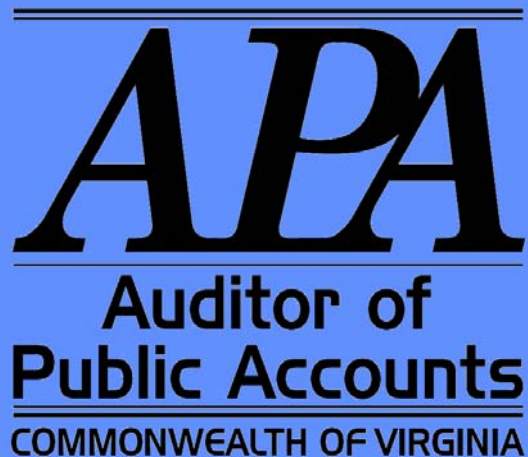


STATE LOTTERY DEPARTMENT

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2008**



AUDIT SUMMARY

Our audit of the State Lottery Department for the year ended June 30, 2008, found:

- the financial statements are presented fairly, in all material respects;
- two internal control matters that we consider to be significant deficiencies; however, we do not consider these matters to be a material weaknesses; and
- no instances of noncompliance required to be reported under Government Auditing Standards.

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INTERNAL CONTROL FINDINGS AND RECOMMENDATIONS

Review Investment Policies for Securities Lending

The State Lottery Department (Lottery) needs to review its investment policies and adopt policies for securities lending. Lottery participates in the Department of the Treasury's securities lending program and needs a means to ensure that Treasury understands and follows Lottery's investment goals.

We recommend Lottery and Treasury review the Lottery's participation in the securities lending program and adopt specific policies that will meet their investment goals. The review should address the issues of the amount of investment risk that the Lottery can assume given their investment goals and whether the Lottery needs to have separate policies on what types of re-investments are appropriate, including the maturity periods of the securities purchased with the cash collateral. In addition, the Lottery and Treasury need to discuss how to handle investment gains and losses and the impact of any future gains and losses on the Lottery's profit projections.

Strengthen Information Systems Security Program

Lottery has improved their Information Systems Security Program over the past year, but there are some key components that still require strengthening in order to be fully compliant with Commonwealth Security Standards and industry best practices:

- Lottery has documented a "Crisis Management and Business Recovery Plan," which identifies essential business functions; but has not updated the plan to reflect the outsourcing of the Department's main gaming system, nor has the Lottery completed the business impact analysis. The business impact analysis is the first step in the risk management process to identify, analyze, prioritize, and mitigate those risks that could compromise the Department's information technology (IT) systems.
- Also, in order to assess the adequacy and effectiveness of the Continuity of Operations and Disaster Recovery Plans, Lottery should minimally perform annual tests of the IT components that support their essential business functions. Such tests provide assurance that essential business functions can continue and staff can restore IT systems in the event of a disaster or disruption.
- It is essential that the Lottery document and maintain its security requirements through the development of policies that accurately reflect business operations and objectives. The Lottery enhances information security through the development and implementation of written policies and procedures that promote the confidentiality, integrity, and availability of the Lottery's data and IT systems.

Lottery should continue to strengthen their Information Systems Security Program by developing and documenting policies that secure IT systems commensurate to the level of risk and sensitivity of the data being stored within those systems. In addition, Lottery management should prioritize and dedicate the resources necessary to support the acceptance and implementation of these policies.

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 of Virginia (Commonwealth) each year in accordance with requirements in the Appropriations 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 \$1.386 billion for fiscal year 2008, the highest total ever for Virginia Lottery sales. Net proceeds totaling \$455.3 million were earned for 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 \$24.1 million (1.77 percent) from last year to \$1.386 billion, a new record level.
- Net income was \$455.3 million, an increase of \$18.1 million (4.1 percent) from last year and established a new record for the highest ever Virginia Lottery profits in a fiscal year.
- Prize expense increased \$554 thousand (less than 1 percent) to a total of \$792.3 million, a new record level.
- Retailers earned \$1.26 million (1.7 percent) more in 2008, with compensation paid to retailers totaling a record \$77.7 million. Retailers earned, on average, 5.6 cents on each dollar sold.

