Colorado Lottery

Financial and Compliance Audit

June 30, 2003 and 2002

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August 20, 2003

Members of the Legislative Audit Committee:

We have completed the financial statement audit of the Colorado Lottery as of and for the year ended June 30, 2003. Our audit was conducted in accordance with auditing standards generally accepted in the United States of America.

We were engaged to conduct our audit pursuant to Section 24-35-211, C.R.S., which authorizes the State Auditor to audit the Lottery Fund. The reports we have issues as a result of this engagement are set forth in the table of contents which follows.

Colorado Lottery

June 30, 2003 and 2002

Contents

Colorado Lottery

Report Summary

Year Ended June 30, 2003

Purposes and Scope of Audit

Authority, Purpose and Scope

The audit of the Colorado Lottery was done under authority of Section 24-35-211, C.R.S., which requires the State Auditor to conduct an annual audit of the Lottery Fund. The purpose of the audit was to express an opinion on the financial statements of the Colorado Lottery for the year ended June 30, 2003.

We conducted our audit in accordance with generally accepted auditing standards. We obtained our information by reviewing documents, interviewing staff, analyzing data and performing other audit procedures as we deemed necessary.

The purposes and scope of this audit were:

- To express an opinion on the financial statements of the Colorado Lottery (the Lottery) as of and for the year ended June 30, 2003, including a review of the related systems of internal controls as required by auditing standards generally accepted in the United States of America.
- To review the Lottery's compliance with rules and regulations governing the expenditure of State funds for the year ended June 30, 2003.
- To evaluate progress in implementing the prior audit recommendations.

Summary of Major Audit Comments

Audit Findings and Financial Statement Audit Report Section

The auditors' findings and recommendations section contains the following recommendations:

- The Lottery has a complex information system and significant reliance is placed on this system and the supporting controls. To reduce the risk of errors in the system, the Lottery should obtain an independent review of the Lottery's internal system. In addition, the Lottery should contract for an independent annual SAS 70, Type II audit performed of its third-party vendor.
- The Lottery has a substantial deposit that is held at Multi-State Lottery Association (MUSL) as a reserve for the grand prize and set prize: this reserve is used to guarantee payment of the grand prize and cash prizes established at set amounts. The Lottery should monitor this account regularly and annually obtain financial statements of MUSL to review for solvency.

The recommendations and the responses from the Lottery can be found in the recommendation locator.

Audit Opinions and Reports

The independent accountants' reports included herein state that the financial statements of the Lottery are fairly stated, in all material respects, in accordance with accounting principles generally accepted in the United States of America, and that no material weaknesses in internal controls were discovered during the course of the audit.

Auditors' Communication to Legislative Audit Committee

The auditors' communication to the legislative audit committee describes the auditors' responsibility under auditing standards generally accepted in the United States of America and significant management judgements and estimates. It also notes that not all proposed audit adjustments were recorded by the Lottery, and that management of the Lottery believes that those adjustments that were not recorded did not materially affect the financial statements as a whole. This communication is located on page 47.

Summary of Progress in Implementing Prior Audit Recommendations

The audit report for the year ended June 30, 2002 contained five recommendations. All of those recommendations were fully implemented in the current Fiscal Year.

Colorado Lottery

Recommendation Locator

Year Ended June 30, 2003

Recommendation Number	Page Number	Recommendation Summary	Response	Implementation Date
1	6	The Lottery should have an independent examination performed on its internal system and a SAS 70, Type II examination performed on its third-party vendor.	Agree	February 2005
2	7	The Lottery should monitor the Lottery deposit at MUSL and MUSL financial statements.	Agree	February 2004

Colorado Lottery
Background
Year Ended June 30, 2003

The Colorado Lottery was created as a Division within the Department of Revenue with the passage of Senate Bill 119 on April 30, 1982. The Lottery began operations on July 1, 1982 and sold its first lottery ticket on January 24, 1983.

During Fiscal Year 2003, the Lottery employed 123 employees in its headquarters in Pueblo and branch offices in Denver, Fort Collins and Grand Junction.

The Lottery is governed by a Commission of five members appointed by the Governor within the Senate. By statute, Lottery Commission members must include an attorney, a certified public accountant and a law enforcement officer. Members may serve up to two 4-year terms. The Commission's responsibilities are stated in Section 24-35-208, C.R.S., and include:

- Promulgation of rules and regulations to govern the Lottery operations.
- Carrying on a continuous study and investigation of the Lottery to determine the need for changes in statutes, rules or regulations or in the administration and operation of the Lottery.

The Lottery's enabling legislation requires that no less than 50% of the total revenue from sales of lottery tickets be for prizes. The legislation also provides guidelines for distribution of net proceeds to beneficiary agencies. "Net lottery proceeds" (that is, proceeds after the payment of prizes and lottery expenses and a reserve for future operations) are to be distributed to the Conservation Trust Fund, the State Division of Parks and Outdoor Recreation, and the Great Outdoors Colorado Trust Fund (GOCO). The amount distributed to GOCO is limited by a constitutional cap. As of Fiscal Year 2002, amounts exceeding the GOCO cap (the spill over) are distributed to the State Public School Fund Contingency Reserve. Prior to this year, spill over funds were distributed to the State General Fund.

Independent Reviews of Systems

The Lottery's internal information system is used to record and track gross ticket sales. In Fiscal Year 2003, the Lottery had gross ticket sales of approximately $391,474,000. All ticket sales are recorded in the Lottery's internal system, which is designed to capture and track winning and non-winning tickets and to validate and pay prize claims. Because of the large number of transactions and high volume of activity, the Lottery has significant risk associated with the operations of the internal system, including tracking of cash receipts from about 2,800 retail vendors and the payment of prizes.

The Lottery also has an external service provider, currently GTECH, that also runs a system to track the above transactions. These two systems are reconciled daily by Lottery staff. In addition, the Lottery is currently in the process of changing its external service provider from GTECH to Scientific Games. The Lottery has signed a contract with Scientific Games and is in the process of developing the transition and implementation plan. The new vendor will be in place in Fiscal Year 2005. Under the new contract, Scientific Games will also, through a subcontractor, be responsible for some functions currently performed by the Lottery. This change-over in vendors and systems will create additional risks for the Lottery.

The information that is obtained from both systems is critical to the information reported in the Lottery's financial statements and the internal controls of the Lottery's operation. The Lottery has not had an independent examination performed on its internal system, and it has not had a SAS 70, Type II examination on its external service provider since July 2002. A SAS 70, Type II report, *Report on Controls Placed in Operation and Tests of Operating Effectiveness*, focuses on testing a service organization's controls such as Scientific Games. Through testing, controls are evaluated whether they are operating with sufficient effectiveness to provide a reasonable, but not absolute, assurance that the control objectives were achieved for a period specified.

Due to the complexity and the high dollar volume of the transactions at both the Lottery and its vendors, there is significant risk related to information system controls, internal controls over financial processing and safeguarding of the Lottery's assets. Third-party independent audits can be a mechanism to help identify weaknesses in the software and the internal control system at both the third-party vendors and internally within the Lottery's system. This testing would help ensure there are quality controls and systems in place and that they are operating properly and effectively to help reduce the risk of loss to the Lottery and to the State of Colorado. This is particularly important during a period of transition.

Recommendation 1

The Colorado Lottery should minimize risks related to information system control, internal controls over financial processing and safeguarding of assets by performing:

a) An annual independent examination of the internal system used to record and track ticket sales.

b) Specific independent testing and examinations as part of the systems reconfiguration to assure reliability prior to activating the new system.

c) An independent SAS 70, Type II, examination on the external service provider and its subcontractor as the new system is being established and annually thereafter.

Colorado Lottery Response

a) Agree. The Lottery will work with the State Auditor's Office to contract an independent examination of the Lottery's internal system that will be used to record and track ticket sales.

Implementation Date: February 2005

b) Agree. The Lottery will use independent contractor(s) to test and examine the systems reconfiguration to assure reliability prior to activating the new system.

Implementation Date: August 2004

c) Agree. The Lottery will work with the State Auditor's Office to contract an independent auditor to perform a SAS 70, Type II, examination of its vendor and their subcontractor.

Implementation Date: February 2005

Review of Multi-State Lottery Association's Financial Statements

In 2000, the citizens of the State of Colorado passed a ballot issue to allow Coloradans to enter into multi-state lotteries. The Colorado Lottery Commission negotiates agreements with other state lottery commissions. The agreements govern which multi-state games are available in Colorado, the rules of play for each game, and the portion of ticket sales that go for prizes. Colorado has become part of an existing Multi-State Lottery Association (MUSL) which consists of 26 other state lotteries. MUSL is a non-profit, government-benefit association owned and operated by its 26-member lotteries. Each MUSL member offers one or more of the games administered by MUSL. All profits are retained by the state lottery and are used to fund projects approved by the State legislatures. Through its contract with MUSL, the Colorado Lottery has been required to place in two reserve accounts, held at MUSL, the total sum of $3,463,399. These reserve accounts are a contingency reserve for the set prize (cash prize established at a set amount) and the grand prize for the Powerball game. For the set prize reserve, the reserve balance required was $865,850 and was fully funded as of June 30, 2003. The grand prize reserve required was $2,597,549, of which $1,677,029 was funded as of June 30, 2003. The remaining $920,520 will be funded by 2% of Powerball sales until it is fully funded.

