Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

July 1, 1997, to June 30, 1998

Audits Division

Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

July 1, 1997, to June 30, 1998

Audits Division

No. 98-47

December 23, 1998

OFFICE OF THE
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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, 1998. 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:
October 28, 1998

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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 is 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, 1998, and on internal control and compliance with applicable laws and regulations.

AUDIT RESULTS

This audit concludes that the Lottery's financial statements for the year ended June 30, 1998, which are included in this report, are fairly presented. For the year ended June 30, 1998, total annual revenues were about $4.5 billion, $4.2 billion from video lottery and $311 million from other lottery games. Operating revenues for the year were approximately $718 million, with $407 million from video lottery and $311 million from other lottery games. Operating revenues equal total annual revenues net of the video lottery prize expense of $3.8 billion. Determining video game operating revenue net of the related prize expense is common 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, 1998, prize expenses for traditional lottery games totaled $195 million, administrative expenses were $229.5 million, and transfers totaled $304 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 prize expenses, 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

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INDEPENDENT AUDITOR'S REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING 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, 1998, and have issued our report thereon dated October 28, 1998, which was qualified because insufficient audit evidence exists to support the Lottery's disclosures with respect to the year 2000 issue. Except as discussed in the preceding sentence, we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards.*

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Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving internal control over financial reporting and its operation that we consider to be material weaknesses.

OREGON AUDITS DIVISION

Sharron E. Walker, CPA, CFE
Deputy Director

October 28, 1998

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

Andrew A. Bromeland, CPA, Audit Administrator
Mary E. Wenger, CPA
Sarah Edwards
Diane Farris

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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, 1998, 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.

Except as discussed in the following paragraph, 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.

Governmental Accounting Standards Board Technical Bulletin 98-1, *Disclosures about Year 2000 Issues*, requires disclosure of certain matters regarding the year 2000 issue. The Lottery has included such disclosures in Note 11. Because of the unprecedented nature of the year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the year 2000 and thereafter. Accordingly, insufficient audit evidence exists to support the Lottery's disclosures with respect to the year 2000 issue made in Note 11. Further, we do not provide assurance that the Lottery is or will be year 2000 ready, that Lottery's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Lottery does business will be year 2000 ready.

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As discussed in Note 1, the financial statements of the Oregon State Lottery Commission are intended to present the financial position and the results of operations and cash flows of proprietary fund types of only that portion of the financial reporting entity of the State that is attributable to the transactions of the Lottery.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding year 2000 disclosures, the financial statements referred to above present fairly, in all material respects, the financial position of the Oregon State Lottery Commission at June 30, 1998, 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

October 28, 1998

Exhibit A

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

BALANCE SHEET

JUNE 30, 1998

Assets		
Current Assets		
Cash and Cash Equivalents	$96,910,116	
Cash – Securities Lending Collateral	8,223,727	
Securities Held–in–Trust	8,316,603	
Advances	9,144	
Accounts Receivable – Net of Allowance for Doubtful Accounts of $518,763	24,502,390	
Interest Receivable	453,374	
Ticket Inventory	2,209,865	$140,625,219
Long–Term Assets		
Securities Held–in–Trust	$77,207,231	
Equipment – Net of Accumulated Depreciation of $7,534,722	8,876,765	
Vehicles – Net of Accumulated Depreciation of $324,352	1,257,512	
Building and Improvements – Net of Accumulated Depreciation of $467,564	9,062,942	
Leased Assets – Net of Accumulated Depreciation of $5,544,448	9,127,800	105,532,250
Total Assets		$246,157,469
Liabilities and Equity		
Current Liabilities		
Accounts Payable	$ 8,567,171	
Obligations Under Securities Lending	8,223,727	
Compensated Absences	285,877	
Deposit Liability	260,193	
Prize Liability	16,162,561	
Deferred Income	5,188,760	
Economic Development Liability	88,211,602	
Capital Lease Liability	2,785,662	$129,685,553
Long -Term Liabilities		
Compensated Absences	$ 857,632	
Capital Lease Liability	6,747,478	
Deferred Prize Liability	77,207,231	84,812,341
Total Liabilities		$214,497,894
Equity		
Retained Earnings		$ 31,659,575
Total Equity		$ 31,659,575
Total Liabilities and Equity		$246,157,469