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 5.3 percent of sales for the fiscal 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, 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 annualized 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>2008</u>	<u>2007</u>	<u>Change</u>
Assets:			
Current assets	\$401.13	\$444.53	\$(43.40)
Investments	269.99	254.35	15.64
Fixed assets, net of accumulated depreciation	<u>6.19</u>	<u>1.60</u>	<u>4.59</u>
Total assets	<u>677.31</u>	<u>700.48</u>	<u>(23.17)</u>
Liabilities:			
Current liabilities	406.48	445.46	(38.98)
Long-term liabilities	<u>270.83</u>	<u>255.02</u>	<u>15.81</u>
Total liabilities	<u>677.31</u>	<u>700.48</u>	<u>(23.17)</u>
Net assets:			
Invested in capital assets	6.19	1.60	4.59
Unreserved	<u>(6.19)</u>	<u>(1.60)</u>	<u>(4.59)</u>
Total net assets	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

* in millions

Current assets and liabilities decreased \$43.4 million and \$38.98 million respectively due to the change in cash held as collateral and obligations for the Lottery's Securities Lending. Investments increased \$15.64 million and consist of U.S. Treasury STRIPS purchased to fund individual jackpot and "For Life" prizes. Long-term liabilities increased \$15.81 million and consist

mainly of prize liabilities for prizes paid in installments over several years. Investments and long-term prize liability both increased because of a number of winners during the fiscal year chose to take the annuity payments for their grand prizes.

The increase in fixed assets reflects the Lottery's purchase of over \$5.6 million in new capital assets in fiscal year 2008. The Lottery acquired new self service equipment to support sales in retailer locations.

Since the Virginia Lottery transfers all net income to the Commonwealth 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>2008</u>	<u>2007</u>	<u>Change</u>
Sales	\$1,386.41	\$1,362.34	1.8%
Prizes	(792.33)	(791.78)	0.1%
Retailer compensation	(77.74)	(76.48)	1.7%
Ticket printing and gaming services	(15.60)	(8.50)	83.5%
Operating expenses	<u>(58.10)</u>	<u>(59.57)</u>	<u>2.5%</u>
Income from operations	442.64	426.01	3.9%
Non-operating revenue and expenses	<u>12.61</u>	<u>11.17</u>	<u>12.9%</u>
Net income	<u>\$ 455.25</u>	<u>\$ 437.18</u>	<u>4.1%</u>

* in millions

Sales

Virginia Lottery products fall into two major categories: scratch games and computer terminal (on-line) games. Scratch games are games in which players scratch off tickets to see whether they have won and include \$1, \$2, \$5, \$10 and \$20 games. Computer terminal games are games for which players buy tickets that are issued by a lottery terminal, for a chance to win prizes either instantly or from a future drawing. Computer terminal games include Pick 3, Pick 4, Cash 5, Win for Life, Mega Millions, Fast Play, and Raffle.

Table 3 compares sales for each lottery product for fiscal years 2008 and 2007. Total sales revenue for fiscal year 2008 was the highest ever, surpassing fiscal year 2006. Pick 4, Mega Millions and Raffle set individual sales records for those products.

Table 3

	<u>Sales</u>		
	<u>2008</u>	<u>2007</u>	<u>Change</u>
Scratch sales	\$ 694.90	\$ 698.27	(0.5) %
Computer terminal sales:			
Pick 3	256.60	265.40	(3.3) %
Pick 4	183.99	179.92	2.3 %
Cash 5	29.02	27.52	5.5%
Fast Play	9.23	13.01	(29.1)%
Raffle	8.80	6.60	33.3%
Win for Life	37.72	41.32	(8.7)%
Mega Millions	<u>166.15</u>	<u>130.30</u>	<u>27.5 %</u>
 Total computer terminal sales	 <u>691.51</u>	 <u>664.07</u>	 <u>4.1 %</u>
 Total sales	 <u>\$1,386.41</u>	 <u>\$1,362.34</u>	 <u>1.8 %</u>

* in millions

Scratch game sales (50.1 percent of total sales) were lower than fiscal year 2007 record levels. Growth in scratch game sales has leveled off, but this product line provides a variety of games with different themes and price points to appeal to many types of players.

Total daily game sales (Pick 3, Pick 4, and Cash 5) represent 33.8 percent of total product sales for the fiscal year, and declined \$3.2 million from the prior year.

Fast Play is an instant-win computer terminal product line that plays like a Scratch game. There were two games in this category during fiscal year 2008: Bingo and Dodge ball. Raffle is a \$20 computer terminal game with a limited offering of 440,000 tickets and four top prizes of \$1,000,000 each, along with various secondary prizes. The drawing for New Year's Raffle occurred December 31, 2007.

Win for Life sales (2.7 percent of total sales) were down \$3.6 million from the prior year. Win for Life has a top prize of \$1,000 a week, payable to the winner for the rest of his or her lifetime. Win for Life was designed to increase the number of grand prize winners. Virginia had nine of the thirteen top prize winners sold among the three member states (Georgia, Kentucky, and Virginia) in fiscal year 2008.

