
Secretary of State

State of Oregon
**OREGON STATE LOTTERY
COMMISSION**

July 1, 1998, to June 30, 1999



Audits Division

Secretary of State

State of Oregon
**OREGON STATE LOTTERY
COMMISSION**

July 1, 1998, to June 30, 1999



Audits Division

OFFICE OF THE
SECRETARY OF STATE
Bill Bradbury
Secretary of State
Suzanne Townsend
Deputy Secretary of State



AUDITS DIVISION
John Lattimer
Director

(503) 986-2255
FAX (503) 378-6767

Auditing for a Better Oregon

The Honorable John Kitzhaber, M.D.
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 report presents the results of our annual audit of the Oregon State Lottery Commission (Lottery).

As required by auditing standards, we performed the audit to obtain reasonable assurance about whether the financial statements and accompanying notes have been presented fairly by management. Our Independent Auditor's Report and the financial statements for the year ended June 30, 1999, are included in the Financial Section of this report. We concluded that the financial statements are fairly presented in accordance with generally accepted accounting principles.

Auditing standards also require us to review the Lottery's internal control and compliance with applicable laws and regulations. Our report on the results of those reviews is included in the Audit Results section of this report. We noted no instances of noncompliance that are required to be reported under government auditing standards. Similarly, we did not note any material weaknesses in internal control over financial reporting.

We appreciate the cooperation and assistance of the Lottery's management and staff during the course of the audit.

OREGON AUDITS DIVISION

John N. Lattimer
Director

Fieldwork Completion Date:
November 12, 1999

-iii-

TABLE OF CONTENTS

	<u>Page</u>
SUMMARY	vii
INTRODUCTION.....	1
AUDIT RESULTS	
REPORT ON INTERNAL CONTROL AND COMPLIANCE.....	5
COMMENDATION.....	7
FINANCIAL SECTION	
INDEPENDENT AUDITOR’S REPORT	11
FINANCIAL STATEMENTS	
Balance Sheet..... Exhibit A.....	13
Statement of Revenues, Expenses, and Changes in Equity..... Exhibit B	15
Statement of Cash Flows	Exhibit C..... 17
Notes to Financial Statements.....	19
REQUIRED SUPPLEMENTARY INFORMATION.....	31
SUPPLEMENTARY SECTION.....	35

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, 1999, 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, 1999, which are included in this report, are fairly presented. For the year ended June 30, 1999, operating revenues totaled approximately \$728 million, with \$402 million from video lottery and \$326 million from other lottery games.

Video Lottery operating revenue is reported net of the related prize expense. Video Lottery gross revenues were \$5.7 billion and the related prize expense was \$5.3 billion. Determining video game operating revenue net of the related prize expense is common industry practice. Prize expense for all other lottery games totaled \$206 million.

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 purposes. For the fiscal year ended June 30, 1999, administrative expenses were \$221.5 million, and transfers totaled \$290 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. Excluding costs of administration and payment of prizes, all proceeds from the Lottery shall be used for the benefit of any of the following public purposes: creating jobs, furthering economic development, financing public education in Oregon, or restoring and protecting Oregon's parks, beaches, watersheds and critical fish and wildlife habitats. State Lottery net proceeds are to be deposited into the Economic Development Fund. Effective July 1, 1997, 15 percent of the net proceeds in the Economic Development Fund shall be deposited into an education endowment fund and, effective July 1, 1999, 15 percent of the net proceeds in the Economic Development Fund shall be deposited into a parks and natural resources fund. 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. No more than 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, Note 2.

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, Cash Quest, 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 fund operations are accounted for in a manner similar to private business enterprises. That is, the costs of providing goods and services to the general public are expected to be financed or recovered primarily from sales and other charges to customers.

AUDIT RESULTS

OFFICE OF THE
SECRETARY OF STATE
Bill Bradbury
Secretary of State
Suzanne Townsend
Deputy Secretary of State



AUDITS DIVISION
John Lattimer
Director

(503) 986-2255
FAX (503) 378-6767

Auditing for a Better Oregon

The Honorable John Kitzhaber, M.D.
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 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, 1999, and have issued our report thereon dated November 12, 1999, which was unqualified. 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*.

