



**VIRGINIA LOTTERY  
RICHMOND, VA**

ANNUAL FINANCIAL REPORT  
FOR THE YEAR ENDED  
JUNE 30, 2005

## **AUDIT SUMMARY**

Our audit of the State Lottery Department for the year ended June 30, 2005, 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 State Lottery Department's (Virginia Lottery) Management's 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 Virginia 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 Virginia 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 \$1.334 billion for FY 2005, the highest total ever for Virginia Lottery sales in Virginia. Net proceeds totaling \$423.5 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 \$71.6 million (six percent) over last year to a record \$1.334 billion.
- Net income was a record \$423.5 million, an increase of \$15.5 million (four percent) from 2004.
- Prize expense increased by \$54.3 million (eight percent) to a record \$774.6 million. Prize expense increases directly with increased sales. Prizes increased at a higher rate than sales because the on-line prize expense rate, which varies with the luck of the draw, was up nearly two percent. In particular, the prize expense rate for Pick 3, a twice-daily drawing game, was 53.4 percent compared to last year's rate of 47.6 percent.
- Retailers earned \$5 million (seven percent) more in 2005 with compensation totaling a record \$75.6 million. Retailers earned, on average, 5.7 cents on each dollar sold, a record compensation rate.
- Although, by law, the Lottery may spend up to ten percent of sales on operating costs, which includes all expenses except prizes and retailer compensation, these costs were only five percent of sales and exceeded the old record of 5.4 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 Virginia Lottery's net assets and their changes. By law, the Virginia 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 Virginia 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 Virginia 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

<u>Statement of Net Assets</u>			
	<u>2005</u>	<u>2004</u>	<u>Change</u>
Assets:			
Current assets	\$448.65	\$411.05	\$ 37.60
Investments	316.90	340.55	(23.65)
Fixed assets, net of accumulated depreciation	<u>7.15</u>	<u>11.91</u>	<u>(4.76)</u>
Total assets	<u>772.70</u>	<u>763.51</u>	<u>9.19</u>
Liabilities:			
Current liabilities	453.99	418.38	35.61
Long-term liabilities	<u>318.71</u>	<u>345.13</u>	<u>(26.42)</u>
Total liabilities	<u>772.70</u>	<u>763.51</u>	<u>9.19</u>
Net assets:			
Invested in capital assets	3.48	5.26	(1.78)
Unreserved	<u>(3.48)</u>	<u>(5.26)</u>	<u>1.78</u>
Total net assets	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

\* in millions

The increase of \$9.19 million in assets and liabilities is mostly attributable to the change in securities lending collateral. According to Governmental Accounting Standards Board (GASB) Statement 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, 2004, \$282.4 million (market value) of the investment account securities on loan was secured in cash deposits. At June 30, 2005, \$332.6 million of the investment account securities on loan was secured in cash deposits.

Investments, both 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 current-year jackpot winners chose to take a one-time cash payment rather than the annuity payments, causing these balances to decline as the continued payments to previous winners outpaced the increase in investments for new winners.

There was no major capital asset activity in FY 2005. In FY's 2001 and 2002, the Virginia Lottery obtained new on-line terminals (ISYS) through a five-year installment purchase agreement. The original book value of equipment capitalized under this agreement totaled \$14,248,000. Footnotes 3 and 7 in the financial statements provide more detailed information regarding capital assets and long-term debt activity.

The Virginia Lottery had to borrow \$15 million from its line of credit with the Commonwealth of Virginia. At year end, the Virginia Lottery is required to transfer all net income to the Commonwealth. This results in a short-term cash flow shortage at the beginning of the new fiscal year. The \$15 million loan payable was repaid on July 15, 2005.

