Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

July 1, 2000, to June 30, 2001

Audits Division

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Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

July 1, 2000, to June 30, 2001

Audits Division

No. 2002-08

February 19, 2002

OFFICE OF THE
SECRETARY OF STATE
Bill Bradbury
Secretary of State

AUDITS DIVISION
Cathy Pollino
Director

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

Auditing for a Better Oregon

The Honorable John Kitzhaber, M.D.
Governor of Oregon
254 State Capitol
Salem, Oregon 97301-4047

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, 2001, 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 did not note any instances of noncompliance that are required to be reported under *Government Auditing Standards*; however, we did identify reportable conditions in internal control over financial reporting. Although reportable, we did not consider these issues to represent a risk that the financial statements could be materially misstated without detection.

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

OREGON AUDITS DIVISION

Cathy Pollino
Director

December 12, 2001

255 Capitol Street NE • Suite 500 • Salem, Oregon 97310 • (503) 986-2255
FAX (503) 378-6767 • INTERNET: Audits.hotline@state.or.us
http://www.sos.state.or.us/audits/audithp.htm

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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, financing public education, and restoring and protecting certain parks and natural resources 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, education, or parks and natural resource restoration/protection. 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, 2001, 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, 2001, which are included in this report, are fairly presented. Our report on compliance with applicable laws and regulations and internal control over financial reporting is included herein. Our review disclosed no instances of noncompliance required to be reported herein under *Government Auditing Standards*. However, we noted a reportable condition involving internal control over financial reporting that we do not consider to be a material weakness. We also noted other matters involving internal control over financial reporting, which we have reported to the Lottery in a separate letter.

For the year ended June 30, 2001, operating revenues totaled approximately $785 million, with $462 million from video lottery and $323 million from other lottery games.

Video Lottery operating revenue is reported net of the related prize expense. Video Lottery gross revenues were $7.3 billion and the related prize expense was $6.8 billion. Determining video game operating revenue net of the related prize expense is common industry practice. Prize expense for all other lottery games totaled $212 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, 2001, administrative expenses were $252 million, and transfers totaled $292 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 Administrative Services 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 shall be available for the payment of administrative expenses.

The revenue amount reported in Lottery's financial statements differs from the revenue amount that Lottery uses to determine compliance with ORS Chapter 461.

In the financial statements, Lottery reports video game revenue net of video prize expense. This is a common financial reporting practice for lotteries. In Note 2 to the financial statements (titled "Legal Compliance"), Lottery calculates compliance with ORS Chapter 461 using video game revenue at gross rather than net of video game prize expense.

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 ten games during the audit period: two instant ticket games ("Scratch-it" and "Breakopen"), seven on-line games (Megabucks, Cash Quest, Pick 4, Powerball, Sports Action, Keno and Win for Life), 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 connected to 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

AUDITS DIVISION
Cathy Pollino
Director

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

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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), an agency of the state of Oregon, as of and for the year ended June 30, 2001, and have issued our report thereon dated December 12, 2001. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Compliance
As part of obtaining reasonable assurance about whether Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, 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 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. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be

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INTERNET: Audits.hotline@state.or.us • http://www.sos.state.or.us/audits/audithp.htm

reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Lottery's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. The matters we consider to be reportable conditions are included in the Findings and Recommendations section of this report.

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. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness. We also noted other matters involving the internal control over financial reporting, which we have reported to management of Lottery in a separate letter.

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 these specified parties.

OREGON AUDITS DIVISION

Bill Bradbury
Secretary of State

December 12, 2001

FINDINGS AND RECOMMENDATIONS

ACCOUNTING AND FINANCIAL REPORTING

The Oregon State Lottery Commission (Lottery) should have a system of internal controls to ensure that agency financial reports accurately reflect property and equipment balances. Those controls should include a system for recording fixed asset transactions and accurately reporting the balances on the agency's financial statements. Lottery also should have procedures for ensuring that reported amounts conform to generally accepted accounting principles and agency capitalization policies.