The Lottery does not monitor the financial statements of MUSL. Section 24-35-208 (1)(i), C.R.S., states that the Lottery is responsible for the operation and supervision of multi-state lotteries. Also, Lottery Commission Rule 14a states that the Lottery is responsible for verifying all MUSL prize fund and reserve allocations and to perform audits of MUSL, if funding is available. By periodically obtaining and reviewing the financial statements of MUSL, the Lottery could monitor the financial condition of MUSL, specifically the reserve accounts held by MUSL on Colorado Lottery's behalf. These reviews should also consider and monitor MUSL's financial capacity to reduce future risk to the Colorado Lottery.

Recommendation 2

The Colorado Lottery should annually obtain and internally review MUSL financial statements to monitor the financial condition and capacity of MUSL and to specifically monitor the asset valuation of the reserve deposits.

Colorado Lottery Response

Agree. The Lottery will begin an annual review of MUSL's audited financial statements for the purpose of monitoring the financial condition of MUSL and to specifically monitor the asset valuation of the reserve deposits.

Implementation Date: February 2004

Colorado Lottery

Disposition of Prior Year Audit Recommendation

Year Ended June 30, 2002

Number	Recommendation	Disposition
1	The Colorado Lottery should ensure that periodic planning and update meetings are held with the contractors selected under the recently issued on-line system vendor, CMOS Project and Security Oversight RFPs. Meetings should focus on open communication, coordination of efforts and minimizing capital expenditures and contract costs. The frequency of such meetings should be set forth contractually with the contractors selected.	Implemented
2	The Colorado Lottery should ensure physical access is cancelled on a timely basis when employees are terminated from employment or when access is no longer required.	Implemented
3	The Colorado Lottery should limit the number of users that are given permanent access to key functions within the on-line gaming and GEMS applications. In situations where emergency access is necessary, we recommend that permanent access be removed and temporary access granted only on an as-needed basis.	Implemented
4	The Colorado Lottery should review the cost/benefit of built-in redundancy for all communication lines with retailers and consider the need for additional redundancy at key locations.	Implemented
5	The Colorado Lottery should require GTECH's, and future on-line vendors', disaster recovery plan be improved by: a. Reviewing the appropriateness of a two week time period for bringing systems back on line. The Lottery should consider making this time period binding contractually with GTECH or any future on-line vendor and require payment of liquidated damages in the event that they are unable to meet the required time frames. b. Testing the disaster recovery plan on a periodic basis. c. Considering circulating back-up tapes offsite daily. d. Documenting processes and procedures for utilizing data backup at the remote location.	Implemented

Independent Accountants' Report on Financial Statements

Members of the Legislative Audit Committee:

We have audited the accompanying basic financial statements of the Colorado Lottery (the Lottery), 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 Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the Colorado Lottery as of June 30, 2002 were audited by other accountants whose report dated August 8, 2002 expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards for 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.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Colorado Lottery as of June 30, 2003, and its changes in financial position and cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 20, 2003 on our consideration of the Lottery's internal control over financial reporting and 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.

The accompanying management's discussion and analysis as listed in the table of contents is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Colorado Lottery
Members of the Legislative Audit Committee

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Lottery's basic financial statements. The accompanying supplementary information, as listed in the table of contents, is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

August 20, 2003

This discussion and analysis of the Lottery's financial performance provides an overview of financial activities for the year ended June 30, 2003, and should be read in conjunction with the Lottery's financial statements, which begin on page 9. These financial statements reflect only activities of the Colorado Lottery, a proprietary fund of the State of Colorado.

Fiscal Year 2003 Financial Highlights

- The Lottery's overall sales performance of $391.5 million reflected a $16.4 million decrease from last year but was still the second largest sales year since start up in 1983. Scratch sales totaled $254.3 million to capture the second highest scratch sales honors. (Despite an increase in marketing efforts including offering a broader range of price points, additional games and an overall upgrade to the look of our scratch tickets.) Scratch sales reflected a $2.9 million decrease from Fiscal Year 2002's record high sales of $257.2 million. A decrease in Lotto sales of $9.4 million from the previous year was a result of competing with a full year of the Lottery's newest on-line game – Powerball. Although the excitement over Powerball diminished in the second year of Colorado's participation, the Lottery still managed to achieve total sales for the year of $75.7 million. These sales reflected a slight decrease from last year's maiden year sales of $79.9 million. (A decrease in sales for a new on-line game in subsequent years is the normal trend in the industry.) Cash 5 sales remained steady at $13.2 million.

- Concurrent with overall sales taking second place honors, proceeds distributions did the same. Second only to last year, the Lottery distributed a total of $104.8 million to the proceeds recipients. This included, for the second time, a spillover into the State Public School Fund Contingency Reserve, this year totaling $3.7 million. A spill-over occurs when the distributions cap for GOCO is reached in any one year. The cap for GOCO is set by taking the 1992 base year and adjusting it for the cost of living increase for the Denver-Boulder area.

- For the fourth year in a row, the Lottery received a Certificate of Achievement from the Government Finance Officers Association. This Certificate is the highest honor awarded for governmental accounting and financial reporting. In addition, in Fiscal Year 2003, the Lottery received a certificate of recognition from the Governmental Accounting Standards Board (GASB) for the early implementation of GASB Statement 34. This certificate states that early implementation of Statement 34 is a testament to the Lottery's professional leadership, initiative and commitment to improving public accountability.

- Gross profit as a percent of sales increased by .8%, a reflection of the decrease in the prize costs (including Powerball prize variance) from 58.9% to 58% of sales.

Using This Annual Report

This annual report consists of a series of financial statements. The statement of net assets provides information about the Lottery's assets and liabilities and reflects the Lottery's financial position as of June 30, 2003 and 2002. The statement of revenues, expenses and changes in net assets reports the activity of selling Lottery products and the expenses related to such activity for the years ended June 30, 2003 and 2002. And finally, the statement of cash flows outlines the cash inflows and outflows related to the activity of selling Lottery products for the years ended June 30, 2003 and 2002.

Statement of Net Assets

The statement of net assets is a financial snapshot of the Colorado Lottery at June 30, 2003 and 2002. It presents the fiscal resources of the Lottery's (assets), the claims against those resources (liabilities) and the residual available for future operations (net assets). Assets and liabilities are classified by liquidity as either current or non-current. Net assets are classified by the ways in which they may be used for future operations.

Condensed Statement of Net Assets
June 30, 2003 and 2002

	2003	2002
Assets		
Current assets	$ 47,485,313	$ 41,506,945
Restricted assets	3,003,518	1,922,223
Capital assets	1,427,326	1,602,736
Total assets	$ 51,916,157	$ 45,031,904
Liabilities		
Current liabilities	$ 48,061,451	$ 41,347,866
Long-term liabilities	958,754	1,007,761
Total liabilities	$ 49,020,205	$ 42,355,627
Net Assets		
Investment in current assets	$ 1,427,326	$ 1,602,736
Restricted – Licensed Agent Recovery Reserve	460,638	464,096
Unrestricted	1,007,988	609,445
Total net assets	$ 2,895,952	$ 2,676,277

The Lottery's total assets at year ended, June 30, 2003, were $51.9 million. Assets consisted primarily of cash and investments with the State Treasury of over $31 million, Prepaid Prize Expense with MUSL of over $2.5 million, receivables from Lottery retailers for the sale of Lottery products of $15.3 million, and a net investment in fixed assets of $1.4 million.

Comparable figures at June 30, 2002, were $45.0 million in total assets, including more than $25.8 million in cash and investments with the State Treasury, Prepaid Prize Expense with MUSL of nearly $1.5 million, $13.7 million in receivables from retailers, and $1.6 million net investment in fixed assets.

The Lottery's total liabilities at June 30, 2003, totaled $49 million consisting primarily of proceeds distributions due to recipients of $25.4 million and prize liability on all Lottery products of $18.6 million.

The Lottery's total liabilities at the prior year end totaled $42.4 million which consisted primarily of proceeds distributions due of $21.9 million and prize liability on all Lottery products of $17.1 million.

Components of the Lottery's net assets are: an amount approved by the Lottery Commission to represent the Lottery's net investment in capital assets as required by a newly mandated reporting model under GASB 34,(See "Total Capital Assets" on the Statement of Net Assets), a Licensed Agent Recovery Reserve (bonding reserve) funded by retailers to cover any uncollectible receivable accounts, and an adjustment made by the Lottery to reflect its share of unrealized gains or losses on investments held by the State Treasurer. The change in net assets between Fiscal Year 2002 and Fiscal Year 2003 consisted of a decrease in investment in capital assets from $1.6 million to $1.4 million, a minor decrease in the bonding reserve from $464,096 to $460,638, and a net increase in unrestricted net assets of $398,543 as a result of a net increase in the adjustments on State Treasury investments.