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.

This report is intended solely for the information and use of the Oregon State Lottery Commission, the Oregon State Lottery's management, the governor of the state of Oregon and the Oregon Legislative Assembly and is not intended to be and should not be used by anyone other than those specified parties.

OREGON AUDITS DIVISION

Sharron E. Walker, CPA, CFE
Deputy Director

November 12, 1999

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

Sarah M. Meyer

Leslie Finley

Ryan Dempster

FINANCIAL SECTION



Auditing for a Better Oregon

The Honorable John Kitzhaber, M.D.
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

We have audited the accompanying balance sheet of the Oregon State Lottery Commission as of June 30, 1999, 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 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 of Oregon that is attributable to the transactions of the Lottery.

The Year 2000 supplementary information on page 29 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and do not express an opinion on it. In

addition, we do not provide assurance that the Oregon State Lottery Commission is or will become year 2000 compliant, that the Lottery's year 2000 remediation efforts will be successful in whole or in part, or that parties with which the Lottery does business are or will become year 2000 compliant.

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, 1999, 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.

In accordance with *Government Auditing Standards*, our report on consideration of the Oregon State Lottery Commission's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants is separately presented in the AUDIT RESULTS section of this report.

OREGON AUDITS DIVISION

Sharron E. Walker, CPA, CFE
Deputy Director

November 12, 1999

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
BALANCE SHEET
 JUNE 30, 1999

Assets

Current Assets

Cash and Cash Equivalents	\$102,183,297	
Cash – Securities Lending Collateral	9,003,766	
Investments for Prize Payments at Fair Value	8,757,878	
Advances	13,719	
Accounts Receivable – Net of Allowance for Doubtful Accounts of \$621,824	22,254,413	
Ticket Inventory	1,894,683	
Prepaid Expenses	349,087	\$144,456,843

Long-Term Assets

Investments for Prize Payments at Fair Value	\$75,615,883	
Equipment – Net of Accumulated Depreciation of \$10,155,807	6,242,130	
Vehicles – Net of Accumulated Depreciation of \$1,583,747	900,963	
Building and Improvements – Net of Accumulated Depreciation of \$741,517	9,443,611	
Leasehold Improvements – Net of Accumulated Depreciation of \$849,094	17,596	
Leased Assets – Net of Accumulated Depreciation of \$8,515,636	6,683,143	98,903,326

Total Assets

\$243,360,169

Liabilities and Equity

Current Liabilities

Accounts Payable	\$ 6,067,509	
Obligations Under Securities Lending	9,003,766	
Compensated Absences	316,481	
Deposit Liability	279,521	
Prize Liability	24,169,245	
Economic Development Liability	72,256,001	
Capital Lease Liability	3,056,882	\$115,149,405

Long -Term Liabilities

Compensated Absences	\$ 949,444	
Capital Lease Liability	4,182,932	
Deferred Prize Liability	75,615,883	80,748,259

Total Liabilities

\$195,897,664

Equity

Retained Earnings		<u>\$ 47,462,505</u>
-------------------	--	----------------------

Total Equity

\$ 47,462,505

Total Liabilities and Equity

\$243,360,169

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

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN EQUITY
 JULY 1, 1998 TO JUNE 30, 1999

