Secretary of State

An Enterprise Fund of the

State of Oregon

OREGON STATE LOTTERY COMMISSION

For the Year Ended June 30, 2003

Audits Division

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State of Oregon

OREGON STATE LOTTERY COMMISSION

For the Year Ended June 30, 2003

Audits Division

No. 2004-03

February 6, 2004

OFFICE OF THE
SECRETARY OF STATE
Bill Bradbury
Secretary of State

AUDITS DIVISION
Cathy Pollino
State Auditor

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Auditing for a Better Oregon

The Honorable Ted Kulongoski
Governor of Oregon
254 State Capitol
Salem, Oregon 97310-4047

Kerry Tymchuck, Chairman
Oregon State Lottery Commission
500 Airport Road SE
Salem, OR 97301

This report presents the results of our annual audit of the Oregon State Lottery Commission.

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 fiscal year ended June 30, 2003, are included in the Financial Section of this report. We concluded that the financial statements were fairly presented in accordance with accounting principles generally accepted in the United States of America.

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

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

OREGON AUDITS DIVISION

Cathy Pollino
State Auditor

November 20, 2003

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SUMMARY

AUDIT PURPOSE

The audit was conducted for the purpose of expressing an opinion on the Lottery's financial statements for the fiscal year ended June 30, 2003, and reporting on compliance and on internal control over financial reporting.

AUDIT RESULTS

Our audit concluded that the Lottery's financial statements for the year ended June 30, 2003, which are included in this report, are fairly presented. Our review disclosed no instances of noncompliance required to be reported under *Government Auditing Standards,* nor did we note matters involving internal control over financial reporting that we considered to be material weaknesses.

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.

FINANCIAL ACTIVITIES

Per ORS 461.500, at least 84 percent of total annual revenues shall be returned to the public. Of that, 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 Lottery's sales revenue was derived from the following games during the audit period: instant ticket games ("Scratch-it" and "Breakopen"), on-line games (Megabucks, Pick 4, Powerball, Sports Action, Keno and Win for Life), and Video Lottery.

For the year ended June 30, 2003, operating revenues totaled approximately $853 million, with $499 million from video lottery and $354 million from other lottery games.

Video Lottery operating revenue is reported net of the related prize expense. Video Lottery gross revenues were approximately $8.1 billion and the related prize expense was approximately $7.6 billion. Determining video game operating revenue net of the related prize expense is common industry practice. Prize expense for all other lottery games totaled approximately $249 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, 2003, administrative expenses were approximately $262 million, and transfers totaled approximately $359 million.

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.

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, 2003, 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. They do not purport to, and do not, present fairly the financial position of the state of Oregon as of June 30, 2003, 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, 2003, and the changes in financial position and cash

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flows 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 November 20, 2003 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

November 20, 2003

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

BALANCE SHEET

JUNE 30, 2003

Assets	
Current Assets	
Cash and Cash Equivalents	$ 131,332,496
Investments for Prize Payments at Fair Value	12,367,975
Cash - Securities Lending Collateral	51,487,504
Advances	10,966
Accounts Receivable - Net of Allowance for Doubtful Accounts of $539,850	26,708,181
Ticket Inventory	2,153,902
Prepaid Expenses	552,841
Total Current Assets	$ 224,613,865
Non-Current Assets	
Cash and Cash Equivalents - Restricted by Multi-State Lottery	$ 3,125,208
Investments for Prize Payments at Fair Value	114,237,086
Capital Assets:	
Equipment	44,788,806
Vehicles	3,823,487
Building and Improvements	10,968,538
Leasehold Improvements	71,436
Leased Assets	593,934
Computer Software	1,098,565
Less Accumulated Depreciation and Amortization	(35,551,234)
Total Non-Current Assets	$ 143,155,826
Total Assets	$ 367,769,691
Liabilities and Net Assets	
Current Liabilities	
Accounts Payable	$ 5,177,127
Deposit Liability	97,503
Prize Liability	26,269,172
Obligations Under Securities Lending	51,487,504
Due to Economic Development Fund	93,705,195
Capital Lease Liability	44,585
Compensated Absences	1,751,519
Total Current Liabilities	$ 178,532,605
Non-Current Liabilities	
Deferred Prize Liability	114,237,086
Total Non-Current Liabilities	$ 114,237,086
Total Liabilities	$ 292,769,691
Net Assets	
Invested in Capital Assets	25,748,947
Unrestricted Net Assets	49,251,053
Total Net Assets	$ 75,000,000
Total Liabilities and Net Assets	$ 367,769,691