Following is a schedule of net assets:

	2003	2002
Net Assets		
Investment in capital assets	$ 1,427,326	$ 1,602,736
Bonding reserve	460,638	464,096
Unrealized gain (loss) on investments	1,007,988	609,445
Total net assets	$ 2,895,952	$ 2,676,277

Sales Activities

Revenues from the sale of Lottery products for the Fiscal Year ended June 30, 2003, were the second highest in the Lottery's twenty-one year history. As shown in the financial statements, overall sales decreased slightly by 4% from the prior year, from $408.0 million in Fiscal Year ended June 30, 2002, to $391.5 million in the current year. The decrease in Scratch sales from $257.2 million to $254.3 represented an even smaller percentage decrease of only 1.1%. Powerball finished off its first full year of sales with nearly a 5.3% decrease from its start-up year. Lotto sales are highly dependent on large jackpots. The current Fiscal Year had fewer large Lotto jackpots than recent years and was further affected by the newest on-line game – Powerball, resulting in a 16.2% reduction in sales.

The following table compares Lottery product sales between Fiscal Years. All sales are presented in millions of dollars:

Product Sales	2003	2002	Difference	Percentage
Scratch	$ 254.3	$ 257.2	$ (2.9)	-1.1%
Powerball	75.7	79.9	(4.2)	-5.3%
Lotto	48.3	57.7	(9.4)	-16.2%
Cash 5	13.2	13.2	—	—
Total	$ 391.5	$ 408.0	$ (16.5)	-4.0%

Total Revenues

Non-operating revenues for the year ended June 30, 2003 totaled $2.3 million as compared with $6.4 million for the year ended June 30, 2002. The major contributing factor for the decrease from Fiscal Year 2002 to Fiscal Year 2003 was $3.9 million of proceeds received from the sale of stock in Fiscal Year 2002 as referred to in the non-recurring revenue section below. Apart from these proceeds, interest income is the primary source of non-operating revenues.

Total revenues, including gross ticket sales and non-operating revenue, were $393.7 million and $414.4 million for the years ended June 30, 2003, and June 30, 2002, respectively. As mentioned elsewhere, the two major contributors to the decrease of approximately $20.7 million was a decrease in Lottery sales of $16.5 million and an decrease in non-operating revenues of over $4 million.

Non-Recurring Revenue

The Colorado Lottery purchases annuities by bidding them out to insurance companies in the event a Lotto grand prize winner chooses the annuity option. During Fiscal Year 2002 the Lottery received notification from two insurance companies from which it has purchased annuities in the past stating that the companies had converted from mutual or policy owned companies to public owned stock companies. As part of the "demutualization," the Lottery received shares of common stock which were sold for a total of $3,947,072. This was a single year windfall and most likely will not recur in future periods. The Colorado Lottery still has annuities held by other insurance companies, which were purchased to fund annuity prizes.

Major Expenses

Approximately $266.4 million of the Lottery's total expenses of $288.7 million for the Fiscal Year ended June 30, 2003, were incurred in direct support of Lottery games. These included prize expense, retailer compensation, money spent to purchase Scratch tickets and compensation to the vendor who maintains and supports the entire on-line gaming system.

In comparison, $281.1 million of the Lottery's total expenses of $303.4 million for the Fiscal Year ended June 30, 2002, were game-related expenses.

Following is a table comparing the game-related expenses between Fiscal Years. All expenses are presented in millions of dollars.

Game Related Expenses	2003	2002	Difference	Percentage
Prize expense/Powerball prize variance	$ 226.9	$ 240.3	$ (13.4)	-5.6%
Retailer compensation				
Commissions	26.0	27.0	(1.0)	-3.7%
Bonuses	3.5	3.8	(.3)	-7.9%
Ticket costs	3.2	3.0	.2	6.7%
Vendor fees	6.8	7.0	(.2)	-2.9%
Total	$ 266.4	$ 281.1	$ (14.7)	-5.2%

Statement of Revenues, Expenses and Changes in Net Assets

The statement of revenues, expenses and changes in net assets presents the financial activity of the Colorado Lottery over the Fiscal Year. The focus is on operating revenues and expenses that have a significant effect on the distributions paid to the proceeds recipients. See table below:

Condensed Statement of Revenues, Expenses and Changes in Net Assets
June 30, 2003 and 2002

	2003	2002
Operating Revenues	$ 391,473,640	$ 407,966,534
Direct Operating Activities	266,444,993	281,067,304
Gross Profit on Sale of Tickets	125,028,647	126,899,230
Other Operating Expenses		
Marketing and communications	9,093,013	9,095,334
Wages and benefits	7,976,826	7,885,989
Other operating expenses	5,221,953	5,390,111
Total operating activities	22,291,792	22,371,434
Operating Income	$ 102,736,855	$ 104,527,796
Non-operating Revenues (Expenses)		
Other revenue	$ 303,134	$ 163,696
Sale of stock	—	3,947,072
Interest income	1,958,747	2,281,228
Proceeds distributions	(104,779,061)	(110,046,688)
Total non-operating revenue (expenses)	102,517,180	(103,654,692)
Increase in Net Assets	219,675	873,104
Net Assets, Beginning of Year	2,676,277	1,803,173
Net Assets, End of Year	$ 2,895,952	$ 2,676,277

The decrease in all game-related expenses is reflective of the decrease in product sales (see the product sales schedule above). The decrease in bonuses of 7.9% is the result of an increased number of scratch games expiring (reaching the end of the 180 day claim period) in Fiscal Year 2003 compared to Fiscal Year 2002 resulting in a higher dollar amount of unclaimed cashing bonuses. The 5.6% decrease in prize expense was partly the result of Fiscal Year 2003 being the first full year Powerball expired draw write-off of unclaimed prizes.

The large percentage increase in ticket costs was a result of offering more higher price point games which have a higher cost per ticket. Six games in Fiscal Year 2002 with a $3 price point were offered compared with ten games in Fiscal Year 2003.

Of the $22.3 million in Fiscal Year 2003 expenses that were not game-related, close to $9.1 million was used for promotions or for institutional and product advertising, and $8.0 million was used to compensate Lottery employees. In comparison, of the $22.4 million in Fiscal Year 2002 non-game related expenses, just under $9.1 million was used for promotions or for institutional and product advertising and $7.9 million was used to compensate Lottery employees.

Distributions to Proceeds' Recipients

The Lottery's efforts in 2003 generated the second highest year of net proceeds distributions (including those incurred prior to but distributed subsequent to June 30, 2003) of $104.8 million in the current Fiscal Year. Of these total proceeds, $48.7 million was allocated to the Great Outdoors Colorado Trust Fund, $41.9 million to the Conservation Trust Fund, and $10.5 million to the Division of State Parks and Recreation per the distribution formula stated in the Colorado Revised Statutes (C.R.S.) 24-35-210. The maximum distribution to Great Outdoors Colorado of $48.7 million pursuant to C.R.S. 33-60-104 (1) (c) and 33-60-104 (2) was reached, thus creating a spill over into the State's Public School Fund Contingency Reserve of nearly $3.7 million pursuant to C.R.S. 22-54-117 (1.6) (a).

The Lottery's proceeds distributions for the prior year set a record at $110.0 million. Approximately $46.5 million was distributed to Great Outdoors Colorado, $44.0 million to the Conservation Trust Fund, $11.0 million to the Division of State Parks and Recreation and a spill over into the State's Public School Fund Contingency Reserve of nearly $8.5 million.

Budgetary Highlights

The Lottery's budget is determined by a variety of methods. The majority of the budget is set by the Legislature through the annual appropriations bill (called the Long Bill), which determines budgets for every agency within the State. The Long Bill and department level allocations are approved shortly before the start of each Fiscal Year. Agencies may also request a supplemental appropriation during the Fiscal Year to cover unexpected expenses (or a negative supplemental for less than expected expenses) as well as year-end transfers of spending authority if needed. In the third quarter of Fiscal Year 2003, the Legislature approved supplemental appropriations to adjust for changes in estimated sales levels and other unforeseen needs/adjustments. Supplemental appropriations were approved in purchased services for the computer center, MNT payments, legal services, leased space, ticket costs and Powerball prize variance lines, offset by reductions in the vehicle lease payments, health/dental/life, short term disability, vendor fees, prizes, retailer compensation and

CMAC project lines. In Fiscal Year 2003, there were no year-end transfers. The final method of funding is special legislation. Effective in 2003, House Bill 02-1459 added $7,800 to the Lottery's payments to other agencies line in order to pay increased costs to the Colorado Bureau of Investigations for finger print checks.

The approved Lottery's budget at the beginning of the year was $366.9 million. Department level allocations approved at the beginning of the Fiscal Year increased the budget by $0.8 million. Supplemental appropriations and adjustments made in the third quarter decreased the budget by $7.9 million to a total of $359.8 million. Total expenditures and roll-forwards for Fiscal Year 2003 came to nearly $293.0 million, resulting in unused appropriations (or savings) of more than $66.8 million.

Economic Factors and Next Year's Budget

The Lottery considered several factors when setting the revenue estimates and the Fiscal Year 2004 budget. On-line sales (Powerball, Lotto and Cash 5) are expected to decrease slightly overall as sales for on-line games naturally decrease over the life cycle of each game.

