
Net assets:		
Invested in capital assets, net of related debt	7,955,454	8,682,504
Unrestricted	(7,955,454)	(8,682,504)
Total net assets	\$ -	\$ -

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 the Years Ended June 30, 2003 and 2002

	2003	2002
Operating revenues:		
Ticket sales	\$ 1,135,729,104	\$ 1,108,067,712
Less:		
Prize expense	638,175,549	613,729,867
Retailer compensation	63,005,680	62,240,342
Instant ticket printing	8,009,561	6,997,063
Gross margin	426,538,314	425,100,440
Operating expenses:		
Advertising and promotion	18,828,296	21,159,033
General and administration	35,388,741	40,689,065
Depreciation	6,545,950	5,861,378
Total operating expenses	60,762,987	67,709,476
Income from operations	365,775,327	357,390,964
Non-operating revenue (expenses):		
Interest income	8,654,703	9,592,873
Interest expense	(481,040)	(491,268)
Other income	1,251,784	1,200,814
Total non-operating income	9,425,447	10,302,419
Net income	375,200,774	367,693,383
Transfer to the Lottery Proceeds Fund	(375,100,000)	(367,690,664)
Available for transfer to the Lottery Proceeds Fund	(100,774)	(2,719)
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 the Years Ended June 30, 2003 and 2002

	2003	2002
Cash flows from operating activities:		
Cash received from ticket sales	\$1,137,379,684	\$1,104,895,132
Cash payments for prizes	(695,059,495)	(672,841,276)
Discounts for retailer compensation	(63,005,680)	(62,240,342)
Cash payments to supplier of instant tickets	(8,821,932)	(7,444,714)
Cash payments to suppliers of other goods and services	(27,242,009)	(30,111,504)
Cash payments to employees for services	(18,324,066)	(19,226,818)
Cash payments to the Literary Fund for unclaimed prizes (Note 10)	(12,304,583)	(9,195,847)
Net cash provided by operating activities	312,621,919	303,834,631
Cash flows from noncapital financing activities:		
Proceeds from other income	1,251,784	1,200,814
Transfers to the Lottery Proceeds Fund	(375,102,719)	(367,251,204)
Net cash used by noncapital financing activities	(373,850,935)	(366,050,390)
Cash flows from capital and related financing activities:		
Acquisition of capital assets	(3,117,404)	(2,239,183)
Principal payments on installment notes	(2,701,495)	(2,080,373)
Interest payment on installment notes	(481,040)	(491,268)
Net cash used for capital and related financing activities	(6,299,939)	(4,810,824)
Cash flows from investing activities:		
Purchase of investment securities	-	(13,348,392)
Proceeds from maturing securities	58,966,000	57,653,000
Interest proceeds from cash balances	8,654,703	9,592,873
Net cash provided by investing activities	67,620,703	53,897,481
Net increase (decrease) in cash and cash equivalents	91,748	(13,129,102)
Cash and cash equivalents at July 1	10,289,986	23,419,088
Cash and cash equivalents at June 30	\$10,381,734	\$10,289,986
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	\$365,775,327	\$357,390,964
Adjustments to reconcile operating income to net cash:		
Depreciation	6,545,950	5,861,378
Accreted interest on investment securities	(30,992,988)	(32,355,661)
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable	1,456,872	(3,605,228)
(Increase) in instant ticket inventory	(812,371)	(447,651)
Decrease (increase) in deferred expenses	(1,058,065)	188,085
Increase (decrease) in accounts payable	(2,686,653)	3,072,840
Increase (decrease) in current prizes payable	2,212,092	(14,023,736)
Increase in deferred revenue	193,708	432,648
Increase in accrued compensated absences	91,097	53,004
(Decrease) in noncurrent prizes payable	(28,103,050)	(12,732,012)
Net cash provided by operating activities	\$312,621,919	\$303,834,631
Noncash Capital Financing Activity:		
Upgrade of new on-line terminals, purchased through the Master Equipment Leasing Program, equipment valued at \$14,248,000.		

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, 2003 AND 2002

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, 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.

Private-sector standards of accounting and financial reporting issued prior to December 1, 1989, generally are followed in proprietary fund financial statements to the extent that those standards do not conflict with or contradict guidance of the Governmental Accounting Standards Board. Governments also have the option of following subsequent private-sector guidance for their enterprise funds, subject to this same limitation. The Lottery has elected not to follow subsequent private sector guidance.