Although Lottery has an automated system for recording fixed asset transactions, the system did not readily provide sufficient detail to support the balances included in the financial statements. In addition, agency efforts to monitor fixed asset records to ensure that they complied with agency policy were not effective. Consequently, initially reported fixed asset balances included more than 400 items that did not meet the agency's capitalization threshold. The net book value of those items totaled approximately $70,000, with accumulated depreciation of approximately $1 million.

In addition, during our review of draft statements, we noted several assets that were not appropriately classified on the balance sheet. For example, the amount reported as accumulated amortization for Leased Assets included approximately $6.5 million that should have been classified as Equipment accumulated depreciation or removed from the balance sheet presentation. Those assets were associated with terminated leases; thus, the assets were subsequently purchased by Lottery, returned to the lessor, or disposed.

Furthermore, Lottery's process for estimating, monitoring and adjusting depreciation and amortization schedules should be improved to ensure that asset costs are allocated over their useful life. Excluding building and improvements, 82 percent of Lottery's fixed assets were fully depreciated or amortized, many for several years. Consequently, asset costs were not properly matched to the revenues they generated according to generally accepted accounting principles.

Lottery corrected the potential misstatements to fixed asset balances noted above. We determined that if left uncorrected, the misstatements would have been immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We recommend that Lottery management evaluate and improve its automated system for tracking and accounting for fixed assets so that it more readily provides information supporting fixed asset balances. In addition, management should perform periodic reviews of the fixed asset database to ensure accuracy and conformity with fixed asset policies and generally accepted accounting principles. We also recommend that Lottery management periodically review and adjust depreciation and amortization schedules to more accurately allocate asset costs.

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

Neal Weatherspoon, CPA, CISA, Audit Administrator
Janice Richards, CPA, CISA
Ryan Dempster
Alan Bell

FINANCIAL SECTION

OFFICE OF THE
SECRETARY OF STATE
Bill Bradbury
Secretary of State

AUDITS DIVISION
Cathy Pollino
Director

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

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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, 2001, 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’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Lottery Operations Fund, an enterprise fund of the State of Oregon that accounts for the operations of the Oregon State Lottery Commission. The financial statements are not intended to present fairly the financial position of the State of Oregon and the results of its operations and cash flows of its proprietary fund types and nonexpendable trust funds in conformity with accounting principles generally accepted in the United States of America.

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In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Oregon State Lottery Commission as of June 30, 2001, and the results of its operations and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The supplementary section listed in the table of contents is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we also have issued our report dated December 12, 2001, on our consideration of the Oregon State Lottery Commission's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

OREGON AUDITS DIVISION

Bill Bradbury
Secretary of State

December 12, 2001

Exhibit A

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

BALANCE SHEET

JUNE 30, 2001

Assets

Current Assets		
Cash and Cash Equivalents	$172,652,150	
Cash – Securities Lending Collateral	16,985,929	
Investments for Prize Payments at Fair Value	9,663,866	
Advances	14,404	
Accounts Receivable – Net of Allowance for Doubtful Accounts of $532,192	23,759,968	
Interest Receivable	68,400	
Ticket Inventory	1,697,012	
Prepaid Expenses	331,545	$225,173,274
Long–Term Assets		
Investments for Prize Payments at Fair Value	$ 78,870,328	
Equipment – Net of Accumulated Depreciation of $18,367,705	2,576,699	
Vehicles – Net of Accumulated Depreciation of $1,822,467	1,718,280	
Building and Improvements – Net of Accumulated Depreciation of $1,316,687	9,759,300	
Leasehold Improvements – Net of Accumulated Amortization of $16,993	16,095	
Leased Assets – Net of Accumulated Amortization of $7,123,034	1,479,375	
Computer Software – Net of Accumulated Amortization of $495,267	394,441	94,814,518
Total Assets		$319,987,792