<u>Operating Revenues</u>		
Scratch-It Instant Tickets (Net of Returns)	\$132,742,079	
Breakopen Instant Tickets	4,513,229	
On-Line – Megabucks	41,658,503	
On-Line – Powerball (MUSL)	43,315,885	
On-Line – Cash Quest	1,757,048	
On-Line – Sports Action	9,692,178	
On-Line – Keno	92,247,605	
Video Lottery (Net Receipts)	402,581,509	
Provision for Bad Debts	(151,831)	
Total Operating Revenues		\$728,356,205
<u>Operating Expenses</u>		
Prizes		\$206,031,348
Retailer Commissions		154,331,189
Game Vendor Charges		17,224,552
Tickets		3,953,853
Advertising		5,876,688
Public Information		2,140,319
Sales Support		1,747,034
Personal Services		19,442,950
Services and Supplies		9,179,637
Depreciation and Amortization		7,607,206
Total Operating Expenses		427,534,776
Operating Income		\$300,821,429
<u>Nonoperating Revenues</u>		
Interest	\$4,346,213	
Investment Income – Securities Lending	454,895	
Net Change In the Fair Value of Investments	2,149,292	
Other Income/Expense	1,078,362	\$ 8,028,762
<u>Nonoperating Expenses</u>		
Investment Expenses – Securities Lending	\$ 454,895	
Investment Income Paid as Prizes	2,149,292	\$ 2,604,187
Income Before Operating Transfers		\$306,246,004
Operating Transfer – To the Economic Development Fund		(290,443,074)
Net Income (Loss)		\$ 15,802,930
Equity – July 1, 1998		31,659,575
Equity – June 30, 1999		\$ 47,462,505

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

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
STATEMENT OF CASH FLOWS
 JULY 1, 1998 TO JUNE 30, 1999

Operating Income		\$300,821,429
<u>Adjustments to Reconcile Operating Income to Net Cash</u>		
<u>Provided by Operating Activities:</u>		
Depreciation and amortization	\$ 7,607,206	
Increase in Obligations Under Securities Lending	780,039	
<u>Changes in Current Assets and Liabilities:</u>		
Increase in Investments for Prize Payments at Fair Value	(441,275)	
Increase in Advances	(4,575)	
Decrease in Accounts Receivable	1,544,445	
Decrease in Inventory	315,182	
Increase in Prepaid Expenses	(349,087)	
Decrease in Accounts Payable	(2,499,662)	
Increase in Compensated Absences Liability	122,416	
Increase in Deposit Liability	19,328	
Increase in Prize Liability	8,006,684	
Decrease in Deferred Income	(5,188,760)	
Increase in Economic Development Liability – Unclaimed Prizes Payable	122,248	
Total Adjustments		10,034,189
Other Income/Loss		1,840,323
Net Cash Provided by Operating Activities		\$312,695,941
<u>Cash Flows from Noncapital Financing Activities:</u>		
Interest Paid on Securities Lending	\$ (454,895)	
Operating Transfers	(306,523,672)	
Net Cash Used in Noncapital Financing Activities		\$(306,978,567)
<u>Cash Flows from Capital Financing Activities:</u>		
Acquisition of Capital Assets	\$ (2,095,069)	
Disposition of Capital Assets	21,651	
Capital Lease Payments	(2,845,218)	
Net Cash Used in Capital Financing Activities		\$ (4,918,636)
<u>Cash Flows from Investing Activities:</u>		
Investment Income on Securities Lending	\$ 454,895	
Interest on Investments and Cash Balances	4,799,587	\$ 5,254,482
Net Increase in Cash and Cash Equivalents		\$ 6,053,220
Cash and Cash Equivalents at Beginning of Year		\$ 105,133,843
Cash and Cash Equivalents at End of Year		\$ 111,187,063

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

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 1999

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.

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.

Notes to the Financial Statements (continued)
June 30, 1999

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 when packs are activated by retailers.

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. 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. Inventories are valued using the specific identification method.

g. 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 \$5,000. The straight-line method of depreciation is used. The estimated life of the major classes of property and equipment currently being depreciated range from three through forty years.

During fiscal year 1999, Lottery's fixed asset policy was changed:

- The capitalization threshold was raised from \$2,000 to \$5,000;
- Asset categories were consolidated and useful lives revised; and
- Salvage values were eliminated for all assets, except for vehicles, which have a ten percent salvage value.

