Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

July 1, 1996, to June 30, 1997

Audits Division

Secretary of State

State of Oregon

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Audits Division

No. 97-86

December 23, 1997

Secretary of State Audits Division

Auditing for a Better Oregon

The Honorable John Kitzhaber
Governor of Oregon
State Capitol
Salem, Oregon 97310

E.D. "Debbs" Potts, Chairman
Oregon State Lottery Commission
500 Airport Road SE
Salem, Oregon 97301

This audit was conducted for the purpose of reporting on the financial statements of the Oregon State Lottery Commission as of and for the year ended June 30, 1997. Our opinion on these financial statements is presented in the Financial Section of this report.

We conducted our audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

As also required by those standards, we reviewed the Oregon State Lottery's internal control and compliance with applicable laws and regulations. Our report on the results of those reviews is presented in the Audit Results section of this report.

OREGON AUDITS DIVISION

John N. Lattimer
Director

Fieldwork Completion Date:
November 3, 1997

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SUMMARY

BACKGROUND

The Oregon State Lottery Commission (Lottery) operates as a self-supporting agency of state government with the primary purpose of maximizing revenue for creating jobs, furthering economic development, and financing public education in Oregon. At least 84 percent of total annual revenues are to be returned to the public in the form of prizes or to be used for the defined public purposes of economic development or education. The remainder of total annual revenues (up to 16 percent) is available for administrative expenses.

AUDIT PURPOSE

The audit was conducted for the purpose of reporting on the Lottery's financial statements for the year ended June 30, 1997, and on internal control and compliance with applicable laws and regulations.

AUDIT RESULTS

This audit concluded that the Lottery's financial statements for the year ended June 30, 1997, which are included in this report, were fairly presented. For the year ended June 30, 1997, the Lottery's total annual revenues totaled about $4 billion, $3.6 billion from video lottery and $334 million from other lottery games. The Lottery's operating revenues were derived from eight games and totaled $726 million. Operating revenues represent total annual game revenues, with the exception of video lottery game revenue, which is reported net of prize expense of $3.2 billion as is industry practice.

Authorized disbursements from the Oregon State Lottery Fund include prize expenses, administrative costs, and transfers to the Department of Administrative Services to be used for the defined public purpose. For the fiscal year ended June 30, 1997, prize expenses for traditional lottery games totaled $207.6 million, administrative expenses were $221.3 million, and transfers totaled $288.4 million.

INTRODUCTION

ORGANIZATION AND FUNCTIONS

The Oregon State Lottery Commission (Lottery) was created by an amendment to the Oregon Constitution (Article XV, Section 4(3)) in 1984. The Lottery Commission (Commission) was created to oversee the Lottery's operations, and is comprised of five members appointed by the Governor and confirmed by the Senate. The Governor also appoints a director, subject to confirmation of the Senate, who is responsible for operating the Lottery pursuant to the rules and under the guidance of the Commission.

The Lottery operates as a self-supporting revenue-raising agency of state government, that is, no appropriations, loans, or other transfers of state funds are made to it. State law governing the operation of the Lottery is codified in Oregon Revised Statutes (ORS), Chapter 461. All proceeds from the Lottery, excluding costs of administration and payment of prizes, are to be used for the purpose of creating jobs, furthering economic development, and financing public education in Oregon. ORS 461.500 provides that at least 84 percent of total annual revenues shall be returned to the public, at least 50 percent must be returned to the public as prizes and the remainder used for the designated public purpose. The remaining 16 percent of total annual revenues is available for the payment of administrative expenses. Total annual revenues are not reported in the operating statement. Video game revenue, as is common industry practice, is reported net of video prize expense in the operating statement. The Lottery reports total annual revenues in its legal compliance note disclosure.

FINANCIAL ACTIVITIES

ORS 461.530 authorizes the creation of the Oregon State Lottery Fund, which is continuously appropriated for the purpose of administration and operation of the Commission and the Lottery. All moneys received by the Lottery are deposited to the credit of this account.

The Lottery's sales revenue was derived from eight games during the audit period: two instant ticket games ("Scratch-it" and "Breakopen") and six on-line games (Megabucks, Daily 4, Powerball, Sports Action, Keno, and Video Lottery). Except for Video Lottery, a vendor owns the play terminals and computer hardware associated with the on-line games and is responsible for their operation. The vendor receives a percentage of the gross revenue as compensation for its role in operating the on-line games. Video Lottery operates separately from the other on-line games through game terminals either leased from several vendors or owned by the Lottery. The game terminals are all tied into one central site computer maintained at Lottery headquarters.

Authorized disbursements from the Oregon State Lottery Fund include prizes, expenses of the Commission, Lottery administrative costs, and transfers to the Department of Administrative Services Economic Development Fund.