Mega Millions sales (12 percent of total sales) were up \$35.8 million over last year due to more favorable jackpot rolls in fiscal year 2008. This product is a multi-state 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 fiscal year 2008, there were eighteen separate jackpot winners. Twelve states sell Mega Millions tickets; Virginia had one Mega Millions jackpot winner in fiscal year 2008.

Expenses

Prizes are the largest expense for the Virginia Lottery and vary with sales fluctuations and player luck. The fiscal year 2008 prize payout rate (percent of sales paid out in prizes) was 57.2 percent, nearly one percent lower than fiscal year 2007. The total prize dollars paid to winners increased \$554,000.

A summary of Virginia Lottery expenses for fiscal years ending June 30, 2007 and 2008 is shown in Table 4.

Table 4

	<u>Expenses</u>					
	<u>2008</u>		<u>2007</u>		<u>Change</u>	
Prize expense	\$792.34	84.0%	\$791.78	84.6%	\$0.56	0.7%
Retailer						
compensation	77.74	8.2%	76.48	8.1%	1.26	1.7 %
Operating expenses	58.08	6.2%	59.57	6.3%	(1.49)	(2.5) %
Gaming Services	<u>15.60</u>	<u>1.6%</u>	<u>8.50</u>	<u>1.0%</u>	<u>7.10</u>	<u>83.5%</u>
Total	<u>\$943.76</u>	<u>100.0%</u>	<u>\$936.33</u>	<u>100.0%</u>	<u>\$7.43</u>	<u>.8 %</u>

* in millions

Retailer compensation increased as a result of increased sales and retailer bonus and incentive programs. The overall retailer compensation rate was the same as the prior year, 5.6 percent of total sales.

Gaming services costs increased, with the inception of a seven-year contract with GTECH Corporation for the operation of the gaming network. Under the contract, GTECH receives compensation as a percentage of net ticket sales.

Other Income

Table 5

	<u>Other Income</u>		
	<u>2008</u>	<u>2007</u>	<u>Change</u>
Interest income	\$ 9.5	\$10.2	(7.3%)
Net other income	<u>3.1</u>	<u>.9</u>	<u>230.0%</u>
Total	<u>\$12.6</u>	<u>\$11.1</u>	<u>12.9%</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, other income was up 12.9 percent in 2008. Interest income for 2008 had a negative variance of 7.3 percent due to the accelerated transfers of Lottery profits to the Lottery Proceeds Fund. Changes to the Appropriations

Act for fiscal year 2008 required the Lottery to transfer estimated profits throughout the fiscal year, compared to a one-time transfer at fiscal year end in fiscal year 2007 and previous years. These periodic transfers caused a reduction in the average cash balances available for investment and interest earnings

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. The most significant source of the increase in net other income was the increase in securities lending income, up \$1.6 million (231%) because the investment yield has been higher due to the higher relative LIBOR levels as compared to Fed Funds over the past twelve months. The LIBOR is the rate at which banks lend to each other for the short term. The spread of the one month LIBOR to Fed Funds has been wider than historical spreads by an average of 40-50 basis points.

Net Income

In fiscal year 2008, the Virginia Lottery generated \$455.3 million in profits. As shown in Table 6, profits were higher than fiscal year 2007 by \$18.1 million (four percent) and this was the highest net income in Virginia Lottery history. Estimated net income of \$455.0 million was transferred to the Commonwealth in April, May, and June, as required by the Appropriations Act. The remaining residual income will be transferred during fiscal year 2009.

Table 6

	<u>Net Income</u>					
	<u>2008</u>		<u>2007</u>		<u>Change</u>	
Net income	<u>\$455.3</u>	<u>32.8%</u>	<u>\$437.2</u>	<u>32.1%</u>	<u>\$18.1</u>	<u>4.1%</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 reflects 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 \$1.39 billion. Uses of cash include payment of prizes to winners (\$798.8 million) and payments to retailers, suppliers, and employees for goods and services (\$137.1 million). The net cash provided by operating activities of \$452.1 million represents a 22% increase.

The cash flows from the non-capital financing activities portion of the statement reflects the \$456 million used for non-capital financing activities, the major portion being the \$458.1 million in total transfers from the Virginia Lottery during the year. This amount represents the \$455.0 million initial estimate of fiscal year 2008 Virginia Lottery profits transferred to the Lottery Proceeds Fund prior to July 1, 2008, and the \$3.1 million transfer of residual 2007 profits. The Virginia Lottery required a Treasury loan of \$5 million to meet its year-end cash transfer requirements and to allow sufficient cash balances on-hand to continue short-term operations.

