Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

July 1, 2001, to June 30, 2002

Audits Division

Secretary of State

State of Oregon

OREGON STATE LOTTERY COMMISSION

July 1, 2001, to June 30, 2002

Audits Division

No. 2003-08

March 10, 2003

OFFICE OF THE
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Secretary of State

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Auditing for a Better Oregon

The Honorable Ted Kulongoski
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, 2002, are included in the Financial Section of this report. We concluded that the financial statements are fairly presented in accordance with accounting principles generally accepted in the United States of America.

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*. Similarly, we did not note any material weaknesses in internal control over financial reporting. We did note other matters, which we reported to the Lottery in a separate letter.

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

OREGON AUDITS DIVISION

Cathy Pollino
Director

December 19, 2002

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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 parks and certain 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 stated above. 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 expressing an opinion on the Lottery's financial statements for the year ended June 30, 2002, and reporting on compliance and internal control.

AUDIT RESULTS

This audit concludes that the Lottery's financial statements for the year ended June 30, 2002, 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,* nor did we note matters involving internal control over financial reporting that we considered to be material weaknesses. However, we did note other matters, which we have reported to the Lottery in a separate letter.

For the year ended June 30, 2002, operating revenues totaled approximately $817 million, with $480 million from video lottery and $337 million from other lottery games.

Video Lottery operating revenue is reported net of the related prize expense. Video Lottery gross revenues were $7.7 billion and the related prize expense was $7.2 billion. Determining video game operating revenue net of the related prize expense is common industry practice. Prize expense for all other lottery games totaled $223 million.

Authorized disbursements from the Oregon State Lottery Fund include prize expenses, administrative costs, and transfers to the Administrative Services Economic Development Fund to be used for the defined public purposes. For the fiscal year ended June 30, 2002, administrative expenses were $257 million, and transfers totaled $361 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. Article XV of the Oregon Constitution requires that 15 percent of the net proceeds in the Administrative Services Economic Development Fund be deposited into the Education Stability Fund and 15 percent of the net proceeds in the Administrative Services Economic Development Fund 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 II, Section B of the financial statements (titled "Stewardship and Legal Compliance – Use of Revenues and Net Revenues"), 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 nine games during the audit period: two instant ticket games ("Scratch-it" and "Breakopen"), six on-line games (Megabucks, Pick 4, Powerball, Sports Action, Keno and Win for Life), and 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 Administrative Services Economic Development Fund.

The Lottery's financial activities are accounted for in a Proprietary Fund Type-Enterprise Fund as required by governmental accounting standards. Governments are required to use enterprise funds when reporting any activity for which there is a legal requirement to recover costs through fees or charges.

AUDIT RESULTS

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

We have audited the financial statements of the Oregon State Lottery Commission (commission), as of and for the year ended June 30, 2002, and have issued our report thereon dated December 19, 2002. 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 the commission'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 the commission'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

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control 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 the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted another matter involving internal control, which we have reported to management of the 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 19, 2002

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
Cynthia Hubbard, CPA
Alan Bell

FINANCIAL SECTION

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INDEPENDENT AUDITOR'S REPORT

We have audited the accompanying basic financial statements of the enterprise fund of the Oregon State Lottery Commission (commission), as of and for the year ended June 30, 2002, as listed in the table of contents. These financial statements are the responsibility of the Oregon State Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As discussed in Note 1, the basic financial statements present only the commission's enterprise fund and do not purport to, and do not, present fairly the financial position of the state of Oregon as of June 30, 2002, and the changes in its financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the enterprise fund of the Oregon State Lottery Commission, as of June 30, 2002, and the changes in financial position and cash flows

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thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements that comprise the commission's enterprise fund. The Budgetary Basis Income Statement 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*, we have also issued our report dated December 19, 2002 on our consideration of the Oregon State Lottery Commission's enterprise fund'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. That report is separately presented in the other reports section as listed in the table of contents.