The Lottery's financial activities are accounted for in a Proprietary Fund Type-Enterprise Fund as required by generally accepted accounting principles. Enterprise funds account for the provision of goods and services where all or most of the costs involved are recovered through user charges to the users of those services.

AUDIT RESULTS

The Honorable John Kitzhaber
Governor of Oregon
State Capitol
Salem, Oregon 97310

E.D. "Debbs" Potts, Chairman
Oregon State Lottery Commission
500 Airport Road SE
Salem, Oregon 97301

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL AND COMPLIANCE BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

We have audited the financial statements of the Oregon State Lottery Commission (Lottery), as of and for the year ended June 30, 1997, and have issued our report thereon dated November 3, 1997.

We conducted our audit in accordance with generally accepted auditing standards and *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.

Internal Control
The management of the Lottery is responsible for establishing and maintaining a system of internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of an internal control system are to provide management with reasonable assurance regarding the reliability of financial reporting, the effectiveness and efficiency of operations, and compliance with laws and regulations. Because of inherent limitations in any system of internal control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

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In planning and performing our audit of the financial statements of the Lottery, for the year ended June 30, 1997, we obtained an understanding of internal control. With respect to the internal control system, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk 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 internal control. Accordingly, we do not express such an opinion.

Our consideration of the internal control would not necessarily disclose all matters affecting internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control components does not reduce to a relatively low level the risk that errors or irregularities 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 internal control or its operations that we consider to be material weaknesses as defined above.

Compliance

Compliance with laws and regulations applicable to the Lottery is the responsibility of the Lottery's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Lottery's compliance with certain provisions of laws, regulations, and contracts. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

OREGON AUDITS DIVISION

Sharron E. Walker, CPA, CFE
Deputy Director

November 3, 1997

REPORT DISTRIBUTION

This report is a public record and is intended for the information of the Oregon State Lottery Commission's management, the governor of the state of Oregon, the Oregon Legislative Assembly, and all other interested parties.

COMMENDATION

The courtesies and cooperation extended by officials and employees of the Oregon State Lottery Commission during the course of the audit were very commendable and sincerely appreciated.

AUDIT TEAM

Nancy Kelm, CPA, CISA, Audit Administrator
Mary E. Wenger, CPA
Sarah Edwards
John Ruell

FINANCIAL SECTION

Secretary of State Audits Division

Auditing for a Better Oregon

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INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying balance sheet of the Oregon State Lottery Commission as of June 30, 1997, and the related statements of revenues, expenses, and changes in equity, and cash flows for the year then ended. These financial statements are the responsibility of the Oregon State Lottery Commission. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *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 1, the financial statements present only the Oregon State Lottery Commission Enterprise Fund and are not intended to present fairly the financial position of the State of Oregon, and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds in conformity with generally accepted accounting principles.

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In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Oregon State Lottery Commission at June 30, 1997, and the results of its operations and cash flows for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary section is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

A report in accordance with *Government Auditing Standards* on the Oregon State Lottery Commission's internal control and its compliance with laws and regulations is separately presented in the AUDIT RESULTS section of this report.

OREGON AUDITS DIVISION

Sharron E. Walker, CPA, CFE
Deputy Director

November 3, 1997

Exhibit A

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
BALANCE SHEET
JUNE 30, 1997

Assets		
Current Assets		
Cash and Cash Equivalents	$89,840,639	
Cash - Securities Lending Collateral	4,540,070	
Securities Held-in-Trust	7,284,171	
Advances	32,153	
Accounts Receivable - Net of Allowance for Doubtful Accounts of $456,490	25,682,989	
Interest Receivable	418,415	
Inventory: Parts	1,266,963	
Tickets	1,931,106	
Prepaid Expenses	1,301,304	$132,297,810
Long-Term Assets		
Securities Held-in-Trust	$63,851,447	
Equipment - Net of Accumulated Depreciation of $5,385,929	10,288,512	
Building and Improvements - Net of Accumulated Depreciation of $208,886	9,075,744	
Leased Assets - Net of Accumulated Depreciation of $5,341,443	9,412,412	92,628,115
Total Assets		$224,925,925
Liabilities and Equity		
Current Liabilities		
Accounts Payable	$ 7,604,994	
Obligations Under Securities Lending	4,540,070	
Compensated Absences	226,806	
Deposit Liability	867,092	
Prize Liability	19,035,527	
Deferred Income	3,891,289	
Economic Development Liability	76,842,593	
Capital Lease Liability	2,266,177	$115,274,548
Long -Term Liabilities		
Compensated Absences	$ 680,419	
Capital Lease Liability	7,308,718	
Deferred Prize Liability	63,851,447	71,840,584
Total Liabilities		$187,115,132
Equity		
Retained Earnings		$ 37,810,793
Total Equity		$ 37,810,793
Total Liabilities and Equity		$224,925,925

The accompanying notes are an integral part of the financial statements.