Scratch sales for Fiscal Year 2003 were down approximately one percent from projections, finishing strong to record overall sales of $254.3 million – second only to Fiscal Year 2002 that posted $257.2 million in Scratch sales. Therefore, the Lottery is projecting that Fiscal Year 2004 sales will be comparable or slightly lower than Fiscal Year 2003.

Fiscal Year 2004 revenue estimates total $390.4 million, a $1.1 million decrease from Fiscal Year 2003 actual sales.

In addition to normal increases in costs, there will be two other major changes in costs in Fiscal Year 2004 which will include increased courier costs, and an increase in computer maintenance costs.

Contacting the Lottery's Financial Management

This management discussion and analysis report is designed to provide Colorado citizens, Colorado government officials, our players, retailers and other interested parties with a general overview of the Lottery's financial activity for Fiscal Year 2003 and to demonstrate the Lottery's accountability for the money it received from the sale of Lottery products. If you have questions about this report or need additional information, contact Mike Saucedo, the Colorado Lottery's Chief Financial Officer, 201 West 8th Street, Suite 600, Pueblo, CO 81003.

Colorado Lottery

Statements of Net Assets

June 30, 2003 and 2002

Assets

	2003	2002
Current Assets		
Cash and investments	$ 31,030,059	$ 25,750,736
Accounts receivable, net of allowance; 2003 – $77,833 and 2002 – $87,708	15,261,679	13,710,073
Game prizes inventory, at cost	—	83,684
Consignment inventory, at cost	131,703	135,851
Warehouse inventory, at cost	917,029	1,290,127
Prepaid expenses	144,843	536,474
Total current assets	47,485,313	41,506,945
Restricted Assets		
Cash and investments – Licensed Agent Recovery Reserve Receipts	460,638	464,096
Prepaid prize expense – Multi-State Lottery Association	2,542,880	1,458,127
Total restricted assets	3,003,518	1,922,223
Capital Assets		
Equipment	5,559,322	5,356,715
Leasehold improvements	330,936	330,936
Less accumulated depreciation and amortization	(4,462,932)	(4,084,915)
Total capital assets	1,427,326	1,602,736
	$ 51,916,157	$ 45,031,904

Liabilities

	2003	2002
Current Liabilities		
Accounts payable	$ 1,590,977	$ 1,206,204
Prize liability	18,565,011	17,090,156
Payable to MUSL	678,159	
Wages and benefits	671,966	119,821
Accrued annual and sick leave	142,254	
Retailer bonus liability	574,247	595,035
Funds available for distribution	25,412,933	21,939,014
Deferred revenue	425,904	397,636
Total current liabilities	48,061,451	41,347,866
Long-term Liabilities		
Accrued annual and sick leave	829,541	883,833
Expired warrants liability	129,213	123,928
Total long-term liabilities	958,754	1,007,761
Total liabilities	49,020,205	42,355,627
Net Assets		
Investment in capital assets	$ 1,427,326	$ 1,602,736
Restricted – Licensed Agent Recovery Reserve	460,638	464,096
Unrestricted	1,007,988	609,445
Total net assets	2,895,952	2,676,277
	$ 51,916,157	$ 45,031,904

Colorado Lottery

Statements of Revenues, Expenses and Changes in Net Assets

Years Ended June 30, 2003 and 2002

	2003	2002
Operating Revenues		
Gross ticket sales	$ 391,473,640	$ 407,966,534
Direct Operating Expenses		
Prize expense	227,514,771	238,854,750
Powerball prize variance	(597,361)	1,467,844
Retailer commissions and bonuses	29,528,971	30,741,925
Cost of tickets and vendor fees	9,998,612	10,002,785
Total direct operating expenses	266,444,993	281,067,304
Gross Profit on Sale of Tickets	125,028,647	126,899,230
Other Operating Expenses		
Marketing and communications	9,093,013	9,095,334
Administration fees paid to MUSL	114,766	178,273
Wages and benefits	7,976,826	7,885,989
Professional services	314,768	131,730
State agencies services	257,947	296,421
Department of Revenue Services	372,155	372,333
Travel	104,985	121,639
Equipment (including $23,124 and $80,838, respectively, of loss on disposition of equipment)	108,330	136,175
Depreciation	463,742	614,064
Accrued annual and sick leave	79,074	81,223
Space rental	718,649	648,270
Rents for equipment	689,546	692,802
Motorpool leasing	284,947	332,950
Materials and supplies	89,984	94,109
Telephone	148,466	169,280
On-line telecommunications	801,383	783,283
Data processing supplies and services	65,850	97,555
Equipment maintenance	264,729	269,321
Postage	74,468	80,699
Printing	69,513	61,471
Other	198,651	228,513
Total other operating expenses	22,291,792	22,371,434
Operating Income	102,736,855	104,527,796

Colorado Lottery

Statements of Revenues, Expenses and Changes in Net Assets (continued)

Years Ended June 30, 2003 and 2002

	2003	2002
Operating Income	102,736,855	104,527,796
Nonoperating Revenues (Expenses)		
Other revenue	303,134	163,696
Sale of contributed capital stock	—	3,947,072
Interest income	1,958,747	2,281,228
Funds distributed for current year	(79,366,128)	(88,107,674)
Funds available for distribution for current year	(25,412,933)	(21,939,014)
Total nonoperating revenues (expenses)	(102,517,180)	(103,654,692)
Increase in Net Assets	219,675	873,104
Net Assets, Beginning of Year	2,676,277	1,803,173
Net Assets, End of Year	$ 2,895,952	$ 2,676,277

Colorado Lottery

Statements of Cash Flows

Years Ended June 30, 2003 and 2002

	2003	2002
Operating Activities		
Cash received from retailers	$ 390,853,822	$ 404,641,668
Cash paid in prizes	(227,822,348)	(238,569,253)
Cash paid in retailer commissions	(25,965,985)	(26,972,691)
Cash payments to suppliers	(21,858,289)	(24,945,792)
Cash payments to employees for services	(7,319,796)	(8,372,145)
Cash received from Lotto subscription sales	654,617	684,676
Cash paid in retailer bonus	(3,625,433)	(3,735,065)
Cash received (used) – other	17,128	(17,461)
Net cash provided by operating activities	104,933,716	102,713,937
Noncapital Financing Activities		
Distribution of net proceeds	(101,305,142)	(108,157,125)
Capital and Related Financing Activities		
Acquisition of capital assets	(311,456)	(109,557)
Investing Activities		
Sale of contributed capital stock	—	3,947,072
Interest received	1,560,204	2,063,327
Net cash provided by investing activities	1,560,204	6,010,399
Increase in Cash and Investments	4,877,322	457,654
Change in Fair Market Value of Investments	398,543	217,901
Cash and Investments, Beginning of Year (Including $464,096 and $411,629, Respectively, in Restricted Accounts)	26,214,832	25,539,277
Cash and Investments, End of Year, (Including $460,638 and $464,096, Respectively, in Restricted Accounts)	$ 31,490,697	$ 26,214,832

Colorado Lottery

Statements of Cash Flows (continued)

Years Ended June 30, 2003 and 2002

	2003	2002
Reconciliation of Operating Income to Net Cash Provided by Operating Activities		
Operating income	$ 102,736,855	$ 104,527,796
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	463,742	614,064
Loss of disposal of equipment	23,124	80,838
Other revenue	303,134	163,696
Change in		
Accounts receivable	(1,551,606)	(1,178,169)
Ticket inventory	377,246	(380,105)
Prepaid prize expense with MUSL	(1,084,753)	(1,458,127)
Other assets	475,315	(482,975)
Liabilities (excluding funds available for distribution)	3,190,659	826,919
Net cash provided by operating activities	$ 104,933,716	$ 102,713,937

Colorado Lottery

Notes to Financial Statements

June 30, 2003 and 2002

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

The Colorado Lottery began operations April 30, 1982, under the provisions of Section 24-35-202, C.R.S. The Colorado Lottery operates under a Commission and provides operation and service of lottery games as authorized by the statute. The Colorado Lottery's revenues are predominately earned from the sale of lottery products including scratch, Lotto, Powerball and Cash 5.

The financial statements reflect activities of the Colorado Lottery, an enterprise fund of the State of Colorado, for the Fiscal Years ended June 30, 2003 and 2002. The Colorado Lottery is an agency of the State of Colorado. The financial statements present only the Colorado Lottery, an enterprise fund of the State of Colorado. The financial statements are intended to present the financial position and results of operations and cash flows of only that portion of the State of Colorado that is attributable to the transactions of the Colorado Lottery in accordance with accounting principles generally accepted in the United States of America.

The accounting policies of the Colorado Lottery conform to accounting principles generally accepted in the United States of America as applicable to governments. The following is a summary of the more significant policies:

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues, expenses, gains, losses and other changes in net assets during the reporting period. Actual results could differ from those estimates.

Fund Accounting

Government resources are allocated to and accounted for in separate sub-entities, called funds, based upon the purposes for which the resources are to be spent and the means by which spending activities are controlled. A fund is a fiscal and accounting entity with a self-balancing set of accounts that comprise its assets, liabilities, net assets, revenues and expenditures.