OREGON AUDITS DIVISION

Bill Bradbury
Secretary of State

December 19, 2002

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

BALANCE SHEET

JUNE 30, 2002

Assets

Current Assets		
Cash and Cash Equivalents	$152,690,026	
Investments for Prize Payments at Fair Value	10,537,668	
Cash – Securities Lending Collateral	19,262,415	
Advances	10,466	
Accounts Receivable – Net of Allowance for Doubtful Accounts of $508,357	24,084,043	
Ticket Inventory	2,329,765	
Prepaid Expenses	534,283	$209,448,666
Non-Current Assets		
Cash and Cash Equivalents – Restricted by Multi State Lottery	$3,073,785	
Investments for Prize Payments at Fair Value	86,701,967	
Capital Assets:		
Equipment	41,260,756	
Vehicles	3,787,960	
Building and Improvements	10,968,731	
Leasehold Improvements	33,088	
Leased Assets	3,041,073	
Computer Software	801,018	
Less Accumulated Depreciation and Amortization	(30,901,418)	118,766,961
Total Assets		$328,215,627

Liabilities and Net Assets

Current Liabilities		
Accounts Payable	$ 6,882,164	
Deposit Liability	163,198	
Prize Liability	22,746,896	
Obligations Under Securities Lending	19,262,415	
Due to Economic Development Fund	115,774,790	
Capital Lease Liability	268,373	
Compensated Absences	1,800,694	$166,898,530
Non-Current Liabilities		
Capital Lease Liability	$44,585	
Deferred Prize Liability	86,701,967	86,746,552
Total Liabilities		$253,645,082

Net Assets

Invested in Capital Assets, Net of Related Debt	$ 28,678,250	
Unrestricted Net Assets	45,892,295	
Total Net Assets		$ 74,570,545
Total Liabilities and Net Assets		$328,215,627

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 FUND NET ASSETS

FOR THE YEAR ENDED JUNE 30, 2002

Operating Revenues		
Scratch-It Instant Tickets (Net of Returns)	$130,697,042	
Breakopen Instant Tickets	3,758,870	
On-Line – Megabucks	33,194,216	
On-Line – Powerball (MUSL)	44,308,637	
On-Line – Cash Quest	(8)	
On-Line – Sports Action	9,455,680	
On-Line – Keno	106,673,563	
On-Line – Pick 4	2,248,679	
On-Line – Win For Life	6,489,818	
Video Lottery (Net Receipts)	480,201,739	
Provision for Bad Debts	(86,908)	
Total Operating Revenues		$816,941,328
Operating Expenses		
Prizes	$223,498,515	
Investment Income Paid as Prizes	8,000,465	
Retailer Commissions	183,271,609	
Game Vendor Charges	14,887,737	
Tickets	3,981,867	
Advertising	6,052,783	
Public Information	2,621,854	
Sales Support	1,273,782	
Salaries and Wages	25,383,940	
Services and Supplies	15,528,284	
Depreciation and Amortization	4,566,058	
Total Operating Expenses		489,066,894
Operating Income		$327,874,434
Nonoperating Revenues (Expenses)		
Interest	$ 4,208,269	
Investment Income – Securities Lending	403,595	
Net Change In the Fair Value of Investments	8,000,465	
Other Income	548,103	
Investment Expenses – Securities Lending	(403,595)	$ 12,756,837
Income Before Transfers		$340,631,271
Transfers To the Economic Development Fund		360,990,312
Change in Net Assets		$ (20,359,041)
Net Assets – July 1, 2001		94,929,586
Net Assets – June 30, 2002		$ 74,570,545