Exhibit B

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN EQUITY

JULY 1, 1996 TO JUNE 30, 1997

<u>Operating Revenues</u>		
Scratch-It Instant Tickets (Net of Returns)	$142,804,497	
Breakopen Instant Tickets	7,680,537	
On-Line - Megabucks	38,658,051	
On-Line - Powerball (MUSL)	30,381,335	
On-Line - Daily 4	3,160,498	
On-Line - Sports Action	8,866,037	
On-Line - Keno	101,519,358	
Video Lottery (Net Receipts)	393,193,068	
Provision for Bad Debts	(205,531)	
Total Operating Revenues		$726,057,850
<u>Operating Expenses</u>		
Prizes		$207,616,772
Retailer Commissions		151,608,816
On-Line Charge		23,030,633
Tickets		4,162,574
Advertising		6,458,756
Public Information		1,294,636
Sales Support		1,429,932
Personal Services		17,521,871
Services and Supplies		11,651,365
Depreciation and Amortization		4,190,803
Total Operating Expenses		$428,966,158
Operating Income		$297,091,692
<u>Nonoperating Revenues</u>		
Interest	$4,091,139	
Investment Income - Securities Lending	662,578	
Other Income/Expense	46,441	$ 4,800,158
<u>Nonoperating Expenses</u>		
Investment Expenses - Securities Lending		$ 662,578
Income Before Operating Transfers		$301,229,272
Operating Transfer - To the Benefit of Economic Development		(288,418,479)
Net Income		$ 12,810,793
Equity - July 1, 1996		25,000,000
Equity - June 30, 1997		$ 37,810,793

The accompanying notes are an integral part of the financial statements.

Exhibit C

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

STATEMENT OF CASH FLOWS

JULY 1, 1996 TO JUNE 30,1997

Operating Income		$297,091,692
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation and amortization	$ 4,328,525	
Increase in Obligations Under Securities Lending	4,540,070	
Changes in Current Assets and Liabilities:		
Increase in Securities Held-In-Trust	(728,706)	
Increase in Advances	(11,266)	
Increase in Accounts Receivable	(2,191,015)	
Increase in Inventory	(99,007)	
Increase in Prepaid Expenses	(1,210,676)	
Increase in Accounts Payable	1,031,993	
Increase in Compensated Absences Liability	113,819	
Increase in Deposit Liability	122,631	
Increase in Prize Liability	4,196,641	
Decrease in Deferred Income	(970,693)	
Increase in Economic Development Liability - Unclaimed Prizes Payable	1,102,748	
Total Adjustments		10,225,064
Other Income		(1,061,661)
Net Cash Provided by Operating Activities		$306,255,095
Cash Flows from Noncapital Financing Activities:		
Interest Paid on Securities Lending	$ (662,578)	
Operating Transfers	(286,442,415)	
Net Cash Used in Noncapital Financing Activities		$(287,104,993)
Cash Flows from Capital Financing Activities:		
Acquisition of Capital Assets	$ (5,860,150)	
Disposition of Capital Assets	14,735	
Capital Lease Payments	(2,042,979)	
Net Cash Used in Capital Financing Activities		$ (7,888,394)
Cash Flows from Investing Activities:		
Investment Income on Securities Lending	$ 662,578	
Interest on Investments and Cash Balances	4,021,378	$ 4,683,956
Net Increase in Cash and Cash Equivalents		$ 15,945,664
Cash and Cash Equivalents at Beginning of Year		$ 78,435,045
Cash and Cash Equivalents at End of Year		$ 94,380,709

The accompanying notes are an integral part of the financial statements.

1. Summary of Significant Accounting Policies

The following briefly describes the significant accounting policies which have been followed in preparing the accompanying financial statements in accordance with generally accepted accounting principles, as prescribed by the Governmental Accounting Standards Board (GASB) and the Financial Accounting Standards Board (FASB).

a. Reporting Entity

The Oregon State Lottery Commission is part of the State of Oregon reporting entity. The Commission was created as an agency of the State of Oregon by enactment of Article XV, Section 4 (3), of the Oregon Constitution, an initiative measure approved by the voters of the State of Oregon at the November 1984 general election. The Commission established the Oregon State Lottery (the "Lottery"). The Lottery commenced operations in January 1985.

b. Basis of Presentation

The Lottery uses an enterprise fund with a self-balancing set of accounts to record its assets, liabilities, fund equity, revenues, and expenses. Enterprise fund operations are accounted for in a manner similar to private business enterprises where the costs of providing goods and services to the general public on a continuing basis are intended to be financed or recovered primarily through user charges.

c. Basis of Accounting

Basis of accounting refers to when revenues and expenses are recognized (recorded) in the accounts and reported in the financial statements. The Lottery uses the accrual basis of accounting. Under this method, revenues are recognized when they are earned and expenses are recognized when liabilities are incurred.

d. Revenue Recognition

Revenues for on-line games are recognized when shares are sold to the public.