Enterprise Fund

The Colorado Lottery accounts for its operations as an enterprise fund. The intent of the State of Colorado Legislature is that the cost (expenses, including depreciation) of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges. As permitted by Governmental Accounting Standards Board Statement No. 20, *Accounting and Financial Reporting Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Colorado Lottery has elected to apply only those applicable Financial Accounting Standards Board Statements and interpretations issued prior to November 30, 1989.

Colorado Lottery
Notes to Financial Statements
June 30, 2003 and 2002

The Colorado Lottery defines operating revenues as those earned as a direct result of the fund's principal ongoing operations, i.e., the sale of lottery products. Operating expenses include expenses incurred in earning those revenues such as the cost of tickets, vendor fees, retailer commissions and bonuses, administrative expenses and depreciation on capital assets. All revenues and expenses not meeting these definitions are reported as nonoperating revenues and expenses.

Basis of Accounting

Basis of accounting refers to when revenues, expenditures or expenses are recognized in the accounts and reported in the financial statements. The Colorado Lottery accounts for funds using the accrual basis of accounting. Revenues from scratch ticket sales are recognized at the point of ticket pack activation. Revenues from Lotto ticket, Powerball ticket, Cash 5 ticket and subscription sales are recognized using the specific performance method whereby sales are recognized at the point that the play becomes active for the next drawing. Expenses are recognized when they are incurred.

Budget

By October 24th of each year, the Department of Revenue Executive Director submits to the Office of State Planning and Budgeting a proposed legislative budget for the Fiscal Year commencing the following July 1. The legislative budget includes proposed expenditures and the means of financing them.

Public hearings are conducted by the Joint Budget Committee to obtain clarification and taxpayer comments. Prior to June 30, the budget is legally enacted through passage of a law referred to as the Long Bill.

During the Fiscal Year, the approved legislative budget may be modified due to roll-forward authorization, supplemental budget approval or line item transfer authorization. All modifications must be approved by the State Controller and the Office of State Planning and/or Budgeting and the Legislature.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable consist of amounts due from retailers for activated ticket packets. The accounts receivable are stated at the amount billed to retailers. Accounts receivable are ordinarily due seven days after the issuance of the invoice and are electronically transferred from the retailers accounts into the Lottery's account.

Allowance for Doubtful Accounts represents a provision for receivables that will probably not be collected in the future. Consideration of the economic climate, credit-worthiness of individual account debtors, bankruptcy of debtor, discontinuance of debtor's business, failure of repeated attempts to collect and barring of collection by statute of limitations are factors used in considering when an account becomes uncollectible. The accrual of a loss contingency is required when a loss is probable and/or can be reasonably estimated.

The Colorado Lottery uses the specific identification method to determine expected uncollectibles. Under the provisions of Section 24-35-219, C.R.S., licensed agent recovery reserve receipts are collected from the retailers to cover uncollectible accounts. The accounts receivable and the licensed agent recovery reserve are shown net of estimated uncollectible receivables of $77,833 and $87,708 as of June 30, 2003 and 2002, respectively.

Game Prizes Inventory

Game Prizes Inventory represents merchandise prizes connected to certain scratch games that, as of the statement of net assets date, have not been claimed.

Consignment Inventory

Inventory on consignment represents non-activated ticket inventory in the possession of retailers who act as agents of the Colorado Lottery. The Colorado Lottery retains title to these tickets since retailers have the right to return non-activated tickets; therefore, the tickets are included in the inventory and reported on the statement of net assets. Consignment inventory is stated at cost using the specific identification method.

Warehouse Inventory

Warehouse inventory represents unsold tickets in possession of the Colorado Lottery and is stated at cost using the specific identification method.

Supplies Inventory

The State of Colorado's threshold for recording supplies inventories is $100,000 per location. The supplies inventory of the Colorado Lottery consistently falls below the $100,000 threshold per location. Accordingly, no supplies inventory appears on the statement of net assets.

Prepaid Prize Expense

As part of the Lottery's agreement with MUSL, for the Powerball game, a certain percentage of sales must be paid to MUSL for set prize and grand prize reserves.

Fixed Assets

Equipment and leasehold improvements are stated at cost. Beginning September 1, 1996, equipment may be capitalized if the cost exceeds $5,000 and has a useful life of more than one year, however, a state agency may select a minimum acquisition cost or useful life which is less than the stated criteria for capitalization. Accordingly, the Colorado Lottery capitalizes equipment with a cost of $1,000 or more that has a useful life of more than one year. In addition, the Colorado Lottery capitalizes all personal computers regardless of their cost. Depreciation for equipment is computed on the straight-line method over estimated useful lives ranging from three to eight years. Leasehold improvements are depreciated over the shorter of the lease term or the estimated useful lives of the improvements. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and resulting gains or losses are recognized in current operations.

The Colorado Lottery made the decision in May of 2003 to remove the Player Express Terminals (PES) from all retailers by the end of January 31, 2004. In accordance with *Generally Accepted Accounting Principles*, the monthly depreciation on these PES terminals was adjusted (accelerated) to insure that they are fully depreciated by the end of their useful life on January 31, 2004. The accelerated depreciation will increase the regular monthly depreciation on these PES terminals from $30,000 per month to $52,061 per for month for the effected months – May 2003 through January 2004. For Fiscal Year 2003, an additional $44,121 of depreciation related to the PES terminals has been recorded and presented on the Lottery's financial statements.

Accrued Wages and Benefits

During Fiscal Year ending June 30, 2003, the State changed the pay date for most State employees deferring the date from June 30 to July 1. For the Lottery, this created an increase in the accrued wages at June 30, 2003 of $645,329.

Prize Liability and Prize Expense

Under the provisions of Section 24-35-210 (9), C.R.S., the Colorado Lottery must pay no less than fifty percent (50%) of total ticket sales as prizes. In the aggregate, all games to date are planned to pay 50% or more of total ticket sales in prizes. Additional prize expense and corresponding liability may be incurred as a result of market fluctuations in the cost of annuities used to pay Lotto jackpots (see Note 11).

All scratch, on-line, and special drawing prizes are accounted for using the accrual basis of accounting. The liability for scratch prizes and on-line prizes is recognized at the point of retail sale. The liability for special drawing prizes is accrued on the first day of sales.

Payments of scratch prize amounts of $150 or less may be done at the Lottery or at the retail outlet; payment of scratch prize amounts of $151 to $600 may be done at the retailer level at the option of the retailer or at the Lottery. Scratch prizes of $600 or more are paid by the Lottery. Prizes may be claimed up to 180 days after game-end. After the final claim date, any unclaimed scratch prizes will result in a decrease to prize expense and any prizes claimed in excess of the liability accrued will result in an increase to prize expense. Net unclaimed scratch prizes resulted in a decrease to prize expense of $4,857,072 for the Fiscal Year ended June 30, 2003 and $3,525,079 for the Fiscal Year ended June 30, 2002. Through the Fiscal Year ended June 30, 2003, there were a total of thirty-six games ended as compared with twenty-eight games ended through Fiscal Year 2002.

Payments of cumulative on-line prize amounts of $150 or less on a single ticket may be done at the Lottery or at the retail outlet; payment of cumulative prize amounts of $151 to $600 on a single ticket may be done at the retailer level at the option of the retailer or at the Lottery. Payment of cumulative prize amounts of $600 or more on a single ticket must be done at the Lottery. Retailers are given credit for prize payments they make on a daily basis. On-line prizes may be claimed up to 180 days after the date of the drawing. After the final claim date, unclaimed on-line prizes will result in a decrease to prize expense so long as the aggregate prize expense of all games exceeds or equals the statutory 50% of sales. In the event that the expiration of an unclaimed prize would result in the aggregate prize expense of all games to fall below the statutory 50% level, the unclaimed prize amount would remain in prize expense and be paid out to players as a guaranteed additional prize. Unclaimed on-line prizes resulted in a decrease to prize expense of $9,433,114 for the Fiscal Year ended June 30, 2003 and $3,811,550 for the Fiscal Year ended June 30, 2002. The significant increase in the write off of unclaimed on-line prizes from Fiscal Year ended June 30, 2002 to Fiscal Year ended June 30, 2003, was an unclaimed Lotto jackpot, cash value of $2.6 million; the expiration of an unclaimed Powerball jackpot, of which Colorado's cash value equaled approximately $1.3 million; the expiration of an unclaimed $500,000 Powerplay prize; and the five months of Powerball unclaimed prize write offs in 2003 compared to an entire year of Powerball unclaimed prize write offs in the Fiscal Year ended June 30, 2002 .

Powerball Prize Variance expense represents a portion of the Powerball 50% prize expense accrual (as mandated by game rule) that is transferred to or received from the MUSL. Powerball Prize Variance expense occurs when Colorado's liability, which consists of the low-tier prizes won by Colorado players plus Colorado's contribution to the jackpot, is less than the 50% accrual. If Colorado's Powerball liability, at the end of any interim reporting period, exceeds the 50% accrual, revenue is recognized. In the event that Colorado's total Powerball liability in any week should exceed the 50% accrual, MUSL will reimburse the excess to the Lottery.