Cash flows from capital financing activities reflect the purchase of capital assets acquired during the period (\$5.6 million). The \$11.8 million cash flows from investing activities reflect purchases of investments to fund Win-For-Life and Mega Millions prizes due to Virginia Lottery winners (\$58.7 million) and payable over time, proceeds from maturing investments previously purchased to fund Virginia Lottery prizes payable (\$61.1 million), and investment income on cash balances (\$9.5 million). The net increase in cash flows from activities totaled \$2.2 million.

Table 7

Statement of Cash Flows

	<u>2008</u>	<u>2007</u>	<u>Change</u>
Cash flows from:			
Operating activities	\$452.12	\$369.80	22.3 %
Non-capital financing activities	(456.05)	(436.00)	(4.6) %
Capital financing activities	(5.65)	(1.30)	(334.6) %
Investing activities	<u>11.83</u>	<u>66.50</u>	<u>(82.2) %</u>
Net change in cash	<u>2.25</u>	<u>(1.00)</u>	<u>320.0%</u>
Ending cash and cash equivalents	<u>\$ 9.57</u>	<u>\$ 7.32</u>	<u>30.1 %</u>

*in millions

Potentially Significant Factors Impacting Next Year

In response to requirements in the Appropriations Act, the Virginia Lottery began periodic transfers of estimated profits to the Lottery Proceeds Fund during the final quarter of fiscal year 2008. Beginning in fiscal year 2009, these transfers will occur throughout the second half of the fiscal year. Transferring estimated profits throughout the year will reduce cash balances available for investment and interest income, and will have a negative impact on total lottery profits beginning in fiscal year 2009 and continuing for future years.

In addition, Virginia continues to monitor competition from the North Carolina Education Lottery along the North Carolina/Virginia border. A competitive advantage that Virginia enjoyed for offering flexible prizes, in particular for scratch games, was lost when North Carolina eased prize payout restrictions. Because scratch tickets account for over half of Virginia's total sales, this product will continue to be closely monitored and evaluated for optimal performance.

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.

Certification

Prepared: Bill Roper – Financial Reporting Manager – 8/21/08

Reviewer: Nancy Arnold – Controller – 8/21/08

FINANCIAL STATEMENTS

STATE LOTTERY DEPARTMENT

STATEMENT OF NET ASSETS

For Fiscal Year Ended June 30, 2008 with Comparative Information for 2007

	2008	2007
ASSETS		
Current assets:		
Cash and cash equivalents (Note 2)	\$ 9,568,110	\$ 7,318,360
Cash held as collateral: (Note 2)		
Lottery securities lending	277,940,268	324,978,714
Treasury securities lending	1,852,487	2,042,833
Accounts receivable	48,411,167	50,759,576
Deferred expenses	621,375	669,542
Short-term investments (Note 2)	62,733,812	58,766,299
Total current assets	<u>401,127,219</u>	<u>444,535,324</u>
Investments (Note 2)	<u>269,991,771</u>	<u>254,346,360</u>
Fixed assets (Note 3)		
Furniture, fixtures and equipment	45,167,992	39,515,764
Less: Accumulated depreciation	<u>(38,982,073)</u>	<u>(37,919,223)</u>
Net fixed assets	<u>6,185,919</u>	<u>1,596,541</u>
Total assets	<u>\$ 677,304,909</u>	<u>\$ 700,478,225</u>
LIABILITIES		
Current liabilities:		
Accounts payable	9,475,586	6,810,047
Treasury loan (Note 4)	5,000,000	6,000,000
Due to the lottery proceeds fund (Note 5)	259,003	3,180,128
Accrued compensated absences (Note 6)	821,550	910,789
Obligations under securities lending: (Note 2)		
Lottery securities lending	277,940,268	324,978,714
Treasury securities lending	1,852,487	2,042,833
Prizes payable:		
Jackpot prizes payable (Note 7)	62,733,812	58,766,299
Other prizes payable	46,335,373	39,932,124
Deferred revenue	<u>2,058,550</u>	<u>2,840,969</u>
Total current liabilities	<u>406,476,629</u>	<u>445,461,903</u>
Noncurrent liabilities:		
Jackpot prizes payable (Note 7)	269,991,771	254,346,360
Accrued compensated absences (Note 6)	<u>836,509</u>	<u>669,962</u>
Total noncurrent liabilities	<u>270,828,280</u>	<u>255,016,322</u>
Total liabilities	<u>677,304,909</u>	<u>700,478,225</u>
NET ASSETS		
Net assets:		
Invested in capital, net of related debt	6,185,919	1,596,541
Unreserved	<u>(6,185,919)</u>	<u>(1,596,541)</u>
Total net assets	<u>-</u>	<u>-</u>
Total liabilities and net assets	<u>\$ 677,304,909</u>	<u>\$ 700,478,225</u>