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

Table 2

Statement of Revenues, Expenses, and Changes in Net Assets

	<u>2005</u>	<u>2004</u>	<u>Change</u>
Sales	\$1,333.95	\$1,262.35	5.7%
Prizes	(774.56)	(720.21)	7.6%
Retailer compensation	(75.63)	(70.65)	7.0%
Ticket printing and services	(9.35)	(9.51)	(1.7)%
Operating expenses	<u>(56.66)</u>	<u>(58.57)</u>	<u>(3.3)%</u>
Income from operations	417.75	403.41	3.9%
Nonoperating revenue and expenses	<u>5.77</u>	<u>4.64</u>	<u>24.1%</u>
Net income	<u>\$ 423.52</u>	<u>\$ 408.05</u>	<u>3.8%</u>

\* in millions

Sales

Virginia Lottery products fall into two major categories: scratch games and on-line games. Scratch games are games in which players scratch off tickets to see whether they have won and include \$1, \$2, \$5, and \$10 games. On-line games are games for which players buy tickets that are issued by a lottery terminal. The winning numbers are drawn randomly by the Virginia Lottery and include Pick 3, Pick 4, Cash 5, Lotto South, and Mega Millions. California joined Mega Millions on June 22, 2005, joining the other member states: Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, and Washington.

Table 3

	<u>Sales</u>		
	<u>2005</u>	<u>2004</u>	<u>Change</u>
Scratch sales	\$ 679.55	\$ 630.93	7.7 %
On-line sales:			
Pick 3	253.22	241.43	4.9 %
Pick 4	169.18	156.93	7.8 %
Cash 5	28.11	28.04	0.3 %
Lotto South	66.69	73.00	(8.6)%
Mega Millions	<u>137.18</u>	<u>132.03</u>	<u>3.9 %</u>
Total on-line sales	<u>654.38</u>	<u>631.43</u>	<u>3.6 %</u>
Total sales	<u>\$1,333.95</u>	<u>\$1,262.36</u>	<u>5.7%</u>

\* in millions

Table 3 compares sales for each lottery game for FYs 2004 and 2005. Total sales revenue for FY 2005 broke the prior sales record set in FY 2004. 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. This category grew by 5.6 percent over the prior year. This growth continues to be significant because FY 2005 continues a growth trend started in FY 2002 after several years of flat sales for this product line.

Lotto South sales (five percent of total sales) were down \$6.3 million over the prior year. Sales in this product are dependent on the amount of the advertised jackpot. Lotto South experienced more jackpot winners than statistically expected in FY 2005, meaning that players had lower than expected jackpots. Virginia sold 7 of the 15 Lotto South jackpot winning tickets sold among the three member states (Georgia, Kentucky, and Virginia) in FY 2005.

Mega Millions sales (ten percent of total sales) were up \$5.2 million over last year due to more favorable jackpot rolls in FY 2005. This product is a lotto style 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 FY 2005, there were 11 separate jackpot winners. Virginia had no Mega Millions jackpot winners in FY 2005.

Scratch game sales (51 percent of total sales) continue along a strong growth trend, up \$48.6 million from FY 2004 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 improvements in distribution to retail locations.

#### Expenses

A summary of Virginia Lottery expenses for fiscal years ending June 30, 2004 and 2005 is shown in Table 4.

Table 4

	<u>Expenses</u>					
	<u>2005</u>		<u>2004</u>		<u>Change</u>	
Prize expense	\$774.56	84.5%	\$720.21	83.9%	\$54.35	7.6 %
Retailer compensation	75.63	8.3%	70.65	8.2%	4.98	7.0 %
Operating expenses	56.66	6.2%	58.57	6.8%	(1.91)	(3.3)%
Scratch ticket printing	<u>9.35</u>	<u>1.0%</u>	<u>9.51</u>	<u>1.1%</u>	<u>(.16)</u>	<u>(1.7)%</u>
Total	<u>\$916.20</u>	<u>100.0%</u>	<u>\$858.94</u>	<u>100.0%</u>	<u>\$57.26</u>	<u>6.7 %</u>

\* in millions

Prizes are the largest expense for the Virginia Lottery and vary with sales fluctuations and player luck. The FY 2005 prize payout rate (percent of sales paid out in prizes) was 58.1 percent, one percent higher than FY 2004. The total prize dollars paid increased because of the higher sales, higher overall payout rates for the daily games and for Pick 3 in particular, and a higher payout rate for the Lotto South game due to the low investment bond yields and, therefore, increased costs to fund advertised jackpots.