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 FISCAL YEAR ENDED JUNE 30, 2003

Operating Revenues	
Scratch-It Instant Tickets (Net of Returns)	$ 133,102,008
Breakopen Instant Tickets	3,290,487
On-Line – Megabucks	44,516,150
On-Line – Powerball (MUSL)	45,107,076
On-Line – Sports Action	9,862,974
On-Line – Keno	111,341,872
On-Line – Pick 4	1,591,390
On-Line – Win For Life	5,990,520
Video Lottery (Net Receipts)	498,712,314
Provision for Bad Debts	(154,345)
Total Operating Revenues	$ 853,360,446
Operating Expenses	
Prizes	$ 248,666,215
Retailer Commissions	190,807,938
Game Vendor Charges	14,140,775
Tickets	4,372,431
Advertising	6,294,027
Public Information	2,743,140
Sales Support	1,397,075
Salaries and Wages	25,607,562
Services and Supplies	11,673,527
Depreciation and Amortization	5,123,916
Total Operating Expenses	$ 510,826,606
Operating Income	$ 342,533,840
Nonoperating Revenues (Expenses)	
Interest	$ 2,331,936
Investment Income – Securities Lending	483,488
Net Change In the Fair Value of Investments	14,002,455
Other Income	452,000
Investment Expenses – Securities Lending	(483,488)
Total Nonoperating Revenues (Expenses)	$ 16,786,391
Income Before Transfers	$ 359,320,231
Transfers To the Economic Development Fund	358,890,776
Change in Net Assets	$ 429,455
Net Assets – July 1, 2002	74,570,545
Net Assets – June 30, 2003	$ 75,000,000

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

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

STATEMENT OF CASH FLOWS

FOR THE FISCAL YEAR ENDED JUNE 30, 2003

Cash Flows from Operating Activities:		
Receipts from Customers	$	850,697,681
Payments to Employees for Services		(25,656,738)
Payments to Suppliers		(233,042,340)
Payments to Prize Winners		(211,439,480)
Other Receipts (Payments)		452,305
Net Cash Provided (Used) in Operating Activities	$	381,011,428
Cash Flows from Noncapital Financing Activities:		
Transfers to Economic Development Fund	$	(387,129,711)
Net Cash Provided (Used) in Noncapital Financing Activities	$	(387,129,711)
Cash Flows from Capital and Related Financing Activities:		
Acquisition of Capital Assets	$	(2,007,527)
Payments on Capital Leases		(268,373)
Proceeds from Disposition of Capital Assets		119,111
Net Cash Provided (Used) in Capital and Related Financing Activities	$	(2,156,789)
Cash Flows from Investing Activities:		
Purchases of Investments	$	(25,966,971)
Proceeds from Sales and Maturities of Investments		10,604,000
Interest on Investments and Cash Balances		2,331,936
Interest Income from Securities Lending		483,488
Interest Expense from Securities Lending		(483,488)
Net Cash Provided (Used) in Investing Activities	$	(13,031,035)
Net Increase (Decrease) in Cash and Cash Equivalents	$	(21,306,107)
Cash and Cash Equivalents – Beginning	$	155,763,811
Cash and Cash Equivalents – Ending	$	134,457,704
Reconciliation of operating income to net cash provided (used) by operating activities:		
Operating Income (Loss)	$	342,533,840
Adjustments to reconcile operating income to net cash provided (used) by operating activities		
Other Income	$	452,000
Investment Income Paid as Prizes		14,002,455
Depreciation and Amortization		5,123,916
(Gain)/Loss on Exchange of Capital Assets		(37,825)
Net Changes in Assets and Liabilities:		
(Increase) / Decrease in Test Cash		(500)
(Increase) / Decrease in Accounts Receivable		(2,624,137)
(Increase) / Decrease in Ticket Inventory		175,864
(Increase) / Decrease in Prepaid Expenses		(18,558)
Increase / (Decrease) in Accounts Payable		(1,705,037)
Increase / (Decrease) in Compensated Absences Liability		(49,176)
Increase / (Decrease) in Deposit Liability		(65,695)
Increase / (Decrease) in Prize Liability		23,224,281
Total Adjustments	$	38,477,588
Net Cash Provided (Used) by Operating Activities	$	381,011,428
Noncash Investing and Capital and Related Financing Activities		
Net Change in Fair Value of Investments	$	14,002,455
Total Noncash Investing and Capital and Related Financing Activities	$	14,002,455