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, 1997 TO JUNE 30, 1998

Operating Revenues		
Scratch-It Instant Tickets (Net of Returns)	$121,900,392	
Breakopen Instant Tickets	6,411,098	
On-Line – Megabucks	37,403,736	
On-Line – Powerball (MUSL)	37,796,596	
On-Line – Daily 4	847,841	
On-Line – Sports Action	9,310,381	
On-Line – Keno	96,749,603	
Video Lottery (Net Receipts)	407,475,217	
Provision for Bad Debts	(267,412)	
Total Operating Revenues		$717,627,452
Operating Expenses		
Prizes		$195,078,669
Retailer Commissions		154,452,235
Game Vendor Charges		22,928,280
Tickets		3,341,134
Advertising		6,066,642
Public Information		1,745,885
Sales Support		988,825
Personal Services		20,162,465
Services and Supplies		14,639,734
Depreciation and Amortization		5,636,322
Total Operating Expenses		425,040,191
Operating Income		$292,587,261
Nonoperating Revenues		
Interest	$4,651,107	
Investment Income – Securities Lending	344,443	
Net Change In the Fair Value of Investments	2,553,441	
Other Income/Expense	470,371	$ 8,019,362
Nonoperating Expenses		
Investment Expenses – Securities Lending	$ 344,443	
Investment Income Paid as Prizes	2,553,441	$ 2,897,884
Income Before Operating Transfers		$297,708,739
Operating Transfer – To the Economic Development Fund		(303,859,957)
Net Income (Loss)		$ (6,151,218)
Equity – July 1, 1997		37,810,793
Equity – June 30, 1998		$ 31,659,575

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, 1997 TO JUNE 30,1998

Operating Income		$292,587,261
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation and amortization	$ 5,636,322	
Increase in Obligations Under Securities Lending	3,683,657	
Changes in Current Assets and Liabilities:		
Increase in Securities Held-In-Trust	(1,032,432)	
Decrease in Advances	23,009	
Decrease in Accounts Receivable	1,407,340	
Decrease in Inventory	988,204	
Decrease in Prepaid Expenses	1,301,304	
Increase in Accounts Payable	962,177	
Increase in Compensated Absences Liability	236,284	
Decrease in Deposit Liability	(606,899)	
Decrease in Prize Liability	(2,872,966)	
Increase in Deferred Income	1,297,471	
Decrease in Economic Development Liability – Unclaimed Prizes Payable	(1,175,353)	
Total Adjustments		9,848,118
Other Income/Loss		(19,224)
Net Cash Provided by Operating Activities		$302,416,155
Cash Flows from Noncapital Financing Activities:		
Interest Paid on Securities Lending	$ (344,443)	
Operating Transfers	(291,301,259)	
Net Cash Used in Noncapital Financing Activities		$(291,645,702)
Cash Flows from Capital Financing Activities:		
Acquisition of Capital Assets	$ (2,662,880)	
Disposition of Capital Assets	266,095	
Capital Lease Payments	(2,581,123)	
Net Cash Used in Capital Financing Activities		$ (4,977,908)
Cash Flows from Investing Activities:		
Investment Income on Securities Lending	$ 344,443	
Interest on Investments and Cash Balances	4,616,146	$ 4,960,589
Net Increase in Cash and Cash Equivalents		$ 10,753,134
Cash and Cash Equivalents at Beginning of Year		$ 94,380,709
Cash and Cash Equivalents at End of Year		$ 105,133,843

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

The accompanying financial statements of the Oregon State Lottery Commission have been prepared in conformity with generally accepted accounting principles as prescribed by the Governmental Accounting Standards Board (GASB), the Financial Accounting Standards Board (FASB), and the American Institute of Certified Public Accountants (AICPA). In accordance with GASB Statement No. 20, the Oregon State Lottery Commission does not apply FASB pronouncements issued after November 30, 1989, unless GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date.