The change in retailer compensation was due to the commission earned on the additional \$71.6 million in sales and increased participation in retailer incentive programs. Total retailer compensation was in line with the expected 5.7 percent of total sales. In FY 2005, both total retailer compensation dollars and the retailer compensation rate set new Virginia Lottery records.

Scratch ticket printing and services costs decreased, although sales of this product increased. In June 2004, the Virginia Lottery entered into a new comprehensive services scratch ticket contract with Oberthur Gaming Technologies. Beginning in FY 2005, scratch ticket printing and related services, including warehouse and distribution services, were paid on a percentage of sales basis rather than the historical method of the Virginia Lottery purchasing scratch ticket inventory. FY 2005 was the first full year of this new contract and the expense shown in this category includes warehousing and distribution costs, while the FY 2004 figure reflects only the cost of ticket printing. In other words, it cost less to print, warehouse, and distribute \$680 million of scratch tickets in FY 2005 than it cost to only print \$631 million of scratch tickets in FY 2004.

Operating spending decreased 3.3 percent from 2004, 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 warehousing and distribution of scratch tickets. The privatization of this function through the new comprehensive services scratch ticket contract generated nearly \$1.9 million in savings.

#### Other Income

Table 5

	<u>Other Income</u>		
	<u>2005</u>	<u>2004</u>	<u>Change</u>
Interest income	\$4.6	\$4.0	16.0%
Net other income	<u>1.3</u>	<u>1.0</u>	<u>29.0%</u>
Total	<u>\$5.9</u>	<u>\$5.0</u>	<u>18.0%</u>

\* in millions



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 5 shows, interest income was up 16 percent in 2005. Even though the average annual composite earnings rate held steady in FY 2005 at 2.34 percent, the monthly earnings rate was higher in FY 2005 than FY 2004 during the last quarter of the fiscal year when cash balances were at their highest levels. The variability and timing of the monthly earnings rates yielded higher interest earnings in FY 2005.

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 FY 2005, other income was up nearly 29 percent, primarily due to increased securities lending income, clerk activation fees assessed when retailers' on-line sales did not sustain minimum required levels, and the sale and disposal of surplus equipment.

### Net Income

In FY 2005, the Virginia Lottery generated \$423.5 million in profits. As shown in Table 6, profits surpassed the prior record of \$408.1 million earned in FY 2004 by \$15.5 million (four percent). Estimated net income of \$423.5 million was transferred to the Commonwealth on June 30, just prior to year-end. The remaining residual income will be transferred during 2006.

Table 6

	<u>Net Income</u>					
	<u>2005</u>		<u>2004</u>		<u>Change</u>	
Net income	<u>\$423.52</u>	<u>31.7%</u>	<u>\$408.05</u>	<u>32.3%</u>	<u>\$15.47</u>	<u>(0.6)%</u>
*in millions						

### Statement of Cash Flows

The Statement of Cash Flows, summarized in Table 7, presents detailed information pertaining to the cash activity of the Virginia 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 Virginia Lottery. Receipts from the sale of tickets and related services totaled over \$1.34 billion. Uses of cash include payment of prizes to winners (\$857.4 million) and payments to retailers, suppliers, and employees for goods and services (\$129.4 million). The net cash provided by operating activities of \$357.9 million represents a two percent increase.

The cash flows from the noncapital financing activities portion of the statement reflects the \$407.6 million used for noncapital financing activities, the major portion being the \$423.8 million in total transfers from the Virginia Lottery during the year. This amount represents the initial estimate of FY 2005 Virginia Lottery profits transferred to the Lottery Proceeds Fund prior to July 1, 2005. The Virginia Lottery required a Treasury loan of \$15 million to meet its year-end cash transfer and to allow sufficient cash balances on-hand to continue short-term operations.

Cash flows from capital financing activities reflect the payment of principal and interest on a financing agreement for capital equipment (\$3.1 million), plus the net cost of capital assets acquired during the period (\$0.7 million). The \$55 million cash flows from investing activities reflect purchases of investments to fund win-for-life prizes due to Virginia Lottery winners (\$3.7 million) and Lotto South winners (\$5.5 million), proceeds from maturing investments previously purchased to fund Virginia Lottery prizes payable (\$60 million), and investment income on cash balances (\$4.6 million). The net increase in cash flows from activities totaled \$1.4 million.