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

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED JUNE 30, 2002

Cash Flows from Operating Activities:		
Receipts from Customers		$ 816,344,572
Payments to Employees for Services		(25,209,694)
Payments to Suppliers		(226,266,275)
Payments to Prize Winners		(216,157,203)
Other Receipts (Payments)		614,069
Net Cash Provided (Used) in Operating Activities		$ 349,325,469
Cash Flows fro m Noncapital Financing Activities:		
Transfers to Economic Development Fund		$(350,942,401)
Net Cash Provided (Used) in Noncapital Financing Activities		$(350,942,401)
Cash Flows from Capital and Related Financing Activities:		
Acquisition of Capital Assets		$ (17,676,648)
Payments on Capital Leases		(1,440,658)
Proceeds from Disposition of Capital Assets		161,110
Net Cash Provided (Used) in Capital and Related Financing Activities		$ (18,956,196)
Cash Flows from Investing Activities:		
Purchases of Investments		$ (10,504,977)
Proceeds from Sales and Maturities of Investments		9,913,098
Interest on Investments and Cash Balances		4,276,669
Interest Income from Securities Lending		403,595
Interest Expense from Securities Lending		(403,595)
Net Cash Provided (Used) in Investing Activities		$ 3,684,790
Net Increase (Decrease) in Cash and Cash Equivalents		$ (16,888,338)
Cash and Cash Equivalents – Beginning		172,652,149
Cash and Cash Equivalents – Ending		$155,763,811
Reconciliation of operating income to net cash provided (used) by operating activities:		
Operating Income (Loss)		$327,874,434
Adjustments to reconcile operating income to net cash provided (used) by operating activities:		
Other Income		$ 434,988
Investment Income Paid as Prizes		$8,000,465
Depreciation and Amortization		4,566,058
(Gain)/Loss on Exchange of Capital Assets		(97,538)
Net Changes in Assets and Liabilities:		
(Increase) / Decrease in Test Cash		(10,466)
(Increase) / Decrease in Advances		14,404
(Increase) / Decrease in Accounts Receivable		(324,075)
(Increase) / Decrease in Ticket Inventory		(632,753)
(Increase) / Decrease in Prepaid Expenses		(202,737)
Increase / (Decrease) in Accounts Payable		2,394,619
Increase / (Decrease) in Compensated Absences Liability		174,246
Increase / (Decrease) in Deposit Liability		(207,488)
Increase / (Decrease) in Prize Liability		7,341,312
Total Adjustments		$ 21,451,035
Net Cash Provided (Used) by Operating Activities		$349,325,469
Noncash Investing and Capital and Related Financing Activities		
Net Change in Fair Value of Investments	$8,000,465	
Total Noncash Investing and Capital and Related Financing Activities	$8,000,465	

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, 2002

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).

I. 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. Measurement Focus, Basis of Accounting, and Financial Statement Presentation

The Lottery uses an enterprise fund, the Lottery Operations Fund, with a self-balancing set of accounts to record its assets, liabilities, net assets, 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 does not apply FASB pronouncements issued after November 30, 1989, unless GASB amends its pronouncements to specifically adopt FASB pronouncements issued after that date.

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. Revenues and expenses are categorized as operating, or non-operating. Operating revenues and expenses are those that are the result of selling Lottery games to the public.

1. Revenue Recognition

Revenues for on-line games (Megabucks, Powerball, and Keno) are recognized when shares are sold to the public.

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

Revenues for instant scratch ticket games are recognized when retailers activate packs of tickets for sale to the public.

Revenues for video lottery games are recognized when sales to the public occur and are reported net of prizes awarded. Video lottery revenue and prize expense are reported at net ($7,724,993,915 – $7,244,792,176 = $480,201,739) in the Statement of Revenues, Expenses, and Changes in Net Assets.

The following reconciles cash amounts and reported amounts for Video Lottery gaming:

Revenue:		**Prize Expense:**	
Cash Received	$1,265,789,641	Cash Paid Out	$785,587,902
Dollars Won and Played	6,459,204,274	Dollars Won and Played	6,459,204,274
Total Revenue	$7,724,993,915	Total Prizes	$7,244,792,176

2. Prize Expense

Prize expense for instant games is recognized when revenue is recognized and is based on game structure. On-line prize expense is recognized as drawings are held, based on the shares sold and the estimated cost of the prize payout. Prize expense for games with long-term annual payouts is adjusted when wins occur and the actual cost of the investments purchased to fund the future prize payments is known. Any increase in the fair value of the investments is recognized as prize expense in the year it is earned. Video prize expense is explained in the previous revenue paragraphs.

C. Assets, Liabilities, and Net Assets

Assets and liabilities are classified as current and non-current. Current assets are available, or will become available within the next year to pay operating expenses and liabilities of the Lottery. Current liabilities are due within one year. Non-current assets are not easily liquidated or are restricted for purposes other than payment of operations and liabilities. Non-current liability amounts are due in periods following the upcoming year.