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 consist of furniture, fixtures, and equipment and are capitalized and depreciated on a straight-line basis over their useful lives, which is between three to five years. 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.

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 2.2-4506 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, 2003, the market value of investment account securities on loan was \$223,353,701 secured by \$228,104,103 in cash deposits, and \$125,161,836 secured by \$127,665,073 in market value securities that cannot be pledged or loaned. For the year ended June 30, 2002, the market value of investment account securities on loan was \$130,585,252 secured by \$132,690,304 in cash deposits, and \$218,721,256 secured by \$223,095,681 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, 2003				
	Category		Carrying Amount	Market Value
	1	3		
Cash and Cash Equivalents:				
Cash on deposit	\$ (380,104)	\$ -	\$ (380,104)	\$ (380,104)
Repurchase agreements	-	2,499,468	2,499,468	2,499,468
Cash with Treasurer of Virginia	-	-	8,257,810	8,257,810
Petty cash	-	-	4,560	4,560
Total cash and cash equivalents	<u>\$ (380,104)</u>	<u>\$ 2,499,468</u>	<u>\$ 10,381,734</u>	<u>\$ 10,381,734</u>
Cash held as collateral:				
Lottery securities lending	\$ -	\$ -	\$ 228,104,103	\$ 228,104,103
Treasury securities lending	-	-	689,856	689,856
Total cash collateral	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 228,793,959</u>	<u>\$ 228,793,959</u>
Investments:				
U. S. Government Securities	<u>\$421,720,953</u>	<u>\$ -</u>	<u>\$421,720,953</u>	<u>\$510,466,815</u>

During the fiscal year 2003 audit, it was determined that the Lottery's fiscal year 2002 securities lending transactions were reported at market value rather than at the value of cash collateral held, as required by *Governmental Accounting Standards Board No. 28, Accounting and Financial Reporting for Securities Lending Transactions*. Securities held as collateral is a Statement of Net Assets only transaction and is disclosed in the notes to the financial statements, both of which have been restated to reflect the proper valuation.

At June 30, 2002				
	Category		Carrying Amount	Market Value
	1	3		
Cash and Cash Equivalents:				
Cash on deposit	\$ 519,352	\$ -	\$ 519,352	\$ 519,352
Repurchase agreements	-	3,698,102	3,698,102	3,698,102
Cash with Treasurer of Virginia	-	-	6,067,972	6,067,972
Petty cash	-	-	4,560	4,560
Total cash and cash equivalents	<u>\$ 519,352</u>	<u>\$ 3,698,102</u>	<u>\$ 10,289,986</u>	<u>\$ 10,289,986</u>
Cash held as collateral:				
Lottery securities lending	\$ -	\$ -	\$ 132,690,304	\$ 130,585,252
Treasury securities lending	-	-	564,095	564,095
Total cash collateral	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 133,254,399</u>	<u>\$ 131,149,347</u>
Investments				
U. S. Government Securities	<u>\$449,693,965</u>	<u>\$ -</u>	<u>\$449,693,965</u>	<u>\$509,095,094</u>

3. FIXED ASSETS

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

	Balance as of <u>July 1, 2002</u>	<u>Additions</u>	<u>Reductions</u>	Balance as of <u>June 30, 2003</u>
Furniture, fixtures and equipment	\$40,540,734	\$ 3,133,583	\$ 871,492	\$ 42,802,825
Less: Accumulated depreciation	<u>19,690,602</u>	<u>6,545,950</u>	<u>855,313</u>	<u>25,381,239</u>
Net fixed assets	<u>\$20,850,132</u>	<u>\$ (3,412,367)</u>	<u>\$ 16,179</u>	<u>\$ 17,421,586</u>

	Balance as of <u>July 1, 2001</u>	<u>Additions</u>	<u>Reductions</u>	Balance as of <u>June 30, 2002</u>
Furniture, fixtures and equipment	\$55,422,399	\$ 5,910,243	\$ 20,791,908	\$ 40,540,734
Less: Accumulated depreciation	<u>33,799,672</u>	<u>5,861,378</u>	<u>19,970,448</u>	<u>19,690,602</u>
Net fixed assets	<u>\$21,622,727</u>	<u>\$ 48,865</u>	<u>\$ 821,460</u>	<u>\$ 20,850,132</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 TO THE LOTTERY PROCEEDS FUND

The amount due to the Lottery Proceeds Fund represents Virginia Lottery net income payable to the Commonwealth of Virginia's General Fund in accordance with Section 3-1.01(G) of Chapter 1042, 2003 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.