A change in estimate to salvage value resulted in additional charges to depreciation expense of approximately \$1.1 million for the fiscal year ending June 30, 1999. It will increase depreciation expense in future periods by approximately \$1.3 million.

h. 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 1999 the Lottery operated within legal constraints:

	<u>Traditional Lottery</u>	<u>Video Lottery</u>	<u>Total</u>	<u>Percent</u>
Distributable Revenues	\$ 326,940,513	\$ 5,663,891,188	\$ 5,990,831,701	100.0
Prize Expense	\$ 206,031,349	\$ 5,257,510,942	\$ 5,463,542,291	91.2
Economic Development Earnings	67,746,933	218,512,447	286,259,380	4.8
Administrative Expenses	48,958,709	172,047,786	221,006,495	3.7
Available Income	4,203,522	15,820,013	20,023,535	0.3
Total	\$ 326,940,513	\$ 5,663,891,188	\$ 5,990,831,701	100.0
Contingency Reserve Contribution	\$ 4,203,522	\$ 11,636,319	\$ 3,848,781	0.3
Total Returned to the Public	\$ 273,778,282	\$ 5,476,023,389	\$ 5,749,801,671	96.0
Total Returned to the Public In the Form of Prizes	\$ 201,779,100	\$ 5,257,418,583	\$ 5,459,197,684	91.1

Video lottery revenue and prize expense are presented separately for comparison purposes only. As discussed in Note 1, these amounts are reported net (\$5,660,092,451 – \$5,257,510,942 = \$402,581,509) 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 \$4,252,248 for Traditional lottery and \$92,359 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.

Notes to the Financial Statements (continued)
June 30, 1999

During Fiscal year 1999, \$4,183,694 million was transferred out of the Contingency Reserve (Retained Earnings) to the Economic Development Fund in excess of the required transfers. It represents revenue earned prior to Fiscal Year 1999 and, thus, was subject to legal compliance requirements in prior years. Accordingly, it is included as an operating transfer on the Statement of Revenues, but is not included in the legal compliance test for Fiscal Year 1999, 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:

<u>Revenue:</u>		<u>Prize Expense:</u>	
Cash Received	\$ 952,787,028	Cash Paid Out	\$ 550,205,519
Dollars Won and Played	4,707,305,423	Dollars Won and Played	4,707,305,423
	<u>\$ 5,660,092,451</u>		
Other Revenue	3,798,737	Total Prizes	<u>\$ 5,257,510,942</u>
Total Revenue	<u>\$ 5,663,891,188</u>		

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 \$95 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, 1999, was \$99,070,475 and the bank balance was \$103,909,998. 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, 1999, this balance was \$3,112,822, and is disclosed separately in MUSL's financial report for the fiscal year ended June 30, 1999.

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 Investments for Prize Payments at Fair Value held by the State Treasurer to fund certain Megabucks and Scratch-it Instant Ticket prize winners. These investments included U.S. Government Securities that had a fair value of \$50,549,561 at June 30, 1999. 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 Investments for Prize Payments at Fair Value 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 \$33,824,200 at June 30, 1999. Investment for Prize Payments at Fair Value 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, 1999, the fair value of current maturities was \$8,757,878 and the long-term portion was \$75,615,883. The increase in fair value for the Fiscal Year ended June 30, 1999 was \$2,149,292 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, 1997 and 1999. 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 certain prize winners' 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, 1999, there were seven Oregon MUSL winners.

Notes to the Financial Statements (continued)
June 30, 1999

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, 1999

	<u>Category</u>			<u>Fair Value</u>
	<u>1</u>	<u>2</u>	<u>3</u>	
Investments – Categorized				
Investments not on Securities Loan:				
US Government and Agency Securities	\$84,373,760			\$ 84,373,760
Subtotal	\$84,373,760			\$84,373,760
Investments – Not Categorized				
Investments Held by Broker-Dealers Under Securities Loans with Cash Collateral:				
US Government and Agency Securities				8,714,523
Short-Term Collateral Investment Pool				9,006,565
Subtotal				\$102,094,848
Less:				
Balances Treated as Cash and Cash Equivalents on the Balance Sheet				(17,721,088)
Total Investments				\$ 84,373,760

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 1999, there were no significant violations of the provisions of securities lending agreements.