Liabilities and Equity

Current Liabilities		
Accounts Payable	$ 4,487,545	
Obligations Under Securities Lending	16,985,929	
Compensated Absences	406,612	
Deposit Liability	370,686	
Prize Liability	20,280,099	
Due to Economic Development Fund	100,683,551	
Capital Lease Liability	1,440,658	$144,655,080
Long -Term Liabilities		
Compensated Absences	$ 1,219,840	
Capital Lease Liability	312,958	
Deferred Prize Liability	78,870,328	80,403,126
Total Liabilities		$225,058,206
Equity		
Retained Earnings		$ 94,929,586
Total Equity		$ 94,929,586
Total Liabilities and Equity		$319,987,792

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, 2000 TO JUNE 30, 2001

Operating Revenues		
Scratch-It Instant Tickets (Net of Returns)	$129,345,971	
Breakopen Instant Tickets	4,229,395	
On-Line – Megabucks	30,880,654	
On-Line – Powerball (MUSL)	38,104,163	
On-Line – Cash Quest	(525)	
On-Line – Sports Action	9,777,530	
On-Line – Keno	104,752,247	
On-Line – Pick 4	2,406,063	
On-Line – Win for Life	3,770,174	
Video Lottery (Net Receipts)	462,398,035	
Provision for Bad Debts	(200,067)	
Total Operating Revenues		$785,463,640
Operating Expenses		
Prizes	$211,890,656	
Retailer Commissions	175,711,399	
Game Vendor Charges	17,284,108	
Tickets	4,444,691	
Advertising	6,629,885	
Public Information	2,413,137	
Sales Support	1,704,981	
Personal Services	23,014,660	
Services and Supplies	15,422,658	
Depreciation and Amortization	5,495,390	
Total Operating Expenses		464,011,565
Operating Income		$321,452,075
Nonoperating Revenues		
Interest	$ 7,679,340	
Investment Income – Securities Lending	1,206,037	
Net Change In the Fair Value of Investments	8,582,272	
Other Income	1,633,418	$ 19,101,067
Nonoperating Expenses		
Investment Expenses – Securities Lending	$ 1,206,037	
Investment Income Paid as Prizes	8,582,272	$ 9,788,309
Income Before Operating Transfers		$330,764,833
Operating Transfers to the Economic Development Fund		(310,909,554)
Net Income (Loss)		$ 19,855,279
Equity – July 1, 2000		75,074,307
Equity – June 30, 2001		$ 94,929,586

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, 2000 TO JUNE 30,2001

Operating Income		$ 321,452,075
Adjustments to Reconcile Operating Income to Net Cash Provided by Operating Activities:		
Depreciation and amortization	$ 5,495,390	
Changes in Current Assets and Liabilities:		
Increase in Investments for Prize Payments at Fair Value	(325,634)	
Decrease in Advances	968	
Increase in Accounts Receivable	(2,625,454)	
Decrease in Interest Receivable	5,983	
Decrease in Ticket Inventory	152,310	
Increase in Prepaid Expenses	(122,193)	
Decrease in Accounts Payable	(2,552,525)	
Increase in Compensated Absences Liability	192,997	
Increase in Deposit Liability	16,103	
Decrease in Prize Liability	(562,105)	
Increase in Due to the Economic Development Fund – Unclaimed Prizes Payable	5,670,342	
Total Adjustments		5,346,182
Other Income		1,113,540
Net Cash Provided by Operating Activities		$ 327,911,797
Cash Flows from Noncapital Financing Activities:		
Operating Transfers to The Economic Development Fund	$(288,191,000)	
Net Cash Used in Noncapital Financing Activities		$(288,191,000)
Cash Flows from Capital Financing Activities:		
Acquisition of Capital Assets	$ (2,657,883)	
Disposition of Capital Assets	349,785	
Capital Lease Payments	(2,424,297)	
Net Cash Used in Capital Financing Activities		$ (4,732,395)
Cash Flows from Investing Activities:		
Investment Income on Securities Lending	$ 1,206,037	
Interest Paid on Securities Lending	(1,206,037)	
Interest on Investments and Cash Balances	7,685,323	$ 7,685,323
Net Increase in Cash and Cash Equivalents		$ 42,673,725
Cash and Cash Equivalents at Beginning of Year		$ 129,978,425
Cash and Cash Equivalents at End of Year		$ 172,652,150

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, 2001

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).