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, 2008 with Comparative Information for 2007

	<u>2008</u>	<u>2007</u>
Operating revenues:		
Ticket sales	\$ 1,386,412,500	\$ 1,362,342,592
Less:		
Prize expense	792,338,987	791,785,078
Retailer compensation	77,745,970	76,484,392
Instant ticket printing and gaming services	<u>15,598,422</u>	<u>8,496,026</u>
Gross margin	<u>500,729,121</u>	<u>485,577,096</u>
Operating expenses:		
Advertising and promotion	27,388,667	26,075,819
General and administrative	29,632,874	31,500,685
Depreciation	<u>1,062,850</u>	<u>1,990,556</u>
Total operating expenses	<u>58,084,391</u>	<u>59,567,060</u>
Income from operations	<u>442,644,730</u>	<u>426,010,036</u>
Non-operating revenues(expenses):		
Interest income	9,481,992	10,230,895
Interest expense	-	(9,898)
Other income (net)	<u>3,132,281</u>	<u>949,095</u>
Total non-operating income	<u>12,614,273</u>	<u>11,170,092</u>
Net income	455,259,003	437,180,128
Transfer to the Lottery Proceeds Fund	(455,000,000)	(434,000,000)
Due from (to) the Lottery Proceeds Fund	<u>(259,003)</u>	<u>(3,180,128)</u>
Net assets at July 1	-	-
Net assets at June 30	<u>\$ -</u>	<u>\$ -</u>

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

STATE LOTTERY DEPARTMENT
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2008 with Comparative Information of 2007

	2008	2007
Cash flows from operating activities:		
Cash received from ticket sales	\$ 1,387,978,490	\$ 1,355,507,766
Cash payments for prizes	(788,285,535)	(843,293,027)
Discounts for retailer compensation	(77,745,970)	(76,484,392)
Cash payments to supplier of instant and online services	(15,598,422)	(8,496,026)
Cash payments to suppliers of other goods and services	(22,487,439)	(26,938,478)
Cash payments to employees for services	(21,265,259)	(19,726,096)
Cash payments to the Literary Fund for unclaimed prizes (Note 9)	(10,477,829)	(10,747,271)
Net cash provided by operating activities	<u>452,118,036</u>	<u>369,822,476</u>
Cash flows from noncapital financing activities:		
Proceeds from other income	3,132,281	949,095
Repayment of Treasury Loan	(6,000,000)	(8,000,000)
Proceeds from Treasury Loan	5,000,000	6,000,000
Transfers to the General Fund of the Commonwealth	(458,180,128)	(434,931,308)
Net cash used by noncapital financing activities	<u>(456,047,847)</u>	<u>(435,982,213)</u>
Cash flows from capital financing and related activities:		
Acquisition of capital assets	(5,652,228)	(667,146)
Disposal of capital assets	-	-
Principal payments on installment notes	-	(610,390)
Interest payment on installment notes	-	(9,898)
Net cash used for capital financing activities	<u>(5,652,228)</u>	<u>(1,287,434)</u>
Cash flows from investing activities:		
Purchase of investment securities	(58,713,203)	(4,195,690)
Sale of investment securities	-	-
Proceeds from maturing securities	61,063,000	60,440,000
Interest proceeds from cash balances	9,481,992	10,230,895
Net cash used for investing activities	<u>11,831,789</u>	<u>66,475,205</u>
Net increase (decrease) in cash and cash equivalents	2,249,750	(971,966)
Cash and cash equivalents at July 1	<u>7,318,360</u>	<u>8,290,326</u>
Cash and cash equivalents at June 30	<u><u>9,568,110</u></u>	<u><u>7,318,360</u></u>
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	442,644,730	426,010,036
Adjustments to reconcile operating income to net cash:		
Depreciation	1,062,850	1,990,556
Accreted interest on investment securities	(21,962,721)	(22,720,527)
Changes in assets and liabilities:		
Decrease (Increase) in accounts receivable	2,348,409	(6,864,993)
Decrease in deferred expenses	48,167	409,039
Increase (Decrease) in accounts payable	2,665,539	(272,373)
Increase in current prizes payable	10,370,762	4,974,376
(Decrease) Increase in deferred revenue	(782,419)	30,167
Increase in accrued compensated absences	77,308	27,993
Increase (Decrease) in noncurrent prizes payable	15,645,411	(33,761,798)
Net cash provided by operating activities	<u>\$ 452,118,036</u>	<u>\$ 369,822,476</u>

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

NOTES TO FINANCIAL STATEMENTS

VIRGINIA STATE LOTTERY
NOTES TO FINANCIAL STATEMENTS
AS OF JUNE 30, 2008

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, Win for Life and Mega Millions. Win for Life 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 Win for Life and Mega Millions.