The financial statements and note disclosures contained in this Financial Report are current and accurate only as of the date of this Financial Report. Circumstances and conditions may change over time, and nothing stated in this Financial Report shall be construed as providing or implying that the information or conditions reported herein will be current at, or continue until, any time in the future.

1. Summary of Significant Accounting Policies

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.

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 and cash equivalents include: cash on hand, cash and investments held by the State Treasury in the Oregon Short-Term Fund and cash deposits held by a fiscal agent. Investments are stated at fair value. 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 1998 the Lottery operated within legal constraints:

	Traditional Lottery	Video Lottery	Total	Percent
Distributable Revenues	$311,398,441	$4,248,697,218	$4,560,095,659	100.0
Prize Expense	$195,078,669	$3,837,767,851	4,032,846,520	88.4
Economic Development Earnings	65,673,835	228,186,121	293,859,956	6.5
Administrative Expenses	50,569,547	178,970,855	229,540,402	5.0
Available Income	76,390	3,772,391	3,848,781	.1
Total	$311,398,441	$4,248,697,218	$4,560,095,659	100.0
Contingency Reserve Contribution	$ 76,390	$ 3,772,391	$ 3,848,781	.1
Total Returned to the Public	$260,752,504	$4,065,953,972	$4,326,706,476	94.9
Total Returned to the Public In the Form of Prizes	$190,520,098	$3,837,520,031	$4,028,040,129	88.3

Video lottery revenue and prize expense are presented separately for comparison purposes only. As discussed in Note 1, these amounts are reported net ($4,245,243,068 – $3,837,767,851 = $407,475,217) 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 $4,558,571 for Traditional lottery and $247,820 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, plus transfers from the Contingency, less amounts contributed to the Contingency Reserve.

During Fiscal year 1998, $10 million was transferred out of the Contingency Reserve (Retained Earnings) to the Economic Development Fund in excess of the required transfers. This resulted in a net decrease in Retained Earnings of $6,151,218 for the year ended June 30, 1998, as presented in the Statement of Revenues, Expenses, and Changes in Equity. The $10 million represents revenue earned prior to Fiscal Year 1998 and, thus, was subject to legal compliance requirements in prior years. Accordingly, the $10 million is included as an operating transfer on the Statement of Revenues, but is not included in the legal compliance test for Fiscal Year 1998, that is, it is not included in the economic development earnings amount in the preceding table.

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

Revenue:		**Prize Expense:**	
Cash Received	$ 862,541,003	Cash Paid Out	$ 455,065,786
Credits Won and Played	3,382,702,065	Credits Won and Played	3,382,702,065
	$4,245,243,068		
Other Revenue	3,454,150	Total Prizes	$3,837,767,851
Total Revenue	$4,248,697,218		

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, which 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, 1998, was $92,984,716 and the bank balance was $95,452,019. 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 OSTF. 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, 1998, this balance was $3,925,400, and is disclosed separately in MUSL's financial report for the fiscal year ended June 30, 1998.

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 fair value of $48,644,543 at June 30, 1998. 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 fair value of $36,879,291 at June 30, 1998. Securities Held in Trust are reported on the balance sheet at fair value, in accordance with the provisions of Governmental Accounting Standards Board Statement Number 31. At June 30, 1998, the fair value of current maturities was $8,316,603 and the long-term portion was $77,207,231. The increase in fair value for the Fiscal Year ended June 30, 1998 was $2,553,441 and is included in the operating statement.

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 in a manner similar to MUSL. 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 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 occurs because securities must be purchased in $1,000 increments. Interest earnings between the maturity and prize payment date is expected to fund this difference. At June 30, 1998, 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, 1998