Table 7

Statement of Cash Flows

	<u>2005</u>	<u>2004</u>	<u>Change</u>
Cash flows from:			
Operating activities	\$ 357.90	\$ 350.70	2.05 %
Noncapital financing activities	(407.60)	(406.80)	0.20 %
Capital financing activities	(3.90)	(3.65)	6.85 %
Investing activities	<u>55.00</u>	<u>57.07</u>	<u>(3.63)%</u>
Net change in cash	<u>\$ 1.40</u>	<u>\$ (2.68)</u>	<u>(152.24)%</u>
Ending cash and cash equivalents	<u>\$ 9.10</u>	<u>\$ 7.70</u>	<u>18.18 %</u>

\* in millions

Potentially Significant Factors Impacting Next Year

The full implementation of the comprehensive services scratch ticket contract with Oberthur Gaming Technologies will continue to yield operational savings for the Virginia Lottery, translating directly into additional profits for the Lottery Proceeds Fund. The Virginia Lottery also continues to evaluate the distribution of scratch tickets to retail outlets across Virginia for optimal sales revenue, ensuring sufficient inventory levels at retailer locations through favorable and equitable billing terms and improvements in store-level inventory management.

Sales of the Mega Millions product will also be sustained and enhanced through the game change implemented with the addition of California to the multi-state consortium. The odds of winning the jackpot prize were lengthened to reflect the additional player base and, as a result, jackpot amounts will grow more quickly and are expected to possibly reach new record levels. Although the odds of winning the jackpot are longer, players will experience higher non-jackpot prizes in the game. FY 2006 will be the first full year of sales with the game changes and the inclusion of California.

Finally, the North Carolina legislature continues to debate the creation a state-run lottery. Because North Carolina shares a significant border with Virginia, a portion of Virginia Lottery sales are to North Carolina residents. The decision regarding a lottery in North Carolina remains unknown as of the date of these statements. However, given the time required to start-up operations, any impact on Virginia Lottery sales in FY 2006 would be minimal.

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 any Virginia Lottery financial issue, please contact the Director of Finance at the Virginia Lottery, 900 East Main Street, Richmond, Virginia 23219.

STATE LOTTERY DEPARTMENT  
STATEMENT OF NET ASSETS  
For Fiscal Year Ended June 30, 2005 with Comparative Information for 2004

	2005	2004
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents (Note 2 )	\$ 9,144,171	\$ 7,696,761
Cash held as collateral (Note 2)	332,572,314	282,432,968
Accounts receivable	46,283,148	57,944,471
Instant ticket inventory (Note 4 )	316,971	3,594,998
Deferred expenses	2,184,896	1,737,285
Short-term investments (Note 2 )	58,144,156	57,646,124
Total current assets	448,645,656	411,052,607
Investments (Note 2 )	316,896,717	340,549,132
Fixed assets: (Note 3)		
Furniture, fixtures, and equipment	38,884,768	42,729,802
Less: Accumulated depreciation	(31,729,673)	(30,823,091)
Net fixed assets	7,155,095	11,906,711
Total assets	772,697,468	763,508,450
<b>LIABILITIES</b>		
Current liabilities:		
Accounts payable	6,030,741	11,408,322
Treasury loan (Note 9)	15,000,000	-
Due to the Lottery Proceeds Fund (Note 5 )	21,322	351,586
Compensated absences (Note 8)	317,859	642,099
Obligations under securities lending (Note 2)	332,572,314	282,432,968
Prizes payable: (Note 6 )		
Jackpot prizes payable	58,144,156	57,646,124
Other	35,537,009	58,774,117
Deferred revenue	3,304,910	4,172,611
Installment notes payable (Note 7)	3,062,343	2,948,268
Total current liabilities	453,990,654	418,376,095
Long-term liabilities:		
Installment notes payable (Note 7 )	610,389	3,695,685
Jackpot prizes payable (Note 6 )	316,896,717	340,549,132
Compensated absences (Note 8 )	1,199,708	887,538
Total long-term liabilities	318,706,814	345,132,355
Total liabilities	772,697,468	763,508,450
<b>NET ASSETS</b>		
Net assets:		
Invested in capital assets, net of related debt	3,482,363	5,262,758
Unrestricted	(3,482,363)	(5,262,758)
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 Fiscal Year Ended June 30, 2005 with Comparative Information for 2004