A separate report is prepared for the Commonwealth, 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 activated for sale by retailers to the public.

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. Non-operating revenues and expenses include activities that have the characteristics of investing transactions and capital and non-capital 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.

Non-operating revenues include interest income from its cash balances held with the Treasurer of Virginia. Non-operating expenses include interest on debt related to the purchase 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

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. Fixed assets are valued at historical or estimated historical cost and donated fixed assets are capitalized at estimated market value at the date of contribution. Equipment is depreciated on a straight-line basis based on a useful life of 3 -5 years.

G. Contractor Fees

The Virginia Lottery has contracted with Scientific Games, International (SGI) for the printing and distribution of instant tickets. SGI receives a fee of 1.1325 percent of the retail value of net tickets distributed and then activated by retailers.

The Virginia Lottery entered into a seven-year contract effective with the implementation of sales on October 28, 2007, with GTECH Corporation for the operation of the gaming network that consists of instant and online retailer ticket terminal and associated software. Under the contract, GTECH receives a fee of .7699 percent of net ticket sales.

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, 2008, the total cash and cash equivalents equaled \$9,568,110. This included cash held overnight for repurchase agreements totaling \$3,045,679 and petty cash on hand of \$1,140.

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 no less than 100 percent of market value by cash or U.S. government obligations and adjusted to market daily, at a minimum, to cover market value fluctuations. Collateral cash is invested in accordance with the investment policies of the State Treasury Board of the Commonwealth of Virginia, and credit rating categories are detailed as part of this footnote. Management assumes reasonable credit risk in these investments, and fluctuations in market conditions may value the invested cash Collateral less than the original investment.

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.

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.

Investments and repurchase agreements consist of the following:

Credit Rating

	<u>Unrated</u>
Bank of America:	
Repurchase agreements ⁽¹⁾	\$ 3,045,679
Prize annuities:	
Treasury bonds ⁽²⁾	<u>332,725,583</u>
Total	<u>\$335,771,262</u>

Investment Securities

	<u>Less than 1 year</u>	<u>1-5 years</u>	<u>6-10 years</u>	<u>11-20 years</u>	<u>Over 20 years</u>
Bank of America:					
Repurchase agreements ⁽¹⁾	\$ 3,045,679	\$ -	\$ -	\$ -	\$ -
Prize annuities:					
Treasury bonds ⁽²⁾	<u>62,733,812</u>	<u>180,057,801</u>	<u>43,747,088</u>	<u>36,346,640</u>	<u>9,840,242</u>
Total	<u>\$65,779,491</u>	<u>\$180,057,801</u>	<u>\$43,747,088</u>	<u>\$36,346,640</u>	<u>\$9,840,242</u>

*Credit quality ratings obtained from Standard & Poor's

⁽¹⁾ 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.

⁽²⁾ 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.

Securities Lending – Collateral for securities lending reported on the balance sheet represents cash collateral received by the Lottery that is subsequently reinvested through the State Treasury's securities lending program. The Commonwealth's policy is to record unrealized gains and losses for the State Treasury's securities lending program in the General Fund in the Commonwealth's basic financial statements. If gains or losses are realized, the actual gains and losses are recorded by the affected agencies. Detailed information related to the credit risk of these investments and the State Treasury's securities lending program is available on a statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

3. FIXED ASSETS

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

	<u>Balance as of July 1, 2007</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance as of June 30, 2008</u>
Furniture, fixtures, and equipment	\$39,515,764	\$5,652,228	\$ -	\$45,167,992
Less: Accumulated depreciation	<u>37,919,223</u>	<u>1,062,850</u>	<u>-</u>	<u>38,982,073</u>
Net fixed assets	<u>\$ 1,596,541</u>	<u>\$4,589,378</u>	<u>\$ -</u>	<u>\$ 6,185,919</u>

4. LINE OF CREDIT

The State Comptroller has provided the Virginia Lottery with a line of credit not to exceed \$40 million in accordance with Section 3-2.03 of Chapter 847, 2008, 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 \$5 million loan payable under this arrangement as of June 30, 2008 that was repaid on July 24, 2008.