Revenues for Breakopen instant tickets are recognized when tickets are sold to retailers.

Revenues for instant scratch ticket games are recognized during the course of the game based upon an estimate of sales to the public. Estimated sales is a function of winning tickets redeemed and the odds of winning such prizes. The greatest level of estimated revenues are recorded and subsequently restated to actual tickets sold to the public at the end of the game.

Revenues for video lottery games are recognized when sales to the public occur and are reported net of prizes awarded.

e. Prize Expense

Prize expense for instant and on-line games is recognized based upon the cost of the prizes awarded.

f. Deferred Income

Deferred income results from the Lottery's recognition of a receivable when instant scratch tickets are activated by retailers.

g. Inventories

Ticket Inventory consists primarily of instant scratch tickets held for sale. The ticket inventory is valued at cost and residual inventory is expensed upon the completion of an instant scratch ticket game.

Parts inventory consists of replacement parts for video lottery terminals. The cost of parts purchased is accumulated in inventory during the year and expensed ratably during the following year, to approximate actual usage.

h. Property and Equipment

Property and equipment are recorded at historical cost. Capitalization occurs for all items with a minimum useful life of two years and a cost in excess of $2,000. The straight-line method of depreciation is used. The estimated life of the major classes of property and equipment currently being depreciated range from two through forty years.

i. Cash and Cash Equivalents, and Investments

Cash equivalents are defined as cash held in the State Treasury and cash with Fiscal Agent. Investments are stated at amortized cost. See Note 3.

2. Legal Compliance

Article XV of the Constitution of the State of Oregon states that at least 84 percent of the total annual revenues from the sale of lottery tickets or shares shall be returned to the public in the form of prizes and net revenues benefiting the public purpose. ORS 461.500 states that at least 50 percent of the total annual revenues shall be returned to the public in the form of prizes, and that no more than 16 percent may be allocated for the payment of administrative expenses.

For fiscal year 1997 the Lottery operated within legal constraints:

	Traditional Lottery	Video Lottery	Total	Percent
Distributable Revenues	$334,026,143	$3,639,617,763	$3,973,643,906	100.0
Prize Expense	$207,616,771	$3,243,477,583	3,451,094,354	86.8
Economic Development Earnings	72,162,292	216,256,187	288,418,479	7.3
Administrative Expenses	52,626,456	168,693,824	221,320,280	5.6
Available Income	1,620,624	11,190,169	12,810,793	.3
Total	$334,026,143	$3,639,617,763	$3,973,643,906	100.0
Contingency Reserve Contribution	$1,620,624	$11,190,169	$12,810,793	.3
Total Returned To The Public	$279,779,063	$3,459,733,770	$3,739,512,833	94.1
Total Returned To The Public In The Form Of Prizes	$202,116,664	$3,243,139,584	$3,445,256,248	86.7

Video lottery revenue and prize expense are presented separately for comparison purposes only. As discussed in Note 1, these amounts are reported net ($3,636,670,651 - $3,243,477,583 = $393,193,068) in the Statement of Revenues, Expenses, and Changes in Equity. Prize Expense amounts differ from prizes returned to the public. Prize expense amounts include unclaimed prizes of $5,500,107 for Traditional lottery and $337,999 for Video lottery. The Economic Development Transfer amount in the Statement of Revenues, Expenses, and Changes in Equity equals economic development earnings plus available income less amounts contributed to the contingency reserve.

The following reconciles cash amounts and reported amounts for Video lottery:

Revenue:	
Cash Received	$798,342,971
Credits Won and Played	2,838,327,680
	$3,636,670,651
Other Revenue	2,947,112
Total Revenue	$3,639,617,763

Prize Expense:	
Cash Paid Out	$405,149,903
Credits Won and Played	2,838,327,680
Total Prizes	$3,243,477,583

ORS 461.510 (4) and Administrative Rule 177-10-045 allow for the creation of a contingency reserve. The Lottery Commission has set a limit of $45 million for the contingency reserve. This amount is reported as Retained Earnings on the Balance Sheet.

3. Cash and Cash Equivalents, Investments, and Securities Lending

a. Deposits

Cash reported on the Balance Sheet consists of cash on deposit with the State Treasurer and cash with Fiscal Agent. All moneys received by the Lottery are deposited with the State Treasurer. Deposits are carried at cost. The book balance of cash on deposit with the State Treasurer at June 30, 1997, was $86,104,023 and the bank balance was $89,226,148. The difference between the balances consists primarily of deposits in transit and outstanding checks.