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

a. Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, cash and investments held by the State Treasury in the Oregon Short-Term Fund and cash held by the Lottery's Fiscal Agent. Deposits are carried at cost.

b. Investments

Investments at year-end included investments held by the State Treasurer to fund certain Megabucks, Keno, and Scratch-it Instant Ticket prizewinners and investments held by the Lottery's fiscal agent to fund Multi-State Lottery (MUSL) prizewinners. Investments are reported at market or fair value.

c. Securities Lending

Securities lending amounts are reported at the fair value of the cash collateral received. The security lending liability also is reported as the cash amount received as collateral.

2. Accounts Receivable

Most retailers who sell Lottery products are required to remit weekly proceeds (Sunday through Saturday), less commissions, on the second following Wednesday. The Lottery is currently undertaking a change to collection on the first following Wednesday, applying the new procedure as new retailers are contracted. Accounts Receivable is reported net of an allowance for those accounts estimated not to be collectible. The allowance amount reported is approximately equal to the amount of receivables over 90 days old.

3. Inventories

Ticket Inventory consists primarily of instant scratch tickets held for sale. The 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.

4. Restricted Assets

Cash held by the Multi-State Lottery (MUSL) is reported as restricted. This cash is available for prize payments and operations of MUSL, and is not available for use in Lottery operations or for payments of liabilities.

5. 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.

Capital lease property and equipment are recorded at the present value of their minimum lease payments and depreciated over the life of the lease.

6. Prize Liability

Prize liability is recorded when the prize expense is recognized. Prize payments due within one year of the financial statement date are considered current liabilities and payments due later than one year are considered long term. Unclaimed prizes (prizes not claimed within one year) are removed from Prize Liability and paid to the Economic Development Fund.

7. 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.

Sick leave is earned at the rate of 8 hours per month, with no maximum limit. Sick leave may be taken only in the event of illness and is not convertible to pay upon termination. No liability is reported for the accumulated sick leave.

Only vacation leave and some compensatory time meet the criteria to qualify for compensated absences accrual. The criteria are:

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 $1,800,694 as of June 30, 2002.

8. Net Assets

All lottery net assets are restricted to uses allowed in Article XV of the Constitution of the state of Oregon.

II. Stewardship and Legal Compliance

A. Budgetary Compliance

The Oregon State Lottery is exempt from state of Oregon Budget laws. Accordingly, the Commission adopts an annual financial plan. The supplementary section contains a schedule comparing actual revenues and expenses to the fiscal year 2002 Business Plan, which has been amended for quarterly Oregon Economic and Revenue Forecasts.

B. Use of Revenues and Net Revenues

Article XV of the Constitution of the state of Oregon states that all Lottery revenues shall be used to pay prizes and expenses of the Lottery and remaining proceeds shall be used to benefit the public purposes of economic development, public education, or restoring and protecting parks, beaches, watersheds and critical fish and wildlife habitats. ORS 461.500 requires that at least 84 percent of the total annual revenues be returned to the public in the form of prizes and net revenues benefiting the public purposes of the Constitution, that at least 50 percent of the total annual revenues 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.[1] For fiscal year 2002 the Lottery operated within legal constraints.

[1] Attorney General Opinion #8220 advises that ORS 461.548 is unconstitutional and is not applicable. It is not included here.

	Traditional Lottery	Video Lottery	Total	
Sales	$ 336,812,053	$ 7,724,921,451	$ 8,061,733,504	
Other Income	821,874	3,555,823	4,377,697	
Distributable Revenue	$ 337,633,927	$ 7,728,477,274	$ 8,066,111,201	
Revenues Returned to the Public				
Prizes	$ 223,498,515	$ 7,244,792,176	$ 7,468,290,691	92.6%
Income Paid/Due to Economic Development Department	56,724,813	283,906,458	340,631,271	4.2%
Total Returned to the Public	$ 280,223,328	$ 7,528,698,634	$ 7,808,921,962	96.8%
Administrative Expense	57,410,599	199,778,640	257,189,239	3.2%
	$ 337,633,927	$ 7,728,477,274	$ 8,066,111,201	100.0%

Actual prizes paid to the public is $7,463,247,351 (prize expense less unclaimed prizes), which is 92.5 percent of the distributable revenues.