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 (Lottery). The Lottery commenced operations in January 1985.

b. Basis of Presentation

The Lottery uses an enterprise fund, the Lottery Operations 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.

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.

c. Measurement Focus and Basis of Accounting

Lottery financial statements are reported using the economic resources measurement focus and accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

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 retailers activate packs.

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 exception to this policy is that groups of approved assets, with component values less than $5,000, are capitalized. 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.

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 2001 the Lottery operated within legal constraints:

	Traditional Lottery	Video Lottery	Total	Percent
Distributable Revenues	$ 325,146,896	$ 7,300,150,343	$ 7,625,297,239	100.0
Prize Expense	$ 211,890,656	$ 6,831,015,004	$ 7,042,905,660	92.4
Economic Development Earnings	59,652,509	232,526,492	292,179,001	3.8
Administrative Expenses	56,842,376	194,772,387	251,626,763	3.3
Available Income	(3,250,645)	41,836,460	38,585,815	0.5
Total	$ 325,146,896	$ 7,300,150,343	$ 7,625,297,239	100.0
Contingency Reserve Contribution	$ (3,250,645)	$ 23,105,907	$ 19,855,262	0.3
Total Returned to the Public	$ 271,543,165	$ 7,063,541,496	$ 7,335,084,661	96.2
Total Returned to the Public In the Form of Prizes	$ 206,549,801	$ 6,830,685,860	$ 7,037,235,661	92.3

Video lottery revenue and prize expense are presented separately for comparison purposes only. As discussed in Note 1, these amounts are reported net ($7,293,413,039 – $6,831,015,004 = $462,398,035) in the Statement of Revenues, Expenses, and Changes in Equity. Prize Expense amounts differ from prizes returned to the public. Prize expense amounts include unclaimed prizes of $5,340,855 for Traditional lottery and $329,144 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 Reserve, less amounts contributed to the Contingency Reserve.

As of June 30, 2001, $18,730,553 was transferred out of the Contingency Reserve (Retained Earnings) to Economic Development Liability to ensure that the Contingency Reserve did not exceed the $95 million maximum set by the Lottery Commission. The additional amount is included in Available Income for legal compliance purposes, because it results from Fiscal Year 2001 operations.

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

Revenue:			**Prize Expense:**		
Cash Received	$	1,174,432,120	Cash Paid Out	$	712,034,083
Dollars Won and Played		6,118,980,921	Dollars Won and Played		6,118,980,921
	$	7,293,413,041			
Other Revenue		6,737,302	Total Prizes	$	6,831,015,004
Total Revenue	$	7,300,150,343			

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 as of June 30, 2001, was $169,435,176 and the bank balance was $172,605,545. The difference between the balances consists primarily of deposits in transit and outstanding checks.

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. As of June 30, 2001, this balance was $3,216,974, and is disclosed separately in MUSL's financial report for the fiscal year ended June 30, 2001.

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, Keno and Scratch-it Instant Ticket prize winners. These investments included U.S. Government Securities that had a fair value of $58,118,464 as of June 30, 2001. 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 $30,415,730 as of June 30, 2001. 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. As of June 30, 2001, the fair value of current maturities was $9,663,866 and the long-term portion was $78,870,328. The increase in fair value for the Fiscal Year ended June 30, 2001 was $8,582,272 and is included in the operating statement.

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.