The State Treasurer maintains the Oregon Short-Term Fund (OSTF), a cash and investment pool available for use by state agencies and local governments. The bank balance includes cash held in demand accounts and amounts invested in the Oregon Short-Term Fund. State Treasurer demand deposit accounts and time certificates of deposit investments of the fund are insured or collateralized for at least 25 percent of the balance in excess of FDIC coverage, as is required by state statute. Other investment securities in this fund are held by the Treasurer's agent in the name of the State of Oregon.

Cash with Fiscal Agent consists of funds transferred to the Multi-State Lottery Association (MUSL) to pay Oregon's proportionate share of MUSL's prize reserve pool and annual operating expenses. At June 30, 1997, this balance was $3,736,616, and is disclosed separately in MUSL's financial report for the fiscal year ended June 30, 1997.

b. Investments

The State's investment policies are governed by statute and the Oregon Investment Council. The State Treasurer is the investment officer for the council and is responsible for the funds on deposit in the State Treasury. Investments at year-end included Securities Held in Trust by the State Treasurer to fund Megabucks prize winners. These investments included U.S. Government Securities that had a carrying value of $36,137,979 and a market value of $35,453,405 at June 30, 1997. Investments with the State Treasurer are held with the State Treasurer's agent in the name of the State of Oregon and segregated in the Treasurer's records in Lottery's name. Additional Securities Held in Trust were held by Oregon's fiscal agent to fund MUSL prize winners. These investments included U.S. Government Securities that had a carrying value of $34,997,639 and a market value of $36,739,597 at June 30, 1997. Securities Held in Trust are reported on the balance sheet at amortized cost of $71,135,618 with $7,284,171 the current portion and $63,851,447 the long-term portion.

Megabucks and Scratch-It Instant Tickets: During Fiscal Year 1994, the Lottery began purchasing U.S. Government Securities to fund Megabucks "Original Plan" jackpot prizes. Certain deferred prizes arising from Scratch-It games were also funded this way during Fiscal Years 1996 and 1997. The State Treasurer purchases and holds the securities on behalf of the Lottery. "Investment Fund" Megabucks jackpot winners receive one-half the jackpot (or their share) in a lump-sum payment when they claim their prize. Any difference between the matured value of securities funding the liability and the actual liability occurs because securities must be purchased in $1,000 increments, while one prize winner's annual installment was not an even multiple of $1,000. Interest earnings between the maturity and prize payment date is expected to fund this difference.

Multi-State Lottery: The Lottery is liable to major Oregon prize winners of Multi-State Lottery (MUSL) for the deferred portion of the prizes. To fund deferred prize liabilities of MUSL winners, MUSL's administrative staff arranges for the purchase of U.S. Government securities with maturity dates that coincide with the deferred prize liability schedule. Securities purchased to fund the liability of the Oregon winners are transferred to the State Street Bank and Trust Company, Oregon's fiscal agent, to be held in a safekeeping account. Any difference between the matured value of securities funding the liability and the actual liability is not reflected in the Lottery's financial statements because MUSL recognizes any gains or losses realized from trading securities in the marketplace. At June 30, 1997, there were seven Oregon MUSL winners.

Lottery’s investments are categorized to give an indication of the level of risk assumed by an entity at year-end. Category 1 includes investments that are insured or registered, with securities held by the Lottery or its agent in the Lottery’s name. Category 2 includes uninsured and unregistered investments, with securities held by the counterparty’s trust department or agent in the Lottery’s name. Category 3 includes uninsured and unregistered investments, with the securities held by the counterparty or by its trust department or agent but not in the Lottery’s name.

INVESTMENTS AS OF JUNE 30, 1997

	Risk Category 1	Risk Category 2	Risk Category 3	Carrying Amount	Market Value
Investments					
Investments not on Securities Loan:					
US Government and Agency Securities	71,135,618			71,135,618	$72,193,002
Allocated Portion of Reinvested Cash Collateral - OSTF:					
US Government and Agency Securities			1,601,430	1,601,430	1,603,287
Repurchase Agreements			491,014	491,014	491,583
Commercial Paper			2,366,339	2,366,339	2,369,082
Subtotal	$71,135,618		$4,458,783	$75,594,401	$76,656,954
Investments - Not Categorized					
Investments Held Under Securities Loans with Cash Collateral:					
US Government and Agency Securities				4,411,801	4,436,788
Subtotal				$80,006,202	$81,093,742
Less:					
Balances Treated as Cash and Cash Equivalents on Balance Sheet				(8,870,584)	(8,900,740)
Total Investments				$71,135,618	$72,193,002

c. Securities Lending

In accordance with State of Oregon investment policies, state agencies may participate in securities lending and the State has, through Securities Lending Authorization Agreements, authorized its custodians to lend the State’s securities pursuant to a form of loan agreement. During fiscal year 1997, there were no significant violations of the provisions of securities lending agreements.