C. Unclaimed Prizes

ORS 461.500 requires all unclaimed prizes to be allocated to the benefit of public purpose**.** Lottery practice is to declare prizes as unclaimed when they have not been validated within one year of the end of the game or one year from the draw date. Prizes in the amount of $5,043,340, were determined to be unclaimed and were either transferred, or accrued for transfer in Fiscal Year 2002.

D. Contingency Reserve

ORS 461.510 (4) and Administrative Rule 177-10-045 allows for the creation of a contingency reserve. The Lottery Commission has set a limit of $95 million for the contingency reserve. The contingency reserve amount was reduced in fiscal year 2002 by obligating an additional transfer of $20,359,041. This obligation, in excess of the transfer required by the constitution and statute, left the balance of Contingency Reserve as of June 30, 2002 as $45,892,295. This balance is reported as Unrestricted Net Assets on the Balance Sheet.

E. Transfer Reconciliation

The Transfers to Economic Development amount shown on the Statement of Revenues, Expenses, and Changes in Net Assets equals the Income Before Transfers amount and the Contingency Reserve transfer obligation of $20,359,041. Actual cash transferred to the Economic Development Fund during fiscal year 2002 is $350,942,401. Transfer amounts remaining are included in the current liability Due to Economic Development Fund shown on the balance sheet. The following schedule reconciles the amounts.

	Beginning Balance	Income Amounts Accrued	Unclaimed Prize Amounts Accrued	Adjust-ments	Cash Paid to Economic Development	Balance Remaining
	$ 100,683,553				$ (100,683,553)	$ (0)
Net Income		$ 340,990,312			(242,343,037)	98,647,275
Contingency Reserve		20,000,000			(4,000,000)	16,000,000
Unclaimed Prizes			5,043,340	(14)	(3,915,811)	1,127,515
	$ 100,683,553	$ 360,990,312	$ 5,043,340	$ (14)	$ (350,942,401)	$ 115,774,790
		Per Statement of Revenues, Expenses, and Changes in Fund Net Assets			Per Cash Flow Statement	

III. Detailed Notes

A. Cash Deposits

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. The book balance of cash on deposit with the State Treasurer as of June 30, 2002, was $152,686,620 and the bank balance was $156,146,746. The difference between the balances consists primarily of deposits in transit and outstanding checks. 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 deposits with MUSL are to pay Oregon's proportionate share of MUSL's prize reserve pool and annual operating expenses. Cash held by MUSL is uncollateralized or collateralized with securities held by the pledging financial institution or by its trust department or agent but not in the state's name. As of June 30, 2002, the book balance was $3,073,785 and the bank balance is 3,073,785. The bank balance is disclosed separately in MUSL's financial report for the fiscal year ended June 30, 2002.

B. Investments

Oregon'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 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.

During Fiscal Year 1994, the Lottery began purchasing US Government Securities to fund Megabucks "Original Plan" jackpot prizes in a manner similar to MUSL. Certain deferred prizes arising from Scratch-It games also were funded this way during Fiscal Years 1996, 1997, 1999, 2000 and 2002. The State Treasurer purchases and holds the securities on behalf of the Lottery. The "Original Plan" differs from the "Investment Fund" Megabucks jackpot winners who 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 prizewinners' 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.

Investments for prize payments are reported on the balance sheet at fair value, in accordance with the provisions of GASB Statement Number 31. Megabucks investments included U.S. Government Securities that had a fair value of $68,381,466 as of June 30, 2002. Investments held for Oregon MUSL winners included U.S. Government Securities that had a fair value of $28,858,169 as of June 30, 2002. As of June 30, 2002, the fair value of investments that will mature in the upcoming year is $10,537,668 and the long-term portion was $86,701,967.

The increase in fair value for all investments, for the Fiscal Year ended June 30, 2002, was $8,000,465 and is included in the operating statement.

C. Securities Lending

The Lottery's cash balances are invested in the Oregon Short Term Fund (OSTF), as is the cash of other state agencies. 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 a loan agreement. There were no significant violations of the provisions of securities lending agreements.

During fiscal year 2002, the state's custodians lent short-term and fixed income securities and received as collateral U.S. dollar cash or U.S. Government and agency Securities. Borrowers were required to deliver collateral for each loan equal to at least 102 percent of the fair value of the loaned security. The state 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.