Retailer Bonus Liability

Under provisions 5.10 and 10.10 of the Colorado Lottery Commission Rules and Regulations effective as of July 1, 1997:

> *". . .the Director may provide such additional compensation to licensees as is deemed appropriate by the Director to further the sale of lottery tickets, so long as such additional compensation is made equally available to all licensees and does not exceed a total of One and Thirteen Hundredths Percent (1.13%) for scratch, Seven Tenths Percent (.7%) for Lotto, Sixty-five Hundredths Percent (.65%) for Powerball, and Ninety-six Hundredths Percent (.96%) for Cash 5."*

A portion of the additional compensation shall be used to pay each licensee, as a bonus, an amount (cashing bonus) equal to one percent (1%) of each prize paid by the licensee up to and including $599.99.

At the Director's discretion, the residual resulting after paying the cashing bonuses may be used to provide additional compensation to licensees and/or to decrease the bonus expense by reverting the excess amount.

The cashing bonus is accrued as tickets are sold and paid as winning tickets are redeemed. Any cashing bonuses unclaimed at the end of the claim period result in a reduction of bonus expense.

Licensed Agent Recovery Reserve

Under the provisions of Section 24-35-219, C.R.S., a Licensed Agent Recovery Reserve was established on January 1, 1988 to maintain surety bond receipts collected from Colorado Lottery retailers. Billing rates are established by the Colorado Lottery Commission and are reviewed on an annual basis. Retailers have the option to obtain private surety bond coverage at a rate of $2,000 surety coverage per outlet at their discretion.

Compensated Leave

All permanent employees of the Colorado Lottery may accrue annual and sick leave based on length of service subject to certain limitations on the amount that will be paid on termination. In addition, employees who are classified as non-exempt from overtime pay have accumulated overtime which must be taken as compensatory time or paid. The estimated cost of compensated absences for which employees are vested is as follows:

	June 30, 2003	June 30, 2002	Increase
Annual leave	$ 776,768	$ 699,331	$ 77,437
Sick leave	192,701	180,040	12,661
Total annual and sick leave	969,469	879,371	90,098
Compensatory time	2,326	4,462	(2,136)
Total compensated leave	$ 971,795	$ 883,833	$ 87,962

Expired Warrants Liability

Expired Warrants Liability represents the expiration of aged uncashed warrants and imprest checks over one (1) year old. In accordance with Section 15-12-914 (2), C.R.S., recipients are entitled to claim payment up to 21 years after original date of issue. Pursuant to Section 24-35-212 (2), C.R.S., the amount of these uncashed warrants shall remain in the Lottery fund.

Deferred Revenue

The Colorado Lottery offers two methods of purchasing on-line tickets for future draws. One is purchased through the terminal, referred to as Advance Play, and allows the player to purchase on-line tickets good for up to 10 draws. The second method is restricted to Lotto tickets only and is purchased through the mail via a pre-printed form, referred to as subscription and allows the player to purchase Lotto tickets good for up to 104 draws. The revenues generated from both methods are recognized as the draws occur. Revenues for future draws are classified as a liability.

A detail of deferred revenue at June 30, 2003 and 2002, is as follows:

	2003	2002
Subscription	$ 238,160	$ 239,493
Advance play – Lotto	84,643	76,517
Advance play – Powerball	68,889	53,438
Advance play – Powerball	15,918	11,203
Advance play – Cash 5	18,294	16,985
Total deferred revenue	$ 425,904	$ 397,636

Promotional Activity

The Colorado Lottery engages in two types of promotional activities in an attempt to enhance sales and to increase the player base. Specific promotional coupons and Lottery Bucks coupons are distributed to players through special promotions and can be redeemed at any retailer for a lottery product. During the Fiscal Years ended June 30, 2003 and 2002, 16,285 and 41,203 coupons were redeemed, respectively. Scratch tickets for specific games are given away as a more direct approach to introduce players to lottery games. During the Fiscal Years ended June 30, 2003 and 2002, 63,008 and 51,200 dollars worth of free scratch tickets were given away, respectively. Scratch tickets and coupons are valued at cost. For the Fiscal Years ended June 30, 2003 and 2002, \$51,453 and \$62,413, respectively, in promotional ticket expense was recorded as Marketing and Communications expense in the statements of revenues, expenses and changes in fund net assets for coupons redeemed and scratch tickets given away.

Reclassifications

Certain reclassifications have been made to the 2002 financial statements to conform to the 2003 financial statement presentation. The reclassifications had no effect on the results of operations.

Note 2: Cash and Investments

Cash

Cash includes petty cash, change funds, an imprest fund, a depository account and cash on deposit with the State Treasurer. A detail of cash at June 30, 2002 and 2001 is as follows:

	2003	2002
Petty cash	$ 1,950	$ 2,450
Change funds	50,300	50,300
Imprest fund	305,258	303,257
Depository account	15,000	18,515
Cash on deposit with State Treasurer	30,657,551	25,376,214
Total unrestricted cash and investments	31,030,059	25,750,736
Restricted cash and investments – Licensed Agent Recovery Reserve Receipts on deposit with State Treasurer	460,638	464,096
Total restricted cash and investments	460,638	464,096
Total cash and investments	$ 31,490,697	$ 26,214,832

Cash on Deposit with State Treasurer

Under the provisions of Section 24-35-210 (6), C.R.S., the State Treasurer shall invest the moneys of the Colorado Lottery in excess of operating and prize payment expenses and all authorized transfers. Interest or any other return on investments is paid to the Lottery Fund Account on a monthly basis. Actual interest payments are determined by the State Treasurer. The annual yield for Fiscal Year 2003 was 4.52%.

In addition, the State Treasurer pools these deposits and invests them in securities approved by Section 24-75-601.1, C.R.S. The Colorado Lottery reports its share of the Treasurer's unrealized gains and losses based on its participation in the State Treasurer's pool only at Fiscal Year end. Effective July 1, 1997, with the Lottery's initial adoption of Governmental Accounting Standards Board Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, all of the Treasurer's investments, which include the net Licensed Agent Recovery Reserve Receipts, are reported at fair value, which is determined based on quoted market prices. The State Treasurer does not invest any of the pool resources in any external investment pool, and there is no assignment of income related to participation in the pool. Additional information on the Treasurer's pool may be obtained in the State of Colorado's Comprehensive Annual Financial Report.

Insured and Collateralized Deposits

The Colorado Lottery has one imprest and one depository account with banking institutions. The depository account is used for the purpose of depositing daily collections throughout the State and transferring the collections to the State Treasurer in a timely manner.

The Public Deposit Protection Act requires financial institutions to collateralize any uninsured public deposits. At June 30, 2003, the Colorado Lottery had cash with a carrying value of $320,258 and a bank balance of $320,258 on deposit with banking institutions. Of the bank balance, $100,000 is insured by federal insurance (FDIC); the amount not insured is covered by collateral held in the pledging institution's trust department in the State's name.

Statement of Cash Flows

The statement of cash flows is prepared under the direct method then adjusted for prize payments and commission and bonus payments to retailers, which are netted from cash received from retailers and applied against accounts receivable balances. For cash flow purposes, cash and investments include restricted cash and investments held by the State Treasurer in its cash and investment pool.

Categorization of Deposits and Investments

The Colorado Lottery's total bank balances are classified in the following three categories of credit risk:

Category 1 – Insured or collateralized with securities held by the Colorado Lottery or by its agent in the Colorado Lottery's name

Category 2 – Collateralized with securities held by the pledging financial institution's trust department or agent in the Colorado Lottery's name

Category 3 – Uncollateralized, including any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the Colorado Lottery's name

Additionally, the Colorado Lottery classifies its investments in the following three categories of credit risk:

Category 1 – Insured or registered, or securities held by the Colorado Lottery or its agent in the Colorado Lottery's name

Category 2 – Uninsured and unregistered, with securities held by the counterparty' s trust department or agent in the Colorado Lottery's name

Category 3 – Uninsured and unregistered, with securities held by the counterparty; or by its trust department or agent but not in the Colorado Lottery's name, including the portion of the carrying amount of any repurchase agreement that exceeds the market value of the underlying securities, if any

The cash deposits bank balance of $320,258 is categorized as follows as of June 30, 2003:

Category 1	$	100,000
Category 2	$	220,258

For Cash on Deposit with State Treasurer, the State Treasurer's investments as of June 30, 2003 are Category 1 investments and its cash deposits are principally Category 2 deposits.