During fiscal year 1997, the State’s custodians lent short-term and fixed income securities and received as collateral U.S. dollar cash, U.S. Government and Agency Securities or letters of credit. Borrowers were required to deliver collateral for each loan equal to not less than 102% of the market value of the loaned security. The custodians did not have the ability to pledge or sell collateral securities absent a borrower default and the State did not impose any restrictions during the fiscal year on the amount of the loans the custodians made on its behalf. The State, through its Securities Lending Agreements, is fully indemnified against borrower default. There were no losses during the year from the failure of borrowers to return loaned securities and no recoveries of amounts from prior losses.

The maturities of investments made with cash collateral during the year generally did not match the maturities of their securities loans. On June 30, 1997, the State had no credit risk exposure to borrowers. On June 30, 1997, the Lottery had no securities on loan.

The Lottery’s cash balances are invested in the Oregon Short-Term Fund, as is the cash of other state agencies. As of June 30, 1997, the market value of the collateral held and the securities on loan, including accrued income, from the OSTF was $272,531,250 and $266,331,457, respectively. The Lottery's allocated portion of the securities on loan and the related collateral is presented in the schedule of investments. The cash collateral amount in the balance sheet of $4,540,070 includes the $4,458,783 reinvested cash collateral shown in the investment schedule and $81,287 in cash.

4. Joint Ventures - Multi-State Lottery Association

The Multi-State Lottery Association (MUSL) was established September 16, 1987. Its members include the District of Columbia Lottery and Charitable Games Control Board, the Iowa Lottery, the Kansas Lottery, the Missouri Lottery, the Oregon Lottery, the Rhode Island Lottery, the West Virginia Lottery, the Wisconsin Lottery, the Montana Lottery, the Idaho Lottery, the South Dakota Lottery, the Minnesota State Lottery, the Hoosier Lottery (Indiana), the Kentucky Lottery Corporation, the Arizona Lottery, the Nebraska Lottery, the Delaware State Lottery, the Connecticut Lottery Corporation, the Louisiana Lottery Corporation, the New Hampshire Sweepstakes Commission, and the New Mexico Lottery Authority.

MUSL is governed by a board, on which each party lottery is represented. Each party lottery has one vote. The Board's responsibilities to administer multi-state lottery games are performed by a Product Group, advisory committees or panels staffed by officers and independent contractors as appointed by the Board. These officers and consultants serve at the pleasure of the Board and the Board prescribes their powers, duties, and qualifications. The budgeting and financing of MUSL is carried out by the Executive Committee, while the annual independent audit is contracted by the Board.

Each party lottery pays an allocated share of MUSL's operating expenses. The Board and Product Group determine a percentage of gross MUSL game sales that are aggregated in a common prize pool. The revenues derived by each party lottery that are not allocated to the common prize pool and MUSL's operating expenses will be the revenue of that party lottery. Upon termination of the MUSL's existence, if such termination should occur, the party lottery would receive any proceeds determined available for distribution by the Board.

The fiscal year end for MUSL is June 30. Long-term liabilities of MUSL are limited to lottery prize annuities due, which are fully funded through investments that are secured by the United States Government.

The Oregon Lottery's share of MUSL's operating expenses for the fiscal year ended June 30, 1997, was $50,928.

The following schedule presents the summarized financial activity of MUSL as of June 30, 1997, and 1996 (in thousands):

	1997	1996
Assets	$1,437,620	$1,243,916
Total Assets	$1,437,620	$1,243,916
Liabilities	$1,437,329	$1,243,700
Fund Balance	291	216
Total Liabilities and Fund Balance	$1,437,620	$1,243,916
Revenues	$3,176	$2,261
Expenditures	3,100	2,227
Operating Income	$76	$34

Complete separate financial statements for MUSL may be obtained from the Multi-State Lottery Association, Attention: Chuck Strutt, 1200 35th Street, Suite 701, West Des Moines, Iowa 50265-1908.

5. Lease Commitments

Financial reporting and accounting procedures differ between operating leases and capital leases. Operating leases are rental agreements where the payments on these leases are chargeable as rent and recorded in the on-line charge expense account. Capital leases are treated similar to purchases on contract. The property is capitalized at the present value when the lease is incurred and a corresponding liability is recorded.

a. Leased Property

The Lottery leases office and warehouse facilities in Salem under long-term operating leases which expire in 1997, 1998 and 1999; one lease is open-ended. Lease expense for the year ended June 30, 1997, was $524,475.

b. Video Lottery Terminals

At June 30, 1997, video lottery terminals (VLTs) were leased from three approved vendors. Because of stipulations in one vendor's lease contract, all leases with this vendor, through June 30, 1997, were classified as capital leases.