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

State of Oregon
Oregon State Lottery Commission
Notes to the Financial Statements
June 30, 2003

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, Keno, Win for Life, Sports Action, and Pick 4) 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 ticket packs 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 ($8,133,309,626 - $7,634,597,312 = $498,712,314) in the Statement of Revenues, Expenses, and changes in Fund Net Assets.

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

Revenue		**Prize Expense**	
Cash Received	$ 1,357,355,968	Cash Paid Out	$ 858,643,654
Dollars Won and Played	6,775,953,658	Dollars Won and Played	$ 6,775,953,658
Total Revenue	$ 8,133,309,626	**Total Prizes**	$ 7,634,597,312

2. Prize Expense

Prize expense for instant games is recognized when revenue is recognized and is based on game structure.

Prize expense for on-line games is recognized as drawings are held, based on the shares sold and the estimated or known cost of the prize payouts. Prize expense for games with long-term annual payouts is adjusted when wins occur and the actual cost of the investments needed to fund the future prize payments is known. Any increase in the fair value of the investments is recognized as revenue and 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 normal 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, Win for Life and Win for Life 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 at 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 collect on the first following Wednesday, applying the new procedure as new retailers sign Lottery contracts. 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 in the Lottery warehouse. A small amount of inventory is held at retail establishments. The inventory is valued at cost and residual inventory is expensed upon the completion of a 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 general Lottery operations or for payments of Lottery 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.

Property and equipment being purchased through a capital lease agreement is recorded at the present value of the 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 the upcoming year are considered long-term. Unclaimed prizes (known prizes not claimed after 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 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:

(a) The employee's right to receive compensations is based on services already rendered;

(b) Rights are vested and accumulate;
(c) Payment of the compensation is probable; and
(d) The amount can be reasonably estimated.

The compensated absences liability is calculated based upon salary rates in effect as of June 30, 2003, and includes applicable tax and retirement costs. The total liability for the Lottery as of June 30, 2003 was $1,751,519.

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 2003 Business Plan, which has been amended by quarterly Oregon Economic and Revenue Forecasts, produced the State's Office of Economic Analysis in conjunction with Lottery staff.

B. Use of Revenues and Net Revenues

Article XV of the Constitution of the State of Oregon requires that all Lottery revenues shall be used to pay prizes and expenses of the Lottery. Any 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 expense.[1] For fiscal year 2003 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	
Revenues				
Sales	$ 354,776,512	$ 8,133,181,246	$ 8,487,957,758	
Other Income	14,410,966	2,019,838	16,430,804	
Distributable Revenue	$ 369,187,478	$ 8,135,201,084	$ 8,504,388,562	
Revenues Returned to the Public				
Prizes	$ 248,666,215	$ 7,634,597,312	$ 7,883,263,527	92.69%
Income Paid/Due to Economic Development Department	63,370,321	295,520,455	358,890,776	4.22%
Total Returned to the Public	$ 312,036,536	$ 7,930,117,767	$ 8,242,154,303	
Administrative Expense	60,074,134	201,730,670	261,804,804	3.08%
Retained for Contingency Reserve	(2,923,192)	3,352,647	429,455	0.01%
Total Revenue Distribution	$ 369,187,478	$ 8,135,201,084	$ 8,504,388,562	100.00%

Actual prizes paid to the public are $7,877,094,186 (prize expense less unclaimed prizes), which is 92.8 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. In fiscal year 2003 prizes in the amount of $6,169,341 were determined to be unclaimed and were either transferred or accrued for transfer to the Economic Development Fund.