	2005	2004
Operating revenues:		
Ticket sales	\$ 1,333,946,125	\$ 1,262,358,367
Less:		
Prize expense	774,558,373	720,214,601
Retailer compensation	75,625,797	70,654,708
Instant ticket printing and services	9,348,274	9,510,249
Gross margin	474,413,681	461,978,809
Operating expenses:		
Advertising and promotion	21,511,136	18,988,122
General and administration	29,660,099	33,599,414
Depreciation	5,489,180	5,986,603
Total operating expenses	56,660,415	58,574,139
Income from operations	417,753,266	403,404,670
Nonoperating revenue/(expenses):		
Interest income	4,641,672	4,005,359
Interest expense	(163,538)	(355,671)
Other income	1,289,922	997,228
Total nonoperating income	5,768,056	4,646,916
Net income	423,521,322	408,051,586
Transfer to the Lottery Proceeds Fund	(423,500,000)	(407,700,000)
Available for transfer from/(to) the Lottery Proceeds Fund	(21,322)	(351,586)
Net assets at July 1	-	-
Net assets at 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, 2005 with Comparative Information for 2004

	2005	2004
Cash flows from operating activities:		
Cash received from ticket sales	\$1,344,739,747	\$1,240,297,132
Cash payments for prizes	(848,144,725)	(759,788,459)
Discounts for retailer compensation	(75,625,797)	(70,654,708)
Cash payments to supplier of instant tickets	(6,070,247)	(8,747,502)
Cash payments to suppliers of other goods and services	(29,241,392)	(17,554,452)
Cash payments to employees for services	(18,457,189)	(19,815,327)
Cash payments to the Literary Fund for unclaimed prizes (Note 10)	(9,309,916)	(13,034,982)
Net cash provided by operating activities	357,890,481	350,701,702
Cash flows from noncapital financing activities:		
Proceeds from other income	1,289,922	997,228
Proceeds from Treasury Loan	15,000,000	-
Transfers to the Lottery Proceeds Fund	(423,851,586)	(407,800,774)
Net cash used by noncapital financing activities	(407,561,664)	(406,803,546)
Cash flows from capital financing activities:		
Acquisition of capital assets	(769,225)	(471,728)
Disposal of capital assets	31,661	-
Principal payments on installment notes	(2,971,221)	(2,822,179)
Interest payment on installment notes	(163,538)	(355,671)
Net cash used for capital financing activities	(3,872,323)	(3,649,578)
Cash flows from investing activities:		
Purchase of investment securities	(9,197,758)	(6,862,150)
Sale of investment securities	42,002	471,240
Proceeds from maturing securities	59,505,000	59,452,000
Interest proceeds from cash balances	4,641,672	4,005,359
Net cash provided by investing activities	54,990,916	57,066,449
Net Increase/(decrease) in cash and cash equivalents	1,447,410	(2,684,973)
Cash and cash equivalents at July 1	7,696,761	10,381,734
Cash and cash equivalents at June 30	\$ 9,144,171	\$ 7,696,761

	2005	2004
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	\$ 417,753,266	\$ 403,404,670
Adjustments to reconcile operating income to net cash:		
Depreciation	5,489,180	5,986,603
Accreted interest on investment securities	(27,194,861)	(29,535,393)
Changes in assets and liabilities:		
Decrease/(Increase) in accounts receivable	11,661,323	(23,206,264)
Decrease in instant ticket inventory	3,278,027	762,747
(Increase)/Decrease in deferred expenses	(447,611)	616,709
Increase/(Decrease) in accounts payable	(5,377,581)	1,712,896
Increase/(Decrease) in current prizes payable	(22,739,076)	13,851,864
Increase/(Decrease) in deferred revenue	(867,701)	1,145,029
(Decrease) in accrued compensated absences	(12,070)	(146,830)
(Decrease) in noncurrent prizes payable	(23,652,415)	(23,890,329)
Net cash provided by operating activities	<u>\$ 357,890,481</u>	<u>\$ 350,701,702</u>

The accompanying Notes to Financial Statements are an integral part of this statement.