During fiscal year 1999, 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, 1999, the State had no credit risk exposure to borrowers. On June 30, 1999, 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, 1999, the fair value of the collateral held and the securities on loan, including accrued income, from the OSTF was \$532,087,901 and \$514,834,680, 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.

Notes to the Financial Statements (continued)
June 30, 1999

The Oregon Lottery's share of MUSL's operating expenses for the fiscal year ended June 30, 1999, was \$65,482.

The following schedule presents the summarized financial activity of MUSL as of June 30, 1999, and 1998 (in thousands):

	<u>1999</u>	<u>1998</u>
Assets	<u>\$1,585,326</u>	<u>\$1,655,689</u>
Total Assets	<u>\$1,585,326</u>	<u>\$1,655,689</u>
Liabilities	\$1,585,097	\$1,655,425
Net Assets – Unrestricted	229	264
Total Liabilities and Net Assets	<u>\$1,585,326</u>	<u>\$1,655,689</u>
Unrestricted Revenues	\$2,714	\$3,123
Unrestricted Expenses	<u>2,749</u>	<u>3,151</u>
Change in Unrestricted Net Assets	<u>(\$35)</u>	<u>(\$28)</u>

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 50266-1908.

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 storage facilities throughout the state under long-term operating leases, which expire from 1999 to 2004. Land for the Salem headquarters is leased from the Department of Administrative services with a 20-year land lease. Lease expense for the year ended June 30, 1999, was \$383,065.

b. Video Lottery Terminals

At June 30, 1999, 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, 1999, were classified as capital leases. During fiscal year

Notes to the Financial Statements (continued)
June 30, 1999

1999, eleven VLTs financed with capital leases were purchased at their fair value. The leased assets and lease liabilities were reduced accordingly.

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, 1999, was \$7,208,625.

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, 1999:

	<u>Fiscal</u> <u>Year</u>	<u>Operating</u> <u>Leases</u>	<u>Capital</u> <u>Leases</u>
	2000	\$ 7,180,569	\$3,557,767
	2001	7,064,256	2,675,708
	2002	6,240,414	1,524,040
	2003	5,022,511	281,899
	2004	3,328,419	45,088
Total Future Minimum Lease Payments		\$28,836,169	\$8,084,502
Less Amounts Representing Interest			844,688
Present Value of Minimum Lease Payments			\$7,239,814

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, 1999. Consequently, this potential obligation is not included in the accompanying financial statements. Total in reimbursements for the year was \$152,713.

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

Notes to the Financial Statements (continued)

June 30, 1999

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. 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, 11410 SW 68th Parkway, Tigard, Oregon 97223.

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 both the employees required contribution and the employer's (Lottery's) required contribution for the years ended June 30, 1999, 1998, and 1997 were approximately \$2,094,000, \$2,060,000, and \$1,790,000, 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 absence accrual:

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 \$1,265,925 at June 30, 1999.

9. Insurance

The State of Oregon administers property and casualty insurance programs covering State government through its Insurance Fund. The Insurance Fund services claims for direct physical loss or damage to State property; tort liability claims brought against the State, its officers, employees, or agents; workers' compensation; and employees, elected officials, and members of commissions and boards for honesty and faithful performance.

As a state agency, the Lottery participates in the Insurance Fund. The cost of servicing insurance claims and payment is covered by charging an assessment to each State entity based on its share of services provided in a prior period. The total statewide assessment of each coverage is based on independent biennial actuarial forecasts and administrative expenses, less any available fund balance in the Insurance Fund from the prior biennium.

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 U.S. Government securities instead of annuities (See Note 3). At June 30, 1999, the contingent liability for future prize payments funded through purchased annuities was \$137,990,685.

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, 1999, is \$13,132,354. 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 \$10,632,354 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.