Operating lease terms are for five consecutive years (fiscal years 1992 through 1997), renewable annually at the option of the Lottery. Capital lease terms are currently five years.

At any time during the lease period, the Lottery may purchase the VLTs at their current fair market value. The minimum lease payments for VLTs were calculated assuming that no VLTs will be purchased during the lease period, and that all leases will be renewed each year.

VLT lease expense for the year ended June 30, 1997, was $9,400,397.

The following is a schedule by fiscal year of future minimum lease payments required under leases that have initial or remaining noncancelable lease terms in excess of one year at June 30, 1997:

	Fiscal Year	Operating Leases	Capital Leases
	1998	$10,082,085	$2,979,540
	1999	12,193,134	2,862,041
	2000	12,868,649	2,783,591
	2001	15,396,355	1,893,231
	2002	17,469,967	744,150
Total Future Minimum Lease Payments		$68,010,190	$11,262,553
Less Amounts Representing Interest			1,687,658
Present Value of Minimum Lease Payments			$9,574,895

6. Unemployment Benefits

State agencies are subject to the Department of Employment Act. State employees who qualify are entitled to benefit payments during periods of unemployment. Each state agency is required to reimburse the Department of Employment for benefit payments made to their former employees. There appears to be no practical method of estimating the amount of future benefit payments which may be made to former employees for wage credits earned prior to June 30, 1997. Consequently, this potential obligation is not included in the accompanying financial statements. Total in reimbursements for the year were $28,168.

7. Defined Benefit Retirement Plan

Lottery employees participate in the Oregon Public Employee's Retirement System (PERS), a cost-sharing multiple-employer defined benefit retirement plan. All Lottery employees are eligible to participate in the system after completing six months of service. The PERS is administered by the Public Employees Retirement Board under the guidelines of Oregon Revised Statutes, Chapter 238. The PERS retirement allowance, payable monthly for life, may be selected from twelve retirement benefit options. Options include survivorship benefits and lump-sum refunds. The basic benefit formula is a percentage (1.67 percent for general employees) of a member's final average salary multiplied by the member's number of years of service. Benefits may also be calculated under either a money match or an annuity-plus-pension computation if the individual was a contributing member before August 21, 1981, if a greater benefit results. All Lottery employees are general employees. PERS also provides death and disability benefits. A copy of the Oregon Public Employees

Retirement System annual financial report may be obtained form PERS, PO Box 23700, Tigard, Oregon 97281-3700.

Covered employees are required by State statute to contribute 6 percent of their salary to the plan. Current law permits employers to pay employee contributions to the Retirement Fund. The Lottery is required by statute to contribute actuarially computed amounts as determined by PERS. Rates are subject to change as a result of subsequent actuarial valuations. Currently the rate is 8.46 percent of each covered employee's salary. The amounts contributed by the Lottery for the years ended June 30, 1997, 1996, and 1995 were $1,790,070, $1,573,692, and $1,387,844, respectively, equal to the required contributions for each year. No pension liability existed at June 30, 1997, determined in accordance with Statement No. 27 of the Governmental Accounting Standards Board.

8. Compensated Absences

Vacation pay is vested when earned and is recorded as an expense when incurred. Employees earn annual leave of from 8 to 17.34 hours per month, depending upon length of service. Executive and Management Service employees can accumulate a maximum of 350 hours per employee (however, only 250 hours will be paid upon termination). All other employees can accumulate a maximum of 250 hours per employee.

Sick leave is earned at the rate of 8 hours per month, with no maximum limit. Sick leave may be taken only in the event of illness and is not convertible to pay upon termination. No liability is reported for the accumulated sick leave. Only vacation leave and some compensatory time meet the criteria to qualify for compensated absences disclosure:

1. The employee’s right to receive compensation is based on services already rendered;
2. Rights are vested and accumulate;
3. Payment of the compensation is probable; and
4. The amount can be reasonably estimated.

The compensated absences liability is calculated by each agency based upon current salary rates. The total liability for the Lottery was $907,224 at June 30, 1997.

9. Insurance

Insurance programs are administered for the State of Oregon by the Risk Management Division of the Department of Administrative Services, which provides insurance coverage to all state agencies with a Blanket Honesty and Faithful Performance Bond, General Liability and Vehicle Liability Self Insurance, and a self-insurance property damage program.

10. Contingencies - Prize Annuities

The Oregon State Lottery is contingently liable to certain prize winners for prize payments funded through the purchase of annuity contracts. Major prizes won by lottery players prior to January 1994 were awarded in the form of 20-year annuities, with the Oregon Lottery making the initial payment and an annuity vendor selected to make the 19 remaining annual payments. After January 1994, the Lottery began purchasing US Government securities instead of annuities (See Note 3).