STATE LOTTERY DEPARTMENT  
NOTES TO FINANCIAL STATEMENTS

AS OF JUNE 30, 2005

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 Georgia, Kentucky, and Virginia. Mega Millions member lotteries include California, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, 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. Effective July 1, 2004, instant ticket revenue is recognized when tickets are activated for sale by retailers to the public. As a result of this change, the Virginia Lottery eliminated its allowance for instant ticket returns.

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 Governmental Accounting Standards Board (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 Virginia 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 Virginia 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, both 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 and are valued at historical 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.

G. Contractor Fees

The Virginia Lottery has contracted with Oberthur Gaming Technologies (OGT) for the printing and distribution of instant tickets. OGT receives a fee of 1.1325 percent of the retail value of net tickets distributed and then activated by retailers. For distribution of instant ticket inventory purchased prior to the new contract, OGT will be paid 0.3 percent of the retail value of net tickets distributed and then activated by retailers.

H. Adoption of New Accounting Principle

For the year ended June 30, 2005, the Virginia Lottery has implemented GASB Statement 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement 3.

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 GASB Statement 40. 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 this 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. For June 30, 2005, the total cash and cash equivalents equaled \$9,144,171. This included cash held overnight for repurchase agreements totaling \$2,866,231 and petty cash on hand of \$3,140.

### 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 the State Treasurer and the Virginia Lottery's investment policy, funds are invested in U.S Treasury obligations for the purpose of payment of deferred prizes to winners. These investments held for future prize payments are available for lending to broker-dealers and other entities (borrowers) for cash collateral that will be returned for the same securities in the future. Cash balances not managed by the Treasurer of Virginia are invested overnight under a Repurchase Agreement, whereby the Lottery purchases an interest in securities that are direct obligations of, or fully guaranteed as to principal and interest by, the U.S. government. These interests are repurchased by the custodial bank at the opening of the following banking day.

Custodial Credit Risk - Custodial credit risk is the risk that, in the event of the failure of the counterparty, the state and Virginia Lottery will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. 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.

Repurchase agreements (overnight investments) held in the Virginia Lottery name, are not insured or guaranteed by the U.S. government, the Federal Deposit Insurance Corporation, or any other government agency and involve investment risk, including loss of principal. Under the repurchase agreement with Bank of America, Bank of America agrees to sell to the Virginia Lottery an interest in securities that are direct obligations of, or fully guaranteed as to principal and interest by, the U.S. government. When the transactions occur, the sweep occurs in the name of the Virginia Lottery and the investment is collateralized.

Interest Rate Risk - Interest rate risk is the risk that investment's fair value decreases as market interest rates increase. The investments in prize annuities are subject to fluctuations in fair value due to interest rate risk, but these bonds are held to maturity to satisfy annual installment obligations to the prize winners. The fair value at maturity is the face value of the bonds, regardless of the fluctuations in the value during the time period that the investments are outstanding.

In accordance with GASB Statement 28, balances for “Cash held as collateral” and “Obligations under securities lending,” reflect the recommended reporting. For the year ended June 30, 2005, the market value of investment account securities on loan was \$326,662,712 secured by \$330,703,032 in cash deposits and \$62,857,840 secured by \$64,114,996 in market value securities that cannot be pledged or loaned.

Cash held as collateral from treasury security lending represents the Virginia Lottery’s share of cash collateral received on security lending transactions associated with their investment of Virginia Lottery cash held in the General Account of the Commonwealth. For the year ended June 30, 2005, treasury security lending balances were \$1,869,282. 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.