	Year Ended <u>June 30, 2003</u>	Year Ended <u>June 30, 2002</u>
Net Income	\$375,200,774	\$ 367,693,383
Less:		
Transfer of net income through June 30	<u>375,100,000</u>	<u>367,690,664</u>
Balance due to the Lottery Proceeds Fund	<u>\$ (100,774)</u>	<u>\$ (2,719)</u>

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.

	Year Ended June 30, 2003			Year Ended June 30, 2002
	Jackpot	For Life	Total	Total
Jackpot Prizes Payable:				
Due within one year	\$ 56,137,220	\$ 1,144,272	\$ 57,281,492	\$ 57,151,454
Due in subsequent years	<u>350,954,534</u>	<u>13,484,927</u>	<u>364,439,461</u>	<u>392,542,511</u>
Total (present value)	407,091,754	14,629,199	421,720,953	449,693,965
Add: Interest to maturity	<u>173,721,245</u>	<u>14,276,802</u>	<u>187,998,047</u>	<u>218,991,035</u>
Jackpot prizes payable at maturity	<u>\$580,812,999</u>	<u>\$28,906,001</u>	<u>\$ 609,719,000</u>	<u>\$ 668,685,000</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.

The following schedule presents the changes in prizes payable. Prizes payable increase when jackpot winners select the annuity option. Prizes payable decrease as the result of the net effect of securities maturing to pay prior jackpot winners and accrued interest. In fiscal year 2003, all jackpot winners selected the cash option, therefore there were no increases in prizes payable.

Balance as of July 1, 2001	Increases	Decreases	Balance as of June 30, 2002	Increases	Decreases	Balance as of June 30, 2003
<u>\$461,642,912</u>	<u>\$13,348,392</u>	<u>\$25,297,339</u>	<u>\$449,693,965</u>	<u>\$ -</u>	<u>\$27,973,012</u>	<u>\$421,720,953</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% to 4.483%. The operating leases are for regional offices and instant validation equipment (SciScan). Original book value of equipment capitalized under installment purchase agreements totals \$14,248,000 at June 30,

2003 and June 30, 2002. Expenses under operating lease agreements were \$3,116,919 and \$5,408,020 as of June 30, 2003 and 2002, respectively. A summary of future obligations under these agreements as of June 30, 2003 follows:

Year Ending June 30,	Operating Lease Obligation	Principal	Installment Purchase Interest	Obligations
2004	\$1,812,855	\$ 2,822,180	\$ 355,670	\$ 3,177,850
2005	276,130	2,948,268	229,582	3,177,850
2006	284,368	3,080,004	97,846	3,177,850
2007	292,854	615,680	13,238	628,918
2008	<u>69,494</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total commitments and gross minimum payments	<u>\$2,735,701</u>	<u>\$ 9,466,132</u>	<u>\$696,336</u>	<u>\$10,162,468</u>

The following schedule presents the changes in installment purchases.

Balance as of July 1, 2001	Increases	Decreases	Balance as of June 30, 2002	Increases	Decreases	Balance as of June 30, 2003
<u>\$11,398,400</u>	<u>\$2,849,600</u>	<u>\$2,080,373</u>	<u>\$12,167,627</u>	<u>\$ -</u>	<u>\$2,701,494</u>	<u>\$9,466,133</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, 2003 and 2002. 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, 2001	Increases	Decreases	Balance as of June 30, 2002	Increases	Decreases	Balance as of June 30, 2003
<u>\$1,532,367</u>	<u>\$858,717</u>	<u>\$805,713</u>	<u>\$1,585,371</u>	<u>\$920,315</u>	<u>\$829,218</u>	<u>\$1,676,468</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 1042, 2003 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, 2003 and 2002.

10. LITERARY FUND AND SETOFF DEBT COLLECTION PAYMENTS

Prizes unclaimed after 180 days are paid to the Literary Fund of the Commonwealth. Payments totaled \$12,304,583 and \$9,195,847 for the years ended June 30, 2003 and 2002, 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. Payments totaled \$675,355 and \$685,426 for the years ended June 30, 2003 and 2002, respectively. 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.

STATE LOTTERY DEPARTMENT
Richmond, Virginia

STATE LOTTERY BOARD
As of June 30, 3003

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