At June 30, 1997, the contingent liability for future prize payments funded through purchased annuities was $167,497,389.

During August 1994, one of the Lottery's annuity vendors, Confederation Life Insurance Company, was seized by Canadian and US regulators after it failed to negotiate a financial rescue package.

This situation is limited to 25 policies that were purchased from 1985 through 1988, totaling $34,819,621. The outstanding prizes represented by these policies at June 30, 1997, is $16,797,577.

The annuity policies are insured up to $100,000 per policy by the Oregon Life and Health Insurance Guaranty Association, a statutorily created association which insures the obligations of insolvent insurers. In the event of default, the Guaranty Association will indemnify the Lottery for a total of $2,500,000, leaving a net exposure to loss of $14,297,577 distributed over the remaining 8 to 11 year lives of the annuities.

Confederation Life Insurance Company has made all scheduled annuity payments as of the date of this report.

On October 23, 1996, a Plan of Rehabilitation for Confederation Life Insurance Company was confirmed. The plan protects all annuities in payout status, that is, 100 percent of all scheduled annuity benefits are expected to continue. The Oregon Life and Health Insurance Guaranty Association does not foresee any interruption in lottery annuity payments by Confederation Life Insurance Company.

SUPPLEMENTARY SECTION

Budgetary Basis Income Statement
For the Fiscal Year Ended June 30, 1997

-UNAUDITED-

The Oregon State Lottery Commission is exempt from State of Oregon budget laws. Accordingly, the Commission adopts an annual financial plan. The following schedule reflects actual revenues and expenses compared to the fiscal year 1997 financial plan.

	Actual	Budget	Variance Favorable/ (Unfavorable)
Revenue			
Scratch-It	$142,804,497	$137,340,000	$5,464,497
Breakopen	7,680,537	7,512,000	168,537
Megabucks	38,658,051	38,260,000	398,051
Powerball	30,381,335	29,579,000	802,335
Daily 4	3,160,498	3,136,000	24,498
Sports Action	8,866,037	8,482,000	384,037
Keno	101,519,358	105,251,000	(3,731,642)
Video Lottery (Gross Receipts)	3,636,670,651	3,411,953,704	224,716,947
TOTAL	$3,969,740,964	$3,741,513,704	$228,227,260
Prize Expense	3,451,094,355	3,248,234,147	(202,860,208)
Net Revenue	$518,646,609	$493,279,557	$25,367,052
Direct Expenses			
Commissions	$151,608,816	$144,040,798	$(7,568,018)
On-Line Charge	22,362,243	24,160,581	1,798,338
Tickets	4,162,574	4,259,862	97,288
Parts and Supplies	2,386,630	1,687,872	(698,758)
Communications Network	1,151,553	213,476	(938,077)
Advertising	6,458,756	7,017,800	559,044
Sales Support	1,429,932	2,392,190	962,258
Capital Lease Interest	668,390	879,448	211,058
Depreciation	3,179,919	3,767,601	587,682
TOTAL	$193,408,813	$188,419,628	$(4,989,185)
Gross Profit	$325,237,796	$304,859,929	$20,377,867
Indirect Revenue			
Other Income	$3,902,943	$4,000,000	$(97,057)

Budgetary Basis Income Statement (continued)
For the Fiscal Year Ended June 30, 1997

-UNAUDITED-

Indirect Expenses			
Public Information	$1,294,636	$1,319,000	$24,364
Personal Services	17,521,871	18,507,192	985,321
Services and Supplies	8,084,076	9,424,337	1,340,261
Depreciation	1,010,884	1,583,870	572,986
TOTAL	$27,911,467	$30,834,399	$2,922,932
Net Profit	$301,229,272	$278,025,530	$23,203,742
Economic Development Earnings	$288,418,479	$274,392,640	$14,025,839
Funds Available for Equity and Economic Development	$12,810,793	$3,632,890	$9,177,903

FACTS ABOUT THE SECRETARY OF STATE AUDITS DIVISION

The mission of the Audits Division is to "*Protect the Public Interest and Improve Oregon Government.*" The Oregon Constitution provides that the Secretary of State shall be, by virtue of his office, Auditor of Public Accounts. The Audits Division exists to carry out this duty. The division reports to the elected Secretary of State and is independent of the Executive, Legislative, and Judicial branches of Oregon government. The division audits all state officers, agencies, boards, and commissions and oversees audits and financial reporting for local governments.

DIRECTORY OF KEY OFFICIALS

Director	John N. Lattimer
Deputy Director	Sharron E. Walker, CPA, CFE
Deputy Director	Cathy Pollino, CGFM

This report is intended to promote
the best possible management of public resources.

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Auditing to Protect the Public Interest and Improve Oregon Government