REQUIRED SUPPLEMENTARY SECTION

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
REQUIRED SUPPLEMENTARY INFORMATION
JUNE 30, 1999

-UNAUDITED-

1. Year 2000 Readiness Disclosure

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, ICS 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), as amended by Technical Bulletin 99-1 issued March 1999, 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 and support systems, as of June 30, 1999, are in the 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, the Department of Revenue and United States Internal Revenue Service for 1099 reporting, and GTECH for online and video gaming activity. The State, federal government, and GTECH 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

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
SUPPLEMENTARY INFORMATION
BUDGETARY BASIS INCOME STATEMENT
FOR THE FISCAL YEAR ENDED JUNE 30, 1999

-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 1999 financial plan, which has been amended to reflect quarterly Oregon Economic and Revenue Forecasts.

	<u>Actual</u>	<u>Budget</u>	<u>Variance Favorable/ (Unfavorable)</u>
<u>Revenue</u>			
Scratch-It	\$132,742,079	\$129,787,000	\$2,955,079
Breakopen	4,513,229	4,510,000	3,229
Megabucks	41,658,503	40,266,000	1,392,503
Powerball	43,315,885	40,213,000	3,102,885
Cash Quest	1,757,048	1,365,000	392,048
Sports Action	9,692,178	9,693,000	(822)
Keno	92,247,605	92,796,000	(548,395)
Video Lottery (Gross Receipts)	5,660,092,451	5,002,694,000	657,398,451
TOTAL	\$5,986,018,978	\$5,321,324,000	\$664,694,978
Prize Expense	\$5,463,542,290	4,803,161,000	(660,381,290)
Net Revenue	\$522,476,688	\$518,163,000	\$4,313,688
<u>Direct Expenses</u>			
Retailer Commissions	\$154,331,189	\$153,020,000	\$(1,311,189)
Game Vendor Charges	16,494,757	17,393,000	898,243
Tickets	3,953,853	3,641,000	(312,853)
VLT Repair Expense	804,864	1,318,377	513,513
Technical Supplies	249,406	574,334	324,928
Advertising	4,996,800	5,764,000	767,200
New Game Launch	879,888	1,500,000	620,112
Sales Support	1,747,034	2,162,000	414,966
Capital Lease Interest	729,795	732,255	2,460
Depreciation	4,180,031	3,842,458	(337,573)
TOTAL	\$188,367,617	\$189,947,424	\$1,579,807
Gross Profit	\$334,109,071	\$328,215,576	\$5,893,495
<u>Indirect Revenue</u>			
Other Income	\$4,812,722	\$4,000,000	\$812,722

Budgetary Basis Income Statement (continued)

For the Fiscal Year Ended June 30, 1999

-UNAUDITED-

	<u>Actual</u>	<u>Budget</u>	<u>Variance Favorable/ (Unfavorable)</u>
<u>Indirect Expenses</u>			
Public Information	\$2,140,319	\$2,267,000	\$126,681
Personal Services	19,442,950	21,458,042	2,015,092
Services and Supplies	7,431,778	9,878,441	2,446,663
Telecommunications Network	233,567	538,022	304,455
Depreciation	3,427,175	2,680,028	(747,147)
TOTAL	<u>\$32,675,789</u>	<u>\$36,821,533</u>	<u>\$4,145,744</u>
Net Profit	<u>\$306,246,004</u>	<u>\$295,394,043</u>	<u>\$10,851,961</u>
Economic Development Earnings	<u>\$286,259,381</u>	<u>\$290,656,000</u>	<u>\$(4,396,619)</u>
Funds Available for Equity and Economic Development	<u>\$19,986,623</u>	<u>\$4,738,043</u>	<u>\$15,248,580</u>

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

Deputy Director

Deputy Director

John N. Lattimer

Sharron E. Walker, CPA, CFE

Catherine E. Pollino, CGFM



This report, which is a public record, is intended to promote the best possible management of public resources.

If you received a copy of an audit and no longer need it, you may return it to the Audits Division. We maintain an inventory of past audit reports. Your cooperation will help us save on printing costs.

Oregon Audits Division
Public Service Building
Salem, Oregon 97310

503-986-2255

We invite comments on our reports through our Hotline or Internet address.

Hotline: 800-336-8218

Internet: Audits.Hotline@state.or.us

<http://www.sos.state.or.us/audits/auditthp.htm>

Auditing to Protect the Public Interest and Improve Oregon Government