During the year, the state and borrowers maintained the right to terminate all securities lending transactions on demand. As a consequence, the maturities of investments made with cash collateral during the year generally did not match the maturities of their securities loans. On June 30, 2002, the state had no credit risk exposure to borrowers related to securities on loan.

As of June 30, 2002, the fair value of all OSTF securities on loan was $525,113,868 and the total cash collateral received for the securities was $539,819,050. The fair value of all investments purchased with the cash collateral received was $540,098,364. The Lottery's allocated portion of the securities on loan and the related collateral is presented in the following schedule of investments.

D. Schedule of Investments

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 the securities held by the counterparty's trust department or agent in the Lottery's name. Category 3 includes uninsured and unregistered investments,

INVESTMENTS AS OF JUNE 30, 2002

	Category 1	Category 2	Category 3	Fair Value
Investments - Categorized				
Investments not on Securities Loan:				
US Government and Agency Securities	$ 89,026,116	-	-	$ 89,026,116
Subtotal	$ 89,026,116	$ -	$ -	$ 89,026,116
Investments - Not Categorized				
Investments Held by Broker-Dealers Under Securities Loan with Cash Collateral:				
US Government and Agency Securities				$ 18,794,951
Securities Lending Short-Term Collateral Investment Pool				19,293,209
Subtotal				$127,114,276
Less:				
Securities Lending Cash Collateral				19,262,415
Treated as Cash and Cash Equivalents on Balance Sheet				10,612,226
Total Investments				$ 97,239,635

with the securities held by the counter party or by its trust department or agent but not in the Lottery's name.

E. Capital Assets

Capital asset activity for the year ended June 30, 2002, is shown in the following schedule.

	Beginning Balance	Additions	Disposals	Reclassify	Ending Balance
Depreciable Capital Assets					
Equipment	$ 20,944,404	$ 22,814,906	$ (2,572,020)	$ 73,466	$ 41,260,756
Vehicles	3,540,747	618,173	(370,960)	-	3,787,960
Building and Improvements	11,075,987	(107,256)	-	-	10,968,731
Leasehold Improvements	33,088	-	-	-	33,088
Leased Assets	8,602,409	-	(5,561,336)	-	3,041,073
Computer Software	889,708	290,193	(305,417)	(73,466)	801,018
Total Assets Being Depreciated	$ 45,086,343	$ 23,616,016	$ (8,809,733)	$ -	$ 59,892,626
Accumulated Depreciation					
Equipment	$ 18,367,705	$ 8,057,412	$ (2,217,787)	$ 49,030	$ 24,256,360
Vehicles	1,822,467	392,392	(314,564)	-	1,900,295
Building and Improvements	1,316,687	314,923	(228)	-	1,631,382
Leasehold Improvements	16,993	6,618	-	-	23,611
Leased Assets	7,123,034	1,235,743	(5,561,337)	-	2,797,440
Computer Software	495,267	174,426	(328,333)	(49,030)	292,330
Total Accumulated Depreciation	$ 29,142,153	$ 10,181,514	$ (8,422,249)	$ -	$ 30,901,418
Net Value of Depreciable Assets	$ 15,944,190	$ 13,434,502	$ (387,484)	$ -	$ 28,991,208

F. Non-Current Liabilities

As of June 30, 2002 annual prize payments due were $6,581,023 for Lottery game winners (48 individuals) and $4,100,000 for MUSL game winners (7 individuals). Investments are owned to provide income and cash flow to meet the payment requirements [see Note III(B)]. Prize payment liabilities are recognized at the investment purchase price and increase as the value of the investment grows (see Note I(B)2). Estimated total future payments and the face value of unmatured investments is $99,506,000 for Lottery game winners and $34,456,836 for MUSL game winners. Investments owned had a fair value at June 30, 2002 of $68,381,466 for Lottery games and $28,858,169 for MUSL games. The number of years of payments remaining ranges from six to 29 years. The following schedule reflects the activity in the prize liabilities as well as amounts due in the next year.