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. In fiscal year 2003 $429,455 of profit was retained by the Lottery, leaving the June 30, 2003 contingency reserve balance at $49,251,053. 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 less the $429,455 retained by the Lottery. Actual cash transferred to the Economic Development Fund during fiscal year 2003 is $387,129,711. 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.

	Balance Owing at June 30, 2002	Income Amounts Accrued	Unclaimed Prize Amounts Accrued	Cash Paid to Economic Development	Balance Remaining at June 30, 2003
Net Income	$ 98,647,260	$ 358,890,776		$ (365,021,566)	$ 92,516,470
Contingency Reserve	16,000,000			(16,000,000)	-
Unclaimed Prizes	1,127,529		$ 6,169,341	(6,108,145)	1,188,725
	$ 115,774,789	$ 358,890,776	$ 6,169,341	$ (387,129,711)	$ 93,705,195
		Per Statement of Revenues, Expenses, and Changes in Fund Net Assets		Per Cash Flow Statement	Per Balance Sheet

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, 2003, was $131,329,716 and the bank balance was $134,943,702. The difference between the balances consists 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, 2003 the book balance was $3,125,208 and the bank balance was $3,125,208. The bank balance is disclosed separately in MUSL's financial report for the fiscal year ended June 30, 2003. To obtain a copy of the financial report, please refer to Note IV.

B. Investments

Statute and the Oregon Investment Council govern Oregon's investment policies. 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 the Multi-State Lottery. (Original Plan jackpot prizes are paid annually for a period of 20 to 25 years.) Certain deferred prizes arising from on-line and Scratch-It games also were funded this way during fiscal years 1996, 1997, 1999, 2000, 2002, and 2003. The State Treasurer purchases and holds the securities on behalf of the Lottery. Any difference between the matured value of securities and the actual liability occurs because securities must be purchased in $1,000 increments, while certain annual installments were not an even multiple of $1,000. Interest earnings between the maturity and prize payment date is expected to fund any difference.

Investments for prize payments are reported on the balance sheet at fair value in accordance with the provisions of GASB Statement Number 31. Investments included US Government securities that had a fair value of $99,020,657 as of June 30, 2003. Investments held for Oregon MUSL winners included US Government securities that had a fair value of $27,584,404 as of June 30, 2003. As of June 30, 2003 the fair value of investments that will mature in the upcoming year is $12,367,975 and the long-term portion was $114,237,086.

The increase in fair value for all investments for the fiscal year ended June 30, 2003 was $14,002,455 and is included on the Statement of Revenues, Expenses, and Changes in Fund Net Assets.

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 2003 the State's custodians lent short-term and fixed income securities and received as collateral US dollar cash or US 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, 2003 the State had no credit risk exposure to borrowers related to securities on loan.

As of June 30, 2003 the fair value of all OSTF securities on loan was $938,276,842 and the total cash collateral received for the securities was $965,152,800. The fair value of all investments purchased with the cash collateral received was $966,339,137. The Lottery's allocated portion of the securities on loan and the related collateral is presented in the following investment schedule section.

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 counter party's trust department or agent in the Lottery's name. Category 3 includes uninsured and unregistered investments with the securities held by the counter party or by its trust department or agent, but not in the Lottery's name.

INVESTMENTS AS OF JUNE 30, 2003

	Category			Fair Value
Investments	1	2	3	
Investments not on Securities Loan:				
US Government and Agency Securities	$ 93,665,569	-	-	$ 93,665,569
Subtotal	$ 93,665,569	$ -		$ 93,665,569
Investments Not Categorized				
Investments Held by Broker Dealers Under Securities Loans with Cash Collateral:				
US Government and Agency Securities				$ 50,062,515
Securities Lending Short-Term Collateral Investment Pool				51,549,078
Subtotal				$ 195,277,162
Less:				
Securities Lending Cash Collateral				(51,487,504)
Balances Treated as Cash and Cash Equivalents on Balance Sheet				(17,184,597)
Total Investments				$ 126,605,061

E. Capital Assets

Capital asset activity for the year ended June 30, 2003 is shown in the following schedule.