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 Lottery Proceeds Fund in accordance with Section 3-1.01 of Chapter 847, 2008, 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, 2008, the net income was \$455,259,003, with a net income transfer through June 30 of \$455,000,000 and a balance due to the Lottery Proceeds Fund of \$259,003.

6. 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, 2008 and 2007. 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, 2007</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance as of June 30, 2008</u>	<u>Due Within One Year</u>
<u>\$1,580,751</u>	<u>\$1,008,861</u>	<u>\$931,553</u>	<u>\$1,658,059</u>	<u>\$821,550</u>

7. 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.

Investments/Prizes Payable Balance As of June 30, 2008				
<u>Note Prizes Payable</u>	<u>Jackpot</u>	<u>Instant For Life</u>	<u>Online For Life</u>	<u>Total</u>
Due within one year	\$ 59,575,093	\$ 2,806,196	\$ 352,523	\$ 62,733,812
Due in subsequent years	<u>227,191,930</u>	<u>37,372,775</u>	<u>5,427,066</u>	<u>269,991,771</u>
Total (present value)	<u>286,767,023</u>	<u>40,178,971</u>	<u>5,779,589</u>	<u>332,725,583</u>

Add: Interest to maturity	92,593,977	32,404,029	5,197,411	130,195,417
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Total at Maturity	<u>\$379,361,000</u>	<u>\$72,583,000</u>	<u>\$10,977,000</u>	<u>\$462,921,000</u>
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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, 2007</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance as of June 30, 2008</u>
<u>\$313,112,659</u>	<u>\$58,713,203</u>	<u>\$39,100,279</u>	<u>\$332,725,583</u>

8. OPERATING LEASE COMMITMENTS

The Virginia Lottery is committed under various operating lease agreements. The operating leases are for regional offices. Expenses under operating lease agreements were \$1,290,606 for the year ended June 30, 2008. A summary of future obligations under these agreements as of June 30, 2008, follows:

<u>Year Ending June 30, Obligation</u>	<u>Operating Lease Principal</u>
2009	\$1,307,379
2010	226,305
2011	170,808
2012	175,564
2013	<u>31,873</u>
<u>Total</u>	<u>\$1,911,929</u>

9. LITERARY FUND AND SETOFF DEBT COLLECTION PAYMENTS

Prizes unclaimed after 180 days are paid to the Literary Fund of the Commonwealth. Payments totaled \$10,477,829 for the year ended June 30, 2008.

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 \$1,069,378 for the year ended June 30, 2008. The Literary Fund and state debt setoff payments are reported as prize expense on the financial statements.

10. PENSION PLAN AND OTHER POST RETIREMENT BENEFITS

Employees of the Virginia Lottery are employees of the Commonwealth. 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. The Commonwealth, not the Virginia Lottery, has the overall responsibility for contributions to these plans.

11. 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.

12. CONTINGENCIES

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



Walter J. Kucharski, Auditor

Commonwealth of Virginia

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

August 22, 2008

The Honorable Timothy M. Kaine
Governor of Virginia

The Honorable M. Kirkland Cox
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 the **State Lottery Department** as of and for the year ended June 30, 2008, as listed in the table of contents. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with 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 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, 2008, 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 the State Lottery Department as of June 30, 2008, and the changes in its financial position and its cash flows for the year ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages three through nine 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 as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below, we identified certain deficiencies in internal control over financial reporting that we consider to be significant deficiencies.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiencies entitled "Review Investment Policies for Securities Lending" and "Strengthen Information Systems Security Program", which are described in the section titled "Internal Control Findings and Recommendations", to be significant deficiencies in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiencies described above are not 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 Department's response to the findings identified in our audit is included in the section titled "Agency Response." We did not audit the Department's response and, accordingly, we express no opinion on it.

Status of Prior Findings

The Department has not taken adequate corrective action with respect to the previously reported finding "Strengthen Information System Security Program". Accordingly, we included this finding in the section entitled "Internal Control Findings and Recommendations." The Department has taken adequate corrective action with respect to audit findings reported in the prior year that are not repeated in this report.

Report Distribution and Exit Conference

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 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.

We discussed this report with management at an exit conference held on October 7, 2008.