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, 1999 and 2000. 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 installments were 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. As of June 30, 2001, 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, 2001

	Category 1	Category 2	Category 3	Fair Value
Investments – Categorized				
Investments not on Securities Loan:				
US Government and Agency Securities	$78,659,974			$ 78,659,974
Subtotal	$78,659,974			$ 78,659,974
Investments – Not Categorized				
Investments Held by Broker-Dealers Under Securities Loans with Cash Collateral:				
US Government and Agency Securities				16,429,713
Securities Lending Short-Term Collateral Investment Pool				17,070,615
Subtotal				$112,160,302
Less:				
Balances Treated as Cash and Cash Equivalents on the Balance Sheet				(23,626,108)
Total Investments				$ 88,534,194

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 2001, there were no significant violations of the provisions of securities lending agreements.

During fiscal year 2001, 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 percent 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, 2001, the State had no credit risk exposure to borrowers. On June 30, 2001, the Lottery had securities on loan in the amount of $9,874,220.

The Lottery's cash balances are invested in the Oregon Short-Term Fund (OSTF), as is the cash of other state agencies. As of June 30, 2001, the fair value of the collateral held and the securities on loan from the OSTF was $283,153,705, and the total cash collateral received for the securities on loan from the OSTF was $296,392,500. The fair value of all investments made with the cash collateral received for those securities on loan was $297,870,212. 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, the New Mexico Lottery Authority, and the Colorado Lottery.

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 Executive Committee carries out the budgeting and financing of MUSL, while the Board contracts the annual independent audit.

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 in United States Government securities.

The Oregon Lottery's share of MUSL's operating expenses for the fiscal year ended June 30, 2001, was $77,230.

The following schedule presents the summarized financial activity of MUSL as of June 30, 2001, and 2000 (in thousands):

	2001	2000
Assets	$1,315,864	$1,433,307
Total Assets	$1,315,864	$1,433,307
Liabilities	$1,315,537	$1,433,129
Net Assets – Unrestricted	327	178
Total Liabilities and Net Assets	$1,315,864	$1,433,307
Unrestricted Revenues	$ 5,192	$ 2,866
Unrestricted Expenses	5,044	2,916
Change in Unrestricted Net Assets	$ 148	$ (50)

Complete separate financial statements for MUSL may be obtained from the Multi-State Lottery Association, Attention: Chuck Strutt, 1701 48th Street, Suite 210, West Des Moines, Iowa 50266-6723.

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 2002 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, 2001, was $110,421.

b. Mainframe Computer

A gaming system mainframe computer is leased from a third-party financing company under a capital lease. The lease term is five years, from November 1998, to October 2003.

c. Video Lottery Terminals

As of June 30, 2001, 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, 2001, 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, 2001, was $8,074,737.

The following is an analysis of leased assets under capital leases by major classes:

Class of Property	Asset Balance at June 30, 2001
Equipment	$ 277,169
Video Lottery Terminals	1,202,206
Total	$1,479,375

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 as of June 30, 2001:

	Fiscal Year	Operating Leases	Capital Leases
	2002	$ 5,886,913	$1,524,040
	2003	1,679,566	277,000
	2004	1,336,193	45,088
	2005	939,356	-
	2006	939,356	-
Total Future Minimum Lease Payments		$10,781,384	$1,846,128
Less Amounts Representing Interest			92,512
Present Value of Minimum Lease Payments			$1,753,616

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 that may be made to former employees for wage credits earned prior to June 30, 2001. Consequently, this potential obligation is not included in the accompanying financial statements. Total in reimbursements for the year was $49,824.

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. PERS also provides death and disability benefits. A copy of the Oregon Public Employees Retirement System annual financial report may be obtained by writing to the Fiscal Services Division, Public Employees Retirement System, 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. For the fiscal year ending June 30, 2001, the rate is 9.73 percent of each covered employee's salary. The amounts contributed by the Lottery for both the employees required contribution and the employer’s (Lottery) required contribution for the years ended June 30, 2001, 2000, and 1999 were approximately $2,571,000, $2,413,000, and $2,094,000, 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 $1,626,449 as of June 30, 2001.