	Beginning Balance	Additions	Disposals	Ending Balance
Depreciable Capital Assets				
Equipment	$ 41,260,756	$ 3,907,018	$ (378,969)	$ 44,788,805
Vehicles	3,787,960	369,112	(333,584)	3,823,488
Building and Improvements	10,968,731	(194)	-	10,968,537
Leasehold Improvements	33,088	38,348	-	71,436
Leased Assets	3,041,073	-	(2,447,139)	593,934
Computer Software	801,018	303,148	(5,600)	1,098,566
Total Assets Being Depreciated	$ 59,892,626	$ 4,617,432	$ (3,165,292)	$ 61,344,766
Accumulated Depreciation				
Equipment	$ 24,256,360	$ 6,625,847	$ (359,339)	$ 30,522,868
Vehicles	1,900,295	348,655	(279,166)	1,969,784
Building and Improvements	1,631,382	320,584	-	1,951,966
Leasehold Improvements	23,611	12,335	-	35,946
Leased Assets	2,797,440	204,038	(2,447,139)	554,339
Computer Software	292,330	229,601	(5,600)	516,331
Total Accumulated Depreciation	$ 30,901,418	$ 7,741,060	$ (3,091,244)	$ 35,551,234
Net Value of Depreciable Assets	$ 28,991,208	$ (3,123,628)	$ (74,048)	$ 25,793,532

F. Non-Current Liabilities

As of June 30, 2003 annual prize payments due were $8,321,023 for Lottery game winners (53 individuals) and $4,100,000 for Multi-State Lottery 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 $136,490,000 for Lottery game winners and $30,355,000 for MUSL game winners. Investments owned had a fair value as of June 30, 2003 of $99,020,658 for Lottery games and $27,584,404 for MUSL games. The number of years remaining for payments ranges from 5 to 29 years. The following schedule reflects the activity in the prize liabilities as well as the market value of securities for amounts due in the next year.

	Beginning Balance	Increases	Decreases	Ending Balance	Due Within One Year
Lottery Games	$ 68,381,466	$ 37,143,191	$ 6,504,000	$ 99,020,657	$ 8,286,625
MUSL Games	28,858,169	$ 2,826,235	4,100,000	$ 27,584,404	4,081,350
Total	$ 97,239,635	$ 39,969,426	$ 10,604,000	$ 126,605,061	$ 12,367,975

IV. Joint Ventures

The Multi-State Lottery Association (MUSL) was established September 16, 1987. The current MUSL members are: Arizona Lottery, California Lottery, Connecticut Lottery Corporation, Colorado Lottery, D.C. Lottery and Charitable Games Control Board, Delaware State Lottery, Hoosier 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, Pennsylvania Lottery, Rhode Island Lottery, South Carolina Education Lottery, South Dakota Lottery, Vermont Lottery, Virgin Islands Lottery, Wisconsin Lottery, and the West Virginia Lottery.

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 annually with an independent auditor.

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 US Government Securities.

The Oregon Lottery's share of MUSL's operating expenses for the fiscal year ended June 30, 2003 was $188,298.

The following schedule presents the summarized financial activity of MUSL as of June 30, 2003 and 2002. Complete separate fianancial 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.

	(In thousands)	
	2003	**2002**
Assets	$1,372,413	$1,294,979
Total Assets	$1,372,413	$1,294,979
Liabilities	$1,372,128	$1,294,674
Net Assets - Unrestricted	285	305
Assets	$1,372,413	$1,294,979
Unrestricted Revenues	$5,397	$6,605
Unrestricted Expenses	5,418	6,627
Change in Unrestricted Net Assets	($21)	($22)

V. Lease Commitments

Financial reporting and accounting procedures differ between operating leases and capital leases. Operating leases are rental agreements where the payments are chargeable as rent and recorded in expense accounts. Capital leases contain a bargain purchase clause and are accounted for similar to purchases on contract. The property is capitalized at the present value of the lease payments when the lease is incurred and a corresponding liability is recorded.

A. Capital Leases

1. Video Lottery Terminals

In May 1995 the Lottery negotiated the capital lease purchase of 2,346 video lottery terminals from WMS Corporation. At the end of the five-year lease period the machines were purchased for $1. In fiscal year 2003 the final lease payments for 413 terminals were paid and the terminals were purchased. Total lease payments in fiscal year 2003 were $141,736 and $2,392 of that amount was interest. The terminals are included in the Equipment value shown on the Balance Sheet.