Note 3: Schedule of Changes in Fixed Assets

Capital assets being depreciated:

	June 30, 2002	Increased	Decreases	June 30, 2003
Equipment	$ 5,356,715	$ 311,456	$ (108,849)	$ 5,559,322
Leasehold improvements	330,936	—	—	330,936
Total capital assets being depreciated	5,687,651	311,456	(108,849)	5,890,258
Less accumulated depreciation for equipment	(3,873,966)	(449,179)	85,725	(4,237,420)
Leasehold improvements	(210,949)	(14,563)	—	(225,512)
Total accumulated depreciation	(4,084,915)	(463,742)	85,725	(4,462,932)
Total capital assets, being depreciated, net	$ 1,602,736	$ (152,286)	$ (23,124)	$ 1,427,326

	June 30, 2001	Increased	Decreases	June 30, 2002
Equipment	$ 5,909,997	$ 118,861	$ (672,143)	$ 5,356,715
Leasehold improvements	330,936	—	—	330,936
Total capital assets being depreciated	6,240,933	118,861	(672,143)	5,687,651
Less accumulated depreciation for equipment	(3,865,771)	(599,500)	591,305	(3,873,966)
Leasehold improvements	(196,385)	(14,564)	—	(210,949)
Total accumulated depreciation	(4,062,156)	(614,064)	591,305	(4,084,915)
Total capital assets, being depreciated, net	$ 2,178,777	$ (495,203)	$ (80,838)	$ 1,602,736

Note 4: Operating Leases

The Colorado Lottery occupies office and warehouse space in Pueblo, Denver, Colorado Springs, Grand Junction and Fort Collins. Rental payments are contingent upon the continuing availability of funds. Specific lease information follows:

Pueblo

Office – The Colorado Lottery occupies office space in the Wells Fargo Bank Building in Pueblo. The lease agreement with 200 South Broadway Limited Partnership began on July 1, 1995 and expires on June 30, 2005. There is no provision for renewal.

Warehouse –The Colorado Lottery leases primary warehouse space from Santa Fe 250 LLC. The Lottery entered into a lease extension agreement, which began September 1, 2002 and expires June 30, 2007. There is no provision for renewal.

Interlott – The Colorado Lottery entered into a rental agreement with International Lottery, Inc. to rent Scratch Ticket Vending Machines (STVMs). The agreement covered the period from July 1, 2000 through June 30, 2002. The Lottery had the option to exercise two twelve-month extensions. On June 3, 2002, the Lottery entered into a contract with Interlott to exercise both twelve-month extensions plus an additional four-month extension which will expire on October 31, 2004. There are no other provisions for extension or renewal.

Denver

Office – The Colorado Lottery occupies office and warehouse space in the Galleria Towers Building in Denver. The lease agreement which began on October 30, 1990, was amended on May 14, 1999 and extended the ending date for the lease from June 30, 1999 to June 30, 2006. There is no provision for renewal.

Warehouse – The Colorado Lottery entered into a lease agreement with Yukon Denver Valley, Inc. to occupy warehouse space. The lease agreement began on September 1, 1999 and expires on August 31, 2004. The Lottery has the option to extend the lease through August 31, 2009.

Fort Collins

The Colorado Lottery occupies space leased by the Department of Revenue and is responsible for reimbursing the Department of Revenue for lease payments.

Grand Junction

The Colorado Lottery occupies space in the Grand Junction State Services Building and is responsible for reimbursing the Capital Complex Division for lease payments.

Colorado Springs

The Colorado Lottery occupies warehouse space in a building located at 2818 Janitell Rd. in Colorado Springs, Colorado. The lease agreement, which began on April 22, 1999, expires on June 30, 2003. There is no provision for renewal. The ownership of the premises changed as of July 31, 2003. The Lottery agreed to pay one month’s rent to the prior owner and entered into a new lease agreement with the new owners, which began on August 1, 2003 and expires on June

30, 2006. The Lottery has the option to exercise two twelve month extensions under the new lease, extending the lease through June 30, 2008. There are no other provisions for renewal.

Operating lease expense incurred for the Fiscal Years ended June 30, 2003 and 2002 and future minimum lease payments for Fiscal Years ending June 30, 2003 through 2006 are as follows:

Location	Expense		Future Minimum Lease Payments			
	2002	2003	2004	2005	2006	2007
Pueblo office	$ 250,336	262,692	$ 275,900	$ 289,773	$ —	$ —
Pueblo warehouse	32,637	74,654	85,885	88,398	91,052	78,623
Interlott	656,846	651,273	653,400	217,800	—	—
Colo. Spgs. warehouse	13,195	13,812	10,577	12,000	12,466	—
Denver office	191,392	197,373	203,354	209,335	215,316	—
Denver warehouse	96,274	103,622	100,612	16,844	—	—
Fort Collins	36,132	36,720	—	—	—	—
Grand Junction	4,942	4,063	—	—	—	—
	$ 1,281,754	$1,344,209	$ 1,329,728	$ 834,150	$ 318,834	$ 78,623

Note 5: Other Revenue

A schedule of other revenue for the Fiscal Years ended June 30, 2003 and 2002 follows:

	2003	2002
License fees	$ 56,376	$ 44,349
Fines and penalties	16,250	11,400
Assignment fees	10,803	11,532
Net Licensed Agent Recovery Reserve Receipts	(3,458)	52,467
Reimbursement production cost of game show from MUSL	190,802	—
Other	32,361	43,948
Total	$ 303,134	$ 163,696

Note 6: Lottery Fund Net Assets

In accordance with Section 24-35-210 (4.1) (a), C.R.S., the Lottery Commission shall reserve “sufficient moneys, as of the end of the Fiscal Year, to ensure the operation of the Lottery for the ensuing year.” Under the provision effective Fiscal Year 2002, the Lottery Commission designated the amount in net assets “equal to net value of the Lottery’s capital assets” to meet these reserve requirements. The net asset balances for the Fiscal Years ended June 30, 2003 and 2002 are composed of the following:

	2003	2002
Reclassification from unrestricted net assets to investment in capital assets for adoption of GASB 34	$ 1,427,326	$ 1,602,736
Restricted – Licensed Agent Recovery Reserve	460,638	464,096
Unrealized gain on investments	1,007,988	609,445
	$ 2,895,952	$ 2,676,277

Note 7: Distribution of Net Proceeds

In accordance with Section 33-60-104, C.R.S., distributions of net proceeds shall be made on a quarterly basis. The State Treasurer shall distribute net lottery proceeds as follows: forty percent (40%) to the Conservation Trust Fund, ten percent (10%) to the Division of Parks and Outdoor Recreation and all the remaining net lottery proceeds in trust to the trust fund board to be split between the Great Outdoors Colorado Trust Fund, and any excess to the General Fund of the State of Colorado as set forth in Section 33-60-104 (1) (c), C.R.S. and Section 33-60-104 (2), C.R.S. For each quarter including and after the first quarter of the State's Fiscal Year 2002, all moneys that would otherwise be transferred to the General Fund shall be transferred to the State Public School Fund as a contingency reserve as set forth in Section 22-54-117 (1.6), C.R.S.

Income available for distribution at June 30:

	2003	2002
Income before distributions	$ 104,998,736	$ 110,919,792
Change in licensed agent recovery reserve	3,458	(52,467)
Change in fair market value of investments	(398,543)	(217,901)
Other changes in net assets	175,410	(602,736)
Income available for distribution	104,779,061	110,046,688
Less distributions prior to year-end	(79,366,128)	(88,107,674)
Income available for distribution	$ 25,412,933	$ 21,939,014

	Accrued at June 30, 2002	Proceeds Distributions Expenses	Distributions Paid	Accrued at June 30, 2003
Great Outdoors Colorado	$ 2,469,568	$ 48,699,156	$ (42,152,634)	$ 9,016,090
State Public School Fund	8,499,940	3,690,377	(8,499,940)	3,690,377
Conservation Trust Fund	8,775,605	41,911,625	(40,522,057)	10,165,173
Division of Parks and Outdoor Recreation	2,193,901	10,477,903	(10,130,511)	2,541,293
	$ 21,939,014	$ 104,779,061	$(101,305,142)	$ 25,412,933

	Accrued at June 30, 2001	Proceeds Distributions Expenses	Distributions Paid	Accrued at June 30, 2002
Great Outdoors Colorado	$ 10,024,726	$ 46,523,408	$ (54,078,566)	$ 2,469,568
State Public School Fund	—	8,499,940	—	8,499,940
Conservation Trust Fund	8,019,781	44,018,673	(43,262,849)	8,775,605
Division of Parks and Outdoor Recreation	2,004,944	11,004,667	(10,815,710)	2,193,901
	$ 20,049,451	$ 110,046,688	$(108,157,125)	$ 21,939,014

Note 8: Pension Plan

Plan Description

Virtually all of the Colorado Lottery's employees participate in a defined benefit pension plan. The plan's purpose is to provide income to members and their families at retirement or in case of death or disability. The plan is a cost-sharing multiple-employer plan administered by the Public Employees' Retirement Association (PERA). PERA was established by State statute in 1931. Responsibility for the organization and administration of the plan is placed with the Board of Trustees of PERA. Changes to the plan require legislation by the General Assembly. The State plan and other divisions' plans are included in PERA's financial statements which may be obtained by writing PERA at 1300 Logan Street, Denver, Colorado 80203, or by calling PERA at 303-832-9550 or 1-800-729-PERA (7372).

Plan members vest after five years of service and most are eligible for retirement benefits at age 50 with 30 years of service, age 60 with 20 years of service or at age 65 with 5 years of service. Members are also eligible for retirement benefits without a reduction for early retirement if they are at least 55 and have a minimum of 5 years of service credit and their age plus years of service equals 80 or more. State troopers and judges comprise a small percentage of plan members but have higher contribution rates and are eligible for retirement benefits at different ages and years of service. Monthly benefits are calculated as a percentage of highest average salary (HAS). HAS is one-twelfth of the average of the highest salaries on which contributions were paid, associated with three periods of 12 consecutive months of service credit.