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Lottery Games	$ 58,118,464	$ 15,963,002	$ 5,700,000	$ 68,381,466	$ 6,467,500
MUSL Games	30,415,730	$ 2,542,439	4,100,000	$ 28,858,169	4,070,168
Total	$ 88,534,194	$ 18,505,441	$ 9,800,000	$ 97,239,635	$ 10,537,668

IV. Joint Ventures

The Multi-State Lottery Association (MUSL) was established September 16, 1987. The current MUSL members are: Arizona Lottery, Connecticut Lottery Corporation, Colorado Lottery, D.C. Lottery and Charitable Games Control Board, Delaware State Lottery, Hoosier (Indiana) Lottery, Idaho Lottery, Iowa Lottery, Kansas Lottery, Kentucky Lottery Corporation, Louisiana Lottery Corporation, Minnesota State Lottery, Missouri Lottery, Montana Lottery, Nebraska Lottery, New Hampshire Sweepstakes Commission, New Mexico Lottery Authority, Oregon Lottery, Pennsylvania Lottery, Rhode Island Lottery, South Dakota Lottery, Wisconsin Lottery, and West Virginia Lottery. The South Carolina Education Lottery became a member on July 1, 2002.

MUSL is governed by a board, on which each member lottery is represented. Each member 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 member 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 member lottery that are not allocated to the common prize pool and MUSL's operating expenses will be the revenue of that member lottery. Upon termination of the MUSL's existence, if such termination should occur, the member 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, 2002 was $181,922.

The following schedule presents the summarized financial activity of MUSL as of June 30, 2002, and 2001:

	(In thousands)	
	2002	**2001**
Assets	$1,294,979	$1,315,864
Total Assets	$1,294,979	$1,315,864
Liabilities	$1,294,674	$1,315,537
Net Assets - Unrestricted	305	327
Total Liabilities and Net Assets	$1,294,979	$1,315,864
Unrestricted Revenues	$6,605	$5,192
Unrestricted Expenses	6,627	5,044
Change in Unrestricted Net Assets	($22)	$148

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.

V. 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 2003 to 2004. Land for the Salem headquarters is leased from the Department of Administrative Services with a 20-year land lease and began in June of 1995. Lease expense for property in the year ended June 30, 2002, was $206,479.

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. Two, one year extensions are available.

C. Video Lottery Terminals

As of June 30, 2002, 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, 2002, were classified as capital leases.

Operating lease terms for one vendor are on a month-to-month basis with no expiration date; the other vendor contract ends March 31, 2003 and has two extensions available through March 31, 2007. Capital lease terms are currently five years.

During the capital 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, 2002, was $3,657,484.

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

Class of Property	Asset Book Value as of June 30, 2002
Equipment	$158,382
Video Lottery Terminals	85,250
Total	$243,632

The following is a schedule by fiscal year of future minimum lease payments required under leases that have initial or remaining non-cancelable lease terms in excess of one year as of June 30, 2002:

	Fiscal Year	Operating Leases	Capital Leases
	2003	$ 4,349,261	$ 277,000
	2004	3,946,742	45,088
	2005	3,264,657	-
	2006	3,264,657	-
	2007	3,114,297	-
Toal Future Minimum Lease Payments		$ 17,939,614	$ 322,088
Less Amounts Representing Interest			9,130
Present Value of Minimum Lease Payments			$ 312,958

VI. 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, 2002. Consequently, this potential obligation is not included in the accompanying financial statements. Total reimbursements for the fiscal year 2002 were $77,055.

VII. 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. PERS provides retirement benefits and cost-of-living adjustments as well as disability, postemployment healthcare, and death benefits to plan members and beneficiaries. A copy of the Oregon Public Employees Retirement System annual financial report may be obtained by writing to the Oregon Public Employee 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. The Lottery contributes this portion for the employee as allowed by law. 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 9.49 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, 2002, 2001, and 2000 were approximately $2,797,000, $2,571,000, and $2,413,000 respectively, equal to the required contributions for each year.

VIII. 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. Lottery's share of the assessment for the fiscal year ending June 30, 2002 was $371,724.

IX. Contingencies

A. Prize Annuities

The Oregon State Lottery is contingently liable to certain prizewinners for prize payments funded through the purchase of annuity contracts. Major prizes won by lottery players prior to January, 1994, were awarded in the form of 20-year annuities, with the Oregon Lottery making the initial payment and an annuity vendor selected to make the 19 remaining annual payments. After January 1994, the Lottery began purchasing US Government securities instead of annuities (See Note III.B.). As of June 30, 2002, the contingent liability for future prize payments funded through purchased annuities was $93,730,629.