9. Insurance

The State of Oregon administers property and casualty insurance programs covering state government through its Central Services Fund (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; worker's compensation; employee dishonesty; and faithful performance coverage for certain key positions required by law to be covered, and other key positions.

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

a. Litigation

A group known as "Oregonians for Gambling Awareness" has filed a complaint challenging the constitutionality of the 1984 initiative measure that amended the Oregon Constitution to authorize the Oregon State Lottery. The State has not yet had the opportunity to fully evaluate the merits of the case. However, if the challenge were successful, the State would no longer be authorized to operate the Lottery. The 2001-2003 State budget passed by the Legislature included approximately $600 million in lottery revenues. An order and judgment dismissing the case was entered on November 2, 2001. On December 3, 2001, plaintiffs filed a timely notice of appeal of the circuit court's order and judgment in the Court of Appeals.

b. 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). As of June 30, 2001, the contingent liability for future prize payments funded through purchased annuities was $108,483,981.

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 as of June 30, 2001, is $9,467,130. The annuity policies are insured up to $100,000 per policy by the Oregon Life and Health Insurance Guaranty Association, a statutorily created association that insures the obligations of insolvent insurers. In the event of default, the Guaranty Association will indemnify the Lottery in the amount of $2,500,000, leaving a net exposure to loss of $6,967,130 distributed over the remaining four-to-seven-year lives of the annuities.

On October 23, 1996, a Plan of Rehabilitation for Confederation Life Insurance Company was confirmed. Allstate Life Insurance Company was selected as the administrator for Confederation Life Insurance Company's US annuity payments, beginning November 1, 1997. Effective July 15, 1999, Pacific Life Insurance Company assumed all Confederation Life Insurance Company's annuity contracts.

11. Subsequent Events

Major Contracts

On August 24, 2001, the Lottery entered into a contract with Video Lottery Consultants, a manufacturer of Video Lottery Terminals (VLTs). The contract provides for the purchase of a minimum of 2,000 VLTs during the period October 15, 2001, through April 15, 2003, at a minimum cost of $7,850 each, or a total purchase price of $15,700,000.

SUPPLEMENTARY SECTION

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
SUPPLEMENTARY INFORMATION
BUDGETARY BASIS INCOME STATEMENT
FOR THE FISCAL YEAR ENDED JUNE 30, 2001

–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 2001 financial plan, which has been amended to reflect quarterly Oregon Economic and Revenue Forecasts.

	Actual	Budget	Variance Favorable/ (Unfavorable)
Revenue			
Scratch-It	$ 129,345,971	$ 130,214,000	$ (868,029)
Breakopen	4,229,395	4,299,000	(69,605)
Megabucks	30,880,654	30,696,000	184,654
Powerball	38,104,163	37,292,000	812,163
Cash Quest	(525)	–	(525)
Sports Action	9,777,530	9,584,000	193,530
Keno	104,752,247	105,030,000	(277,753)
Pick 4	2,406,063	2,393,000	13,063
Win for Life	3,770,174	3,710,000	60,174
Video Lottery (Gross Receipts)	7,293,413,039	6,982,276,000	311,137,039
TOTAL	$7,616,678,711	$7,305,494,000	$ 311,184,711
Prize Expense	7,042,905,660	6,730,990,000	(311,915,660)
Net Revenue	$ 573,773,051	$ 574,504,000	$ (730,949)
Direct Expenses			
Retailer Commissions	$ 175,711,399	$ 176,508,000	$ 796,601
Game Vendor Charges	17,052,159	18,260,000	1,207,841
Tickets	4,444,691	4,607,000	162,309
Advertising	6,629,885	6,880,000	250,115
Sales Support	1,704,981	2,112,960	407,979
Maintenance and Supplies	4,045,046	3,901,000	(144,046)
Capital Lease Interest	231,949	231,949	–
Depreciation	2,240,288	2,238,444	(1,844)
TOTAL	$ 212,060,398	$ 214,739,353	$ 2,678,955
Gross Profit	$ 361,712,653	$ 359,764,647	$ 1,948,006
Indirect Revenue			
Other Income	$ 8,618,256	$ 4,000,000	$ 4,618,526