	Category			Reported	Fair
	1	2	3	Amount	Value
Investments – Categorized					
Investments not on Securities Loan:					
US Government and Agency Securities	$85,523,834			$ 85,523,834	$ 85,523,834
Allocated Portion of Reinvested Cash Collateral – OSTF:					
US Government and Agency Securities			1,406,388	1,406,388	1,407,352
Repurchase Agreements			3,081,833	3,081,833	3,081,833
Commercial Paper			2,840,039	2,840,039	2,844,741
Corporate Bonds			629,253	629,253	629,253
Asset-Backed Securities			266,214	266,214	266,214
Subtotal	$85,523,834		$8,223,727	$ 93,747,561	$ 93,753,227
Investments – Not Categorized					
Investments Held by Broker-Dealers Under Securities Loans with Cash Collateral:					
US Government and Agency Securities				8,073,269	8,073,269
Subtotal				$101,820,830	$101,826,496
Less:					
Balances Treated as Cash and Cash Equivalents on the Balance Sheet				(16,296,996)	(16,302,662)
Total Investments				$ 85,523,834	$ 85,523,834

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 act as agents in the lending of the State's securities pursuant to a form of loan agreement. During fiscal year 1998, there were no significant violations of the provisions of securities lending agreements.

During fiscal year 1998, 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 fair 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, 1998, the State had no credit risk exposure to borrowers. On June 30, 1998, 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, 1998, the fair value of the collateral held and the securities on loan, including accrued income, from the OSTF was $460,795,946 and $452,054,000, respectively. The Lottery's allocated portion of the securities on loan and the related collateral is presented in the schedule of investments.

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, 1998, was $61,530.

The following schedule presents the summarized financial activity of MUSL as of June 30, 1998, and 1997 (in thousands):

	1998	1997
Assets	$1,655,689	$1,437,620
Total Assets	$1,655,689	$1,437,620
Liabilities	$1,655,425	$1,437,329
Net Assets – Unrestricted	264	291
Total Liabilities and Net Assets	$1,655,689	$1,437,620
Unrestricted Revenues	$3,123	$3,176
Unrestricted Expenses	3,151	3,100
Change in Unrestricted Net Assets	$(28)	$76

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 1998 and 1999; one lease is open-ended. Lease expense for the year ended June 30, 1998, was $492,857.

b. Video Lottery Terminals

At June 30, 1998, 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, 1998, were classified as capital leases.

Operating lease terms are for five consecutive years, renewable annually at the option of the Lottery. Capital lease terms are currently five years.

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, 1998, was $8,834,007.

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, 1998:

	Fiscal Year	Operating Leases	Capital Leases
	1999	$12,404,666	$3,517,918
	2000	13,100,979	3,439,468
	2001	15,396,355	2,549,108
	2002	17,469,967	1,395,128
	2003	17,314,640	147,561
Total Future Minimum Lease Payments		$75,686,607	$11,049,183
Less Amounts Representing Interest			1,516,043
Present Value of Minimum Lease Payments			$9,533,140

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, 1998. Consequently, this potential obligation is not included in the accompanying financial statements. Total in reimbursements for the year were $61,731.

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 from PERS, PO Box 23700, Tigard, Oregon 97281-3700.

Covered employees are required by state statutes 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 8.2 percent of each covered employee's salary. The amounts contributed by the Lottery for the years ended June 30, 1998, 1997, and 1996 were approximately $2,060,000, $1,790,000, and $1,570,000, respectively, equal to the required contributions for each year.

8. Compensated Absences

Vacation pay is vested when earned and is recorded as an expense when incurred. Employees earn annual leave of from 10 to 17.34 hours per month, depending upon length of service. All Lottery employees can accumulate a maximum of 350 hours per employee (however, only 250 hours will be paid upon termination).

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 based upon current salary rates. The total liability for the Lottery was $1,143,509 at June 30, 1998.

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, 1998, the contingent liability for future prize payments funded through purchased annuities was $152,744,037.

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, 1998, is $14,964,965. 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 $12,464,965 distributed over the remaining 7 to 10 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.

11. Year 2000 Readiness Disclosure

-UNAUDITED-

The following disclosure is required by the Governmental Accounting Standards Board and is subject to the provisions of the Year 2000 Information and Readiness Disclosure Act, Public Law 105-271.