2. Mainframe Computer System

In September 1998 a lease purchase agreement was signed between the Lottery and Leasetec Corporation for hardware and software capable of tracking all gaming activity. At the end of the five-year lease period and with payment of the final lease payment, the Lottery can purchase the system for $1. Lease payments are in advance, due on the first of the month for that month. The first monthly payment was for December 1998 and the final monthly payment is due November 1, 2003. Lease payments in fiscal year 2003 totaled $135,264, which included $6,235 in interest. Total minimum lease payments due for the upcoming year are $45,088. The gross value of the computer system is listed on the Balance Sheet under Leased Assets. The gross value is $593,934. The lease agreement was assigned to Koch Financial Corporation in December 1998.

B. Operating Leases

1. Non-cancelable Lease Term in Excess of One Year

At June 30, 2003 there were four lease agreements in effect that either had or have a non-cancelable lease term in excess of one year. The agreements cover land for the Salem headquarters, a video lottery central computer system, and two storage facilities in the state used as area depots. The term end for those agreements are 2015, 2008, 2007 and 2004, respectively. The land for the Salem headquarters is leased from the State of Oregon, Department of Administrative Services. The computer system and storage facilities are leased through private companies. The minimum lease payments are reported in the next schedule.

2. Short term Leases

The Lottery also had signed agreements for video lottery terminal rentals, storage facility rentals throughout the state, and copy machine rentals. These agreements are cancelable, the longest period for cancellation being 180-day notice. Minimum lease payments are not reported for these leases but the lease expense for fiscal year ending June 30, 2003 is included in the following lease expense table.

C. Schedule of Future Minimum Lease Payments

The schedule below shows required lease payments for the next five years.

Fiscal Year	Operating Leases	Capital Leases
2004	$ 1,864,769	$ 45,088
2005	1,843,032	
2006	1,843,751	
2007	1,844,492	
2008	648,966	
Total Minimum Lease Payments	**$ 8,045,010**	**$ 45,088**
Interest Amount Included in Payments		**$ 503**

D. Schedule of Lease Expense

The following schedule shows lease expense for the fiscal year ending June 30, 2003.

	Lease/Rent Expense
Video Lottery Terminals	$ 2,373,400
Video Central Computer System	1,771,236
Land for Salem Headquarters	47,829
Storage Facilities	179,231
Copy Machines	56,470
Total Lease/Rent Expense	**$ 4,428,166**

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, 2003. Consequently, this potential obligation is not included in the accompanying financial statements. Total reimbursements for the fiscal year 2003 were $110,028.

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, post-employment 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 six 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. The rate charged in fiscal year 2003 is 9.49 percent of each covered employee's salary. The rate that will be charged in fiscal year 2004 is 11.31 percent of each covered employee's salary. The amount's contributed by the Lottery for both the employees required contribution and the employer's (Lottery's) required contribution for the years ended June 30, 2003, 2002 and 2001 were approximately $2,818,000, $2,797,000, and $2,571,000 respectively.

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 for each coverage type is based on independent biennial actuarial forecasts and administrative costs, less any available fund balance in the Insurance Fund from the prior biennium. Lottery's share of the 2001-2003 biennial assessment for the fiscal year ending June 30, 2003 was $371,724.

IX. Contingencies

E. Prize Annuities

The 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. The Lottery made the initial payment and an annuity vendor selected to make the 19 remaining annual payments. The annuity contracts are held in the name of the prizewinner. After January 1994 the Lottery began purchasing U.S. Government securities, held in the Lottery's name, instead of annuity contracts [see note III (B)]. As of June 30, 2003, the contingent liability for future prize payments funded through purchased annuities was $78,977,277. This contingent liability is not included in the financial statements.

In August of 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, 2003 are $5,801,907. 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 $3,301,907 distributed over the remaining 2- to 5-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 United States 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

-UNAUDITED-

STATE OF OREGON

OREGON STATE LOTTERY COMMISSION

SUPPLEMENTARY INFORMATION

BUDGETARY BASIS INCOME STATEMENT

FOR THE FISCAL YEAR ENDED JUNE 30, 2003

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 2002 financial plan, which has been amended to reflect quarterly Oregon Economic and Revenue Forecasts.