Budgetary Basis Income Statement (continued)
For the Fiscal Year Ended June 30, 2001

–UNAUDITED–

	Actual	Budget	Variance Favorable/ (Unfavorable)
Indirect Expenses			
Public Information	$ 2,413,137	$ 2,550,000	$ 136,863
Personal Services	23,014,660	23,897,916	883,256
Services and Supplies	10,883,464	10,532,411	(351,053)
Depreciation	3,255,102	2,783,353	(471,749)
TOTAL	$ 39,566,363	$ 39,763,680	$ 197,317
Non-Operating Income/Expense			
Investment Income	$ 8,582,272	$ –	$ 8,582,272
Investment Income Paid as Prizes	(8,582,272)	–	(8,582,272)
Unclaimed Prize Revenue	5,669,999	–	5,669,999
Unclaimed Prize Expense	(5,669,999)	–	(5,669,999)
TOTAL	$ –	$ –	$ –
Net Profit	$ 330,764,816	$ 324,000,967	$ 6,763,849
Transfer Commitment	292,179,001	293,849,000	(1,669,999)
	$ 38,585,815	$ 30,151,967	$ 8,433,848
Analysis of Changes in Equity			
Available for Equity	$ 19,855,262	$ 30,151,967	$ (10,296,705)
Earnings Available for Additional Transfer	18,730,553	–	18,730,553
	$ 38,585,815	$ 30,151,967	$ 8,433,848

AGENCY'S RESPONSE TO THE AUDIT REPORT

It Does Good Things

January 24, 2002

Cathy Pollino, Director
Secretary of State Audits Division
255 Capitol Street NE, Suite 500
Salem, OR 97310

Dear Ms. Pollino:

The Oregon Lottery appreciates the work performed by the Secretary of State Audits Division in their annual financial audit of the Oregon State Lottery.

In general, the Lottery agrees with the audit findings and recommendations.

Additional reports have been developed to track and account for fixed asset account balances. The reports are currently being produced by the Asset Manager system which details all categories of assets and related depreciation information. Each month the Controller will review the reports for completeness.

A project has been in place since September to review fixed assets for compliance with policy including identifying and removing property that does not meet the Lottery's capitalization threshold. Reviews of fixed asset information will take place by the Controller on a monthly basis.

To ensure that asset costs are allocated over their useful life the Chief Financial Officer will perform a review and adjust depreciation and amortization schedules at least once every two years. This will involve obtaining input from Lottery Management responsible for the day-to-day custody of assets. A review of this information for fiscal year 2002 is almost complete.

The Lottery appreciated the attention of the state auditors and looks forward to continuing to work with you.

Sincerely,

Chris Lyons
Director

500 Airport Road SE • Salem Oregon 97301-5075 • PO Box 12649 • Salem Oregon 97309-0649

PHONE 503-540-1000 • FAX 503-540-1001 • www.oregonlottery.org

FACTS ABOUT THE SECRETARY OF STATE AUDITS DIVISION

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	Cathy Pollino
Deputy Director	Charles Hibner, CPA
Deputy Director	Mary E. Wenger, CPA

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

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Oregon Audits Division
Public Service Building
255 Capitol Street NE • Suite 500
Salem, Oregon 97310

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Ph. 503-986-2255
Hotline: 800-336-8218
Internet: Audits.Hotline@state.or.us

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Auditing to Protect the Public Interest and Improve Oregon Government

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