Investments and repurchase agreements consist of the following:

	<u>Credit Rating</u>			
	<u>Unrated</u>	<u>AAA</u>	<u>A-1+</u>	<u>A-1</u>
Bank of America:				
Repurchase agreements <sup>(1)</sup>	\$ 2,866,231	\$ -	\$ -	\$ -
Prize annuities:				
Treasury bonds <sup>(2)</sup>	375,040,873	-	-	-
Securities lending:				
Master note	-	-	39,500,000	5,000,000
Certificate of deposit	-	-	24,996,363	-
Corporate bond	-	-	17,006,325	35,000,000
Commerical paper	-	-	19,998,111	4,962,125
Asset-backed	3,000,000	25,374,366	7,000,000	-
Repurchase agreements	20,000,000	-	48,035,742	60,000,000
Bank note	-	-	20,830,000	-
Total	<u>\$400,907,104</u>	<u>\$25,374,366</u>	<u>\$177,366,541</u>	<u>\$104,962,125</u>

	<u>Investment Securities</u>				
	<u>Less than 1 year</u>	<u>1-5 years</u>	<u>6-10 years</u>	<u>11-20 years</u>	<u>21-30 years</u>
Bank of America:					
Repurchase agreements <sup>(1)</sup>	\$ 2,866,231	\$ -	\$ -	\$ -	\$ -
Prize annuities:					
Treasury bonds <sup>(2)</sup>	58,144,156	-	-	-	-
Securities lending:					
Master note	44,500,000				
Certificate of deposit	24,996,363				
Corporate bond	52,006,325	-	-	-	-
Commercial paper	24,960,236	-	-	-	-
Asset-backed	35,374,366	-	-	-	-
Repurchase agreements	128,035,742	-	-	-	-
Bank note	20,830,000	-	-	-	-
Total	<u>\$391,713,419</u>	<u>\$224,784,077</u>	<u>\$72,445,863</u>	<u>\$14,786,231</u>	<u>\$4,880,546</u>

\* Credit quality ratings obtained from Standard & Poor’s

<sup>(1)</sup> Repurchase agreements (overnight investments) held in the Virginia Lottery name, are not insured or guaranteed by the U.S. government, the Federal Deposit Insurance Corporation, or any other government agency and involve investment risk, including loss of principal. Under the repurchase agreement with Bank of America, Bank of America agrees to sell to the Virginia Lottery an interest in securities that are direct obligations of, or fully guaranteed as to principal and interest by, the U.S. government or agency thereof.

<sup>(2)</sup> Virginia Lottery prize investments 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. All investments are made through U.S. government and agency securities that are explicitly guaranteed by the U.S. government.

### 3. FIXED ASSETS

The following schedule presents the changes in fixed assets by category.

	Balance as of <u>July 1, 2004</u>	<u>Additions</u>	<u>Reductions</u>	Balance as of <u>June 30, 2005</u>
Furniture, fixtures, and equipment	\$42,729,802	\$ 769,225	\$4,614,259	\$38,884,768
Less: Accumulated depreciation	<u>30,823,091</u>	<u>5,489,180</u>	<u>4,582,598</u>	<u>31,729,673</u>
Net fixed assets	<u>\$11,906,711</u>	<u>\$(4,719,955)</u>	<u>\$ 31,661</u>	<u>\$ 7,155,095</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 activated by 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 951, 2005, 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, 2005, the net income was \$423,521,322, with a net income transfer through June 30 of \$423,500,000 and a balance due to the Lottery Proceeds Fund of \$21,322.

### 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 represents 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	\$ 56,445,980	\$ 1,698,176	\$ 58,144,156
Due in subsequent years	<u>294,570,861</u>	<u>22,325,856</u>	<u>316,896,717</u>
Total (present value)	351,016,841	24,024,032	375,040,873
Add: Interest to maturity	<u>123,865,159</u>	<u>22,321,968</u>	<u>146,187,127</u>
Jackpot prizes payable at maturity	<u>\$474,882,000</u>	<u>\$46,346,000</u>	<u>\$521,228,000</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.

The following schedule presents the changes in prizes payable.