	Actual	Budget	Variance Favorable/ (Unfavorable)
Revenue			
Scratch It	$ 133,102,008	$ 131,657,000	$ 1,445,008
Breakopen	3,290,487	3,118,000	172,487
Megabucks	44,516,150	44,023,000	493,150
Powerball	45,107,076	43,581,000	1,526,076
Cash Quest	-	-	(8)
Sports Action	9,862,974	9,863,000	(26)
Keno	111,341,872	109,618,000	1,723,872
Pick 4	1,591,391	1,606,000	(14,609)
Win For Life	5,990,520	5,824,000	166,520
Video Lottery (Gross Receipts)	8,133,309,626	7,912,249,000	221,060,626
Total Revenue	$ 8,488,112,104	$ 8,261,539,000	$ 226,573,096
Prize Expense	7,869,261,072	7,644,828,000	(224,433,072)
Net Revenue	$ 618,851,032	$ 616,711,000	$ 2,140,032
Direct Expenses			
Retailer Commissions	$ 190,807,938	$ 189,944,000	$ (863,938)
Game Vendor Charges	14,138,383	13,979,129	(159,254)
Tickets	4,372,431	4,829,000	456,569
Advertising	6,294,028	6,200,000	(94,028)
Sales Support	1,397,075	1,571,000	173,925
Maintenance and Supplies	2,291,588	5,302,331	3,010,743
Capital Lease Interest	2,392	2,393	1
Depreciation	3,308,717	4,742,637	1,433,920
Total Direct Expense	$ 222,612,552	$ 226,570,490	$ 3,957,938
Gross Profit	$ 396,238,480	$ 390,140,510	$ 6,097,970

-UNAUDITED-

STATE OF OREGON
OREGON STATE LOTTERY COMMISSION
SUPPLEMENTARY INFORMATION
BUDGETARY BASIS INCOME STATEMENT
FOR THE FISCAL YEAR ENDED JUNE 30, 2003

	Actual	Budget	Variance Favorable/ (Unfavorable)
Indirect Revenue			
Other Income	$ 2,312,857	$ 3,500,000	$ (1,187,143)
Indirect Expenses			
Public Information	$ 2,743,140	$ 2,835,000	$ 91,860
Personal Services	25,607,563	27,052,154	1,444,591
Services and Supplies	9,065,204	11,243,043	2,177,839
Depreciation	1,815,199	2,217,419	402,220
Total Indirect Expenses	$ 39,231,106	$ 43,347,616	$ 4,116,510
Net Profit	$ 359,320,231	$ 350,292,894	$ 9,027,337
Transfer Commitment	337,662,094	336,511,000	(1,151,094)
Available for Contingencies	$ 21,658,137	$ 13,781,894	$ 7,876,243
Analysis of Changes in Net Assets			
Profit Available for Increase to Net Assets	$ 359,320,231	$ 350,292,894	$ 9,027,337
Profit Accrued for Transfer	(358,890,776)	(336,511,000)	(22,379,776)
Previously Earned Profit Transfers (Contingency Reserve)			-
Total Increase (Decrease) in Contingency Reserve	$ 429,455	$ 13,781,894	$ (13,352,439)

*Budget adopted by Commission and adjusted by Economic Forecasts throughout the year.

OTHER REPORTS

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Auditing for a Better Oregon

The Honorable Ted Kulongoski
Governor of Oregon
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Salem, Oregon 97310-4047

Kerry Tymchuck, Chairman
Oregon State Lottery Commission
500 Airport Road SE
Salem, Oregon 97301

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

We have audited the financial statements of the enterprise fund of the Oregon State Lottery Commission (commission), as of and for the year ended June 30, 2003, and have issued our report thereon dated November 20, 2003. 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 control that

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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.

This report is intended solely for the information and use of the 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

November 20, 2003

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

State Auditor	Cathy Pollino, CGFM, MBA
Deputy State Auditor	Charles A. Hibner, CPA
Deputy State Auditor	Mary E. Wenger, CPA

Audit Team

Kelly L. Olson, CPA, Audit Administrator

Debbie A. Ferguson

Jamie E. Breyman

Alan J. Bell

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

Auditing to Protect the Public Interest and Improve Oregon Government

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