During August 1994, Canadian and WE regulators seized one of the Lottery's annuity vendors, Confederation Life Insurance Company, 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, 2002, is $7,634,519. The Oregon Life and Health Insurance Guaranty Association, a statutorily created association that insures the obligations of insolvent insurers, insure the annuity policies up to $100,000 per policy. 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 $5,134,519 distributed over the remaining 3 to 6 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.

SUPPLEMENTARY INFORMATION

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

SUPPLEMENTARY INFORMATION

BUDGETARY BASIS INCOME STATEMENT

FOR THE FISCAL YEAR ENDED JUNE 30, 2002

—UNAUDITED—

	Actual	Budget	Variance Favorable/ (Unfavorable)
Revenue			
Scratch It	$ 130,697,042	$ 130,611,000	$ 86,042
Breakopen	3,758,870	3,634,000	124,870
Megabucks	33,194,216	33,118,000	76,216
Powerball	44,308,637	44,185,000	123,637
Cash Quest	(8)	-	(8)
Sports Action	9,455,680	9,457,000	(1,320)
Keno	106,673,563	105,330,000	1,343,563
Pick 4	2,248,679	2,259,000	(10,321)
Win For Life	6,489,818	6,343,000	146,818
Video Lottery (Gross Receipts)	7,724,993,915	7,604,320,000	120,673,915
Total Revenue	$8,061,820,412	$7,939,257,000	$122,563,412
Prize Expense	7,468,290,692	7,342,547,000	(125,743,692)
Net Revenue	$ 593,529,720	$ 596,710,000	$ (3,180,280)
Direct Expenses			
Retailer Commissions	$ 183,271,609	$ 182,159,000	$ (1,112,609)
Game Vendor Charges	14,817,383	15,625,000	807,617
Tickets	3,981,867	4,554,000	572,133
Advertising	6,052,783	6,017,000	(35,783)
Sales Support	1,273,782	1,812,000	538,218
Maintenance & Supplies	4,168,720	4,000,848	(167,872)
Capital Lease Interest	70,354	2,000	(68,354)
Depreciation	2,071,423	2,161,042	89,619
Total Direct Expense	$ 215,707,921	$ 216,330,890	$ 622,969
Gross Profit	$ 377,821,799	$ 380,379,110	$ (2,557,311)
Indirect Revenue			
Other Income	$ 4,190,789	$ 5,000,000	$ (809,211)
Indirect Expenses			
Public Information	$ 2,621,854	$ 2,767,000	$ 145,146
Personal Services	25,383,940	26,673,000	1,289,060
Services and Supplies	10,880,888	11,374,383	493,495
Depreciation	2,494,635	3,504,000	1,009,365
Total Indirect Expenses	$ 41,381,317	$ 44,318,383	$ 2,937,066

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
SUPPLEMENTARY INFORMATION
BUDGETARY BASIS INCOME STATEMENT
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

—UNAUDITED—

	Actual	Budget	Variance Favorable/ (Unfavorable)
Non-Operating Income/Expense			
Investment Income	$ 8,000,465	-	$ 8,000,465
Investment Income Paid as Prizes	(8,000,465)	-	(8,000,465)
Unclaimed Prize Revenue	5,043,340	-	5,043,340
Unclaimed Prize Expense	(5,043,340)	-	(5,043,340)
Total Non-Operating Income/Expense	-	-	$ -
Net Profit	$ 340,631,271	$ 341,060,727	$ (429,456)
Transfer Commitment	323,758,448	323,855,505	97,057
Available for Contingencies	$ 16,872,823	$ 17,205,222	$ (332,399)
Analysis of Changes in Net Assets			
Profit Available for Increase to Net Assets	$ 340,631,271	$ 341,060,727	$ (429,456)
Profit Transfers	(340,631,271)	(323,855,505)	(16,775,766)
Previously Earned Profit Transfers (Contingency Reserve)	(20,359,041)		(20,359,041)
	$ (20,359,041)	$ 17,205,222	$ (37,564,263)

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

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