<u>Balance as of July 1, 2004</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance as of June 30, 2005</u>
<u>\$398,195,256</u>	<u>\$9,197,758</u>	<u>\$32,352,141</u>	<u>\$375,040,873</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 new on-line terminals (ISYS). This is a five-year installment loan with interest rates ranging from 2.68 to 2.98 percent. The operating leases are for regional offices. Original book value of equipment capitalized under installment purchase agreements totaled \$14,248,000 at June 30, 2005. Expenses under operating lease agreements were \$1,636,493 as of June 30, 2005. A summary of future obligations under these agreements as of June 30, 2005, follows:

<u>Year Ending June 30,</u>	<u>Operating Lease Obligation</u>	<u>Installment Purchases</u>		
		<u>Principal</u>	<u>Interest</u>	<u>Obligation</u>
2006	\$1,296,199	\$3,062,342	\$63,798	\$3,126,140
2007	198,910	610,389	9,898	620,287
2008	115,889	-	-	-
2009	119,365	-	-	-
2010	<u>58,901</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total	<u>\$1,789,264</u>	<u>\$3,672,731</u>	<u>\$73,696</u>	<u>\$3,746,427</u>

The following schedule presents the changes in installment purchases.

<u>Balance as of July 1, 2004</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance as of June 30, 2005</u>
<u>\$6,643,953</u>	<u>\$ -</u>	<u>\$2,971,221</u>	<u>\$3,672,732</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 2005. Compensated absences were calculated in accordance with GASB Statement 16, *Accounting for Compensated Absences*. The amount reflects all earned leave payable under the Virginia Lottery'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.

<u>Balance as of July 1, 2004</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance as of June 30, 2005</u>	<u>Due Within One Year</u>
<u>\$1,529,637</u>	<u>\$900,924</u>	<u>\$912,994</u>	<u>\$1,517,567</u>	<u>\$317,859</u>

9. LINE OF CREDIT

The State Comptroller has provided the Virginia Lottery with a line of credit not to exceed \$25 million in accordance with Section 3-2.03 of Chapter 951, 2005, Acts of Assembly, to fund administrative and operating expenses in the event unreserved cash is insufficient to cover these short-term costs. There was a \$15 million loan payable under this arrangement as of June 30, 2005 that was repaid on July 15, 2005. 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 \$9,310,666 for the year ended June 30, 2005.

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 \$905,654 for the year ended June 30, 2005. 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 of, 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.

## 13. CONTINGENCIES

The Virginia Lottery is named as a party in a legal proceeding. It is not possible at the present time to estimate ultimate outcome or liability, if any, of the Virginia Lottery in respect to this proceeding; however, it is believed that any ultimate liability resulting from this lawsuit will not have a material, adverse effect on the financial condition of the Virginia Lottery.



# Commonwealth of Virginia

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

Walter J. Kucharski, Auditor

August 12, 2005

The Honorable Mark R. Warner  
Governor of Virginia

The Honorable Lacey E. Putney  
Chairman, Joint Legislative Audit  
and Review Commission

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

## INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying basic financial statements of **State Lottery Department** as of and for the year ended June 30, 2005, as listed in the Table of Contents. These financial statements are the responsibility of the State Lottery Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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 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 State Lottery 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 Commonwealth of Virginia's overall financial position as of June 30, 2005, and the changes in its financial position and its cash flows, where applicable, 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 State Lottery Department as of June 30, 2005, and the changes in its net assets and its cash flow for the year ended, in conformity with accounting principles generally accepted in the United States of America.

As disclosed in Note 1B to the financial statements, the Virginia Lottery changed their revenue recognition for instant ticket sales.

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

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

#### 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 an opinion 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 reportable 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 caused by error or fraud 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 control over financial reporting and its operation that we consider to be material weaknesses.

#### Compliance and Other Matters

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, contracts, and grant agreements, 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 or other matters that are required to be reported under Government Auditing Standards.

The "Independent Auditor's Report on Internal Control over Financial Reporting and on Compliance and Other Matters" 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 13, 2005.

AUDITOR OF PUBLIC ACCOUNTS

LCR/kva



STATE LOTTERY DEPARTMENT

STATE LOTTERY BOARD  
As of June 30, 2005

Paul J. Lanteigne  
Chairperson

Stuart C. Siegel  
Vice-Chairperson

Gilliam M. Cobbs, Sr.

Susan Smith Feaster

David E. Fife

Donna VanCleave  
Interim Director