For year 2000 purposes, Lottery computer systems are divided into two categories: Mission Critical and Support. We have identified the following internal Mission Critical systems: the Video, On-Line, and Instant Ticket System, and the related Accounts Receivable applications. Support systems include all other applications. Technical Bulletin 98-1 “Disclosures about Year 2000 Issues” issued in October 1998 by the Governmental Accounting Standards Board (GASB), has identified stages necessary to implement a year 2000-compliant system. The Assessment Stage occurs when the organization begins the actual process of identifying all of its systems (preparing an inventory) and individual components of the systems. The Remediation Stage is when the organization actually makes changes to systems and equipment. The Validation/Testing Stage is defined as the stage in which the organization validates and tests the changes made during the conversion process. The identified Mission Critical systems, as of June 30, 1998, are in the Remediation and Validation Testing Stages. Support systems, as of June 30, 1998, are in a combination of Assessment, Remediation, and Validation Testing Stages.

The Lottery has few interfaces with external data sources, however, they are critical to its operation. These interfaces include: Department of Administrative Services for payroll transactions, Oregon State Treasury for banking transactions, and the Department of Revenue and United States Internal Revenue Service for 1099 reporting. The State and federal government are responsible for the remediation of these systems.

Because of the unprecedented nature of the Year 2000 issue, its effects and the success of related remediation efforts will not be fully determinable until the Year 2000 and thereafter. The Lottery cannot assure that it is or will be Year 2000 ready, that its remediation efforts will be successful in whole or in part, or that parties with whom the Lottery does business will be Year 2000 ready.

SUPPLEMENTARY SECTION

Budgetary Basis Income Statement
For the Fiscal Year Ended June 30, 1998

-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 compares actual revenues and expenses to the fiscal year 1998 financial plan, which has been amended to reflect quarterly Oregon Economic and Revenue Forecasts.

	Actual	Budget	Variance Favorable/ (Unfavorable)
Revenue			
Scratch-It	$121,900,392	$124,200,000	$(2,299,608)
Breakopen	6,411,098	6,300,000	111,098
Megabucks	37,403,736	38,000,000	(596,264)
Powerball	37,796,596	37,700,000	96,596
Daily 4	847,841	847,841	0
Sports Action	9,310,381	9,300,000	10,381
Keno	96,749,603	98,000,000	(1,250,397)
Video Lottery (Gross Receipts)	4,245,243,068	4,170,582,000	74,661,068
TOTAL	$4,555,662,715	$4,484,929,841	$70,732,874
Prize Expense	$4,032,846,520	3,960,909,000	(71,937,520)
Net Revenue	$522,816,195	$524,020,841	$(1,204,646)
Direct Expenses			
Retailer Commissions	$154,452,235	$155,816,000	$1,363,765
Game Vendor Charge	22,016,648	24,674,182	2,657,534
Tickets	3,341,134	3,263,000	(78,134)
Spare Parts	2,102,488	1,087,500	(1,014,988)
Technical Supplies	454,614	577,500	122,886
Advertising	6,066,642	6,930,310	863,668
Sales Support	988,825	2,159,073	1,170,248
Capital Lease Interest	911,632	891,189	(20,443)
Depreciation	3,741,604	3,183,730	(557,874)
TOTAL	$194,075,822	$198,582,484	$4,506,662
Gross Profit	$328,740,373	$325,438,357	$3,302,016
Indirect Revenue			
Other Income	$4,432,944	$4,000,000	$432,944

Budgetary Basis Income Statement (continued)
For the Fiscal Year Ended June 30, 1998

-UNAUDITED-

<u>Indirect Expenses</u>			
Public Information	$1,745,885	$2,118,000	$372,115
Personal Services	20,162,465	21,283,674	1,121,209
Services and Supplies	7,461,530	10,068,872	2,607,342
Telecommunications Network	4,199,982	228,757	(3,971,225)
Depreciation	1,894,718	1,766,821	(127,897)
TOTAL	$35,464,580	$35,466,124	$1,544
Net Profit	$297,708,737	$293,972,233	$3,736,504
Economic Development Earnings	$293,859,957	$294,082,000	$(222,043)
Funds Available for Equity and Economic Development	$3,848,780	$(109,767)	$3,958,547

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Deputy Director	Sharron E. Walker, CPA, CFE

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