AUDITOR OF PUBLIC ACCOUNTS

LCW/wdh

Timothy M. Kaine
Governor

Paula I. Otto
Executive Director

900 East Main Street
Richmond, Virginia
23219
PHONE: 804-692-7000
www.valottery.com



October 7, 2008

Mr. Walter J. Kucharski
Auditor of Public Accounts
101 North 14th Street
Richmond, Virginia 23219

Dear Mr. Kucharski:

Attached are the Virginia Lottery's responses to the Auditor of Public Accounts Internal Control and Compliance Findings and Recommendations for inclusion in the auditor's report for the period ended June 30, 2008.

Review Investment Policies for Securities Lending

Since 1994, the Virginia Lottery has participated in the Commonwealth's Securities Lending program. As part of that participation, as well as the overall management of cash balances, the Lottery continues to value and benefit from the investment expertise provided by the Treasury and guided by the Treasury Board. Lottery and Treasury staffs interact on an ongoing basis, for both routine and non-routine matters.

Participation in securities lending has included both fee income from the exchange of securities and investment income from cash Collateral pledged in exchange for borrowed securities. In 2001, Lottery management met with account representatives to discuss various options for securities lending, including risk and income potential. At that time, Lottery management decided to move its securities lending practices in alignment with the Commonwealth's guidelines, meaning that the Lottery fully participated in the program consistent with the Commonwealth's investment guidelines and acceptance of risk. In 2004, the Lottery and the Treasury executed an updated Memorandum of Understanding, which did include general account investment guidelines.

Similar to interest income on cash balances held by the Treasurer, securities lending income is reflected in the Lottery's non-operating income and transferred as part of total Lottery profits each fiscal year. The Lottery agrees that, with the increased complexity of securities lending activities, increased monitoring and review is necessary to ensure that all parties are fully aware of the status of investments, any changes in risk, and any revisions necessary to ensure that investment goals are met. The Lottery will coordinate with Treasury an overall review of the Lottery's participation in the securities lending program and discuss any specific policies that the Lottery may require. These discussions have already begun, with a meeting conducted with representatives from the Office of the Secretary of Finance and Department of Treasury. As a result of these discussions, an updated MOU with Treasury will be executed. In addition, in conjunction with the Office of the

Helping Virginia's Public Schools

Secretary of Finance, the Lottery will participate in discussions with the Comptroller to clarify an agreement for the financial reporting of unrealized losses related to the Lottery's participation in the Securities Lending program.

Strengthen Information Systems Security Program

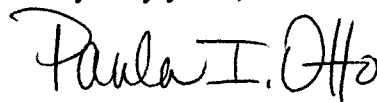
While the Lottery strongly believes it has consistently maintained an effective Information Systems Security Program, we did make significant progress during the past year in strengthening and documenting our Program to ensure its compliance with the Commonwealth's Security Standards and industry best practices. This was accomplished in the midst of a major online gaming system conversion which required considerable effort by many of the same staff resources. As such, we believe our achievement clearly demonstrates the Lottery's continued commitment to ensuring the security, integrity, and availability of our systems. We do acknowledge, however, that some aspects of the Program could still be improved, and we have taken the following actions to help attain that goal

- The Lottery's draft Strategic Plan identifies improvement and implementation of the Information Systems Security Program, and revision of the Continuity of Operations and Disaster Recovery Plans, as high priority projects for FY09. This designation signifies management's intended dedication of the resources necessary to support completion of these initiatives.
- In part, these resources include a budget allocation to employ consulting services to assist with the development, documentation, and exercising of updated Continuity of Operations and Disaster Recovery Plans. If feasible, the Lottery plans to leverage the consulting services to assist in completing a Business Impact Analysis as well.
- The Lottery plans to use the results of the Business Impact Analysis to update our Risk Assessment.
- A draft Incident Response Plan has now been completed, and forwarded to appropriate Lottery staff for initial review. This plan, as well as data backup and restoration procedures, will be finalized as we continue to improve documentation of our practices.

Again, Lottery management reiterates its commitment to ensuring our Information Systems Security Program remains effective. Prioritization and allocation of resources for this initiative will continue to occur based on areas of greatest risk and business necessity.

Please contact me if you have any questions.

Very truly yours,

A handwritten signature in cursive script that reads "Paula I. Otto". The signature is written in dark ink and is positioned above the printed name.

Paula I. Otto

STATE LOTTERY DEPARTMENT

STATE LOTTERY BOARD

As of June 30, 2008

David H. Hallock, Jr
Chairman

James M. Wofford
Vice-Chairman

Susan Smith Feaster Cynthia D. Lawrence
Gilliam M. Cobbs

Paula I. Otto
Executive Director

Richard E. Williams, Jr.
Deputy Director