Members disabled, who have five or more years of service credit, six months of which has been earned since the most recent period of membership, may receive retirement benefits if determined to be permanently disabled. If a member dies before retirement, their spouse or their eligible children under the age of 18 (23 if a full time student) are entitled to monthly benefit payments. If there is no eligible spouse, financially dependent parents will receive a survivor's benefit.

Funding Policy

Most employees contribute 8.0% (10.0% for State troopers) of their gross covered wages to an individual account in the plan.

During Fiscal Year 2003, the State contributed 10.04% (12.74% for State troopers and 11.82% for the Judicial Branch) of the employee's gross covered wages. Before January 1, 2003, 1.64% was allocated to the Health Care Trust Fund and after January 1, 2003 1.1% was allocated to the Health Care Trust Fund. Throughout the Fiscal Year, the amount needed to meet the match requirement established by the PERA Board was allocated to the Matchmaker Program (see Note 9). The balance remaining after allocations to the Matchmaker Program and the Health Care Trust Fund was allocated to the defined benefit plan.

The annual gross covered wages subject to PERA is the gross earnings less any reduction in pay to offset employer contributions to the State sponsored IRC 125 plan established under Section 125 of the Internal Revenue Code. The contribution requirements of plan members and their employers are established, and may be amended, by the General Assembly.

The Colorado Lottery's contributions to the three programs described above for the Fiscal Years ended June 30, 2003, 2002 and 2001, were $659,854, $623,072, and $611,262, respectively. These contributions met the contribution requirement for each year.

Note 9: Voluntary Tax-Deferred Retirement Plans

Beginning on January 1, 2001, the Matchmaker Program established a State match for PERA members' voluntary contributions to tax-deferred retirement plans. For Calendar Years 2001 and 2002, the match was 100% of up to 3% of employees' gross covered wages paid during the month (7% for judges in the Judicial Branch). The PERA Board sets the level of the match annually based on the actuarial funding of the defined benefit pension plan. Two percent of gross salary plus 50% of any reduction in the overall contribution rate due to overfunding of the pension plan was available for the match. In Calendar Year 2003 the plan was not overfunded. However, the maximum one year change in the match rate is statutorily limited to one percent, and therefore, the match decreased from 3% to 2%. PERA offers a voluntary 401(k) plan entirely separate from the defined benefit pension plan. The State offers a 457 deferred compensation plan and certain agencies and institutions of the State offer a 403(b) plan. Members who contribute to any of these plans also receive the State match.

The Colorado Lottery's contributions to the Program described above for the Fiscal Years ended June 30, 2003, 2002 and 2001 were $138,919, $156,897 and $71,343, respectively.

Note 10: Post Retirement Health Care and Life Insurance Benefits

PERACare (formerly known as the PERA Health Care Program) began covering benefit recipients and qualified dependents on July 1, 1986. This benefit was developed after legislation in 1985 established the Program and the Health Care Trust Fund. Under this program, PERA subsidizes a portion of the monthly premium for health care coverage. The benefit recipient pays any remaining amount of that premium through an automatic deduction from the monthly retirement benefit. During the Fiscal Year ended June 30, 2003, the premium subsidy was $115.00 for those with 20 years of service credit ($230.00 for members under age 65), and it was reduced by 5% for each year of service fewer than 20. Medicare eligibility also affects the premium subsidy.

The Health Care Trust Fund is maintained by an employer's contribution as discussed above in Note 8.

Monthly premium costs for participants depend on the health care plan selected, the number of persons being covered, Medicare eligibility and the number of years of service credit. PERA contracts with a major medical indemnity carrier to administer claims for self-insured plans and with health maintenance organizations providing services within Colorado. As of December 31, 2002, there were 35,418 participants, including spouses and dependents, from all contributors to the plan.

Life Insurance Program

PERA provides its members access to two group life insurance plans offered by Prudential and Anthem Life (formerly known as Rocky Mountain Life). Members may join one or both plans and may continue coverage into retirement. Premiums are collected monthly by payroll deduction or other means.

Note 11: Contingencies and Commitments

Prize Annuities – The Colorado Lottery purchases annuity contracts in the name of individual jackpot prize winners. Although the annuity contracts are in the name of the individual winners, the Colorado Lottery retains title to the annuity contracts. The Colorado Lottery remains liable for the payment of the guaranteed minimum prizes in the event the insurance companies issuing the annuity contracts default. The following guaranteed minimum prize payments for which annuity contracts have been purchased are due in varying amounts through September 24, 2025.

Specified prize payments	$ 605,721,018
Lifetime prize payments	47,070,000
Total guaranteed minimum prize payments	$ 652,791,018

Self Insurance – The State of Colorado currently self-insures its agencies, officials and employees for the risks of losses to which they are exposed. That includes general liability, motor vehicle liability, workers' compensation and medical claims. The State Risk Management Fund is a restricted General Fund used for claims adjustment, investigation, defense and authorization for the settlement and payment of claims or judgments against the State except for employee medical claims. The State Employees and Officials Insurance Fund is an Internal Service Fund established for the purpose of risk, financing employees' and officials' medical claims. Property claims are not self-insured; rather, the State has purchased insurance.

Colorado employers are liable for occupational injuries and diseases of their employees. Benefits are prescribed by the Worker's Compensation Act of Colorado for medical expenses and loss of wages resulting from job-related disabilities. The State utilizes the services of Pinnacol Assurance (formerly Colorado Compensation Insurance Authority), a related party, to administer its plan. The State reimburses Pinnacol Assurance for the current cost of claims paid and related administrative expenses.

The Colorado Lottery participates in the Risk Management Fund. State agency premiums are based on an assessment of risk exposure and historical experience. Liabilities are reported when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated. Liabilities include an amount for claims that have been incurred but not reported. Because actual claims liabilities depend on such complex factors as inflation, changes in legal doctrines and damage awards, the process used in computing claims liability does not necessarily result in an exact amount. Claims liabilities are reevaluated periodically to take into consideration recently settled claims, the frequency of claims and other economic and social factors.

The limits of liability for which the State accepts responsibility pursuant to Section 24-10-114(1), C.R.S., are as follows:

Liability	Limits of Liability
General and automobile	Each person $150,000 Each occurrence $600,000

Medical and Disability Benefits

The Group Benefit Plans Fund is a Pension and Other Employee Benefits Fund established for the purpose of risk financing employee and State-official medical claims. The fund includes several medical plan options ranging from provider of choice to managed care. Before January 1, 2000, the State offered a variety of medical plans; some of the plans were fully insured while others were self-insured using Anthem Blue Cross Blue Shield as the plan administrator. After January 1, 2000, self-insured plans were no longer offered, and the State and its employees paid premiums for insurance purchased to cover medical claims. Through Fiscal Year 2001-02, the Group Benefit Plans Fund continued to cover claims originating before January 1, 2000. The State's contribution to the premium is fixed in statute; State employees pay the difference between the statutory contribution and the premium set by the insurer.

Before January 1, 1999, the Group Benefit Plans Fund provided an employer-paid short-term disability plan for all employees. On January 1, 1999, the Public Employees Retirement

Association (PERA) began covering short-term disability claims for State employees eligible under its retirement plan. The Group Benefit Plans Fund continues to provide short-term disability coverage for employees not yet qualified for the retirement plan and secondary benefits for employees also covered under the PERA short-term disability plan. The Group Benefit Plans program provides an employee with 60 percent of their pay beginning after 30 days of disability or the exhaustion of the employee's sick leave balance, whichever is later. This benefit expires six months after the beginning of the disability. Although fully insured, the Group Benefit Plans disability program includes a risk-sharing feature that provides experience rating refunds and a termination premium that is calculated as earned premium less the aggregate of incurred claims, claim reserve, retention charge and refunds paid previously over the term of the contract. Refunds, when applicable, are paid annually while deficits are carried forward.

Furniture and Equipment – The State of Colorado carries a $15,000 deductible replacement policy on all State owned furniture and equipment. For each loss incurred, the Colorado Lottery is responsible for the first $1,000 of the deductible and the State of Colorado is responsible for the next 14,000. Any loss in excess of $15,000 is covered by the insurance carrier up to replacement cost.

Gaming Operations Commitments – The Colorado Lottery has entered into long-term contracts with certain significant vendors related to providing scratch tickets and on-line data processing services in support of the Colorado Lottery's gaming operations. The on-line data processing contract expires October 31, 2004. The total amount to be paid on the on-line data contract shall not exceed $51,800,000 over the period of the contract. The scratch ticket contract expires June 30, 2004 with one annual renewal available on the contract. Ticket rates are based upon ticket volume, physical size and design. The total costs of the contract for the initial contract period shall not exceed $13,000,000 and $3,000,000, respectively.

The Colorado Lottery was approved as a member of the MUSL on February 26, 2001 and thus entered into an agreement with MUSL on June 6, 2001 to become a member and participate in Powerball games. As a member, the Colorado Lottery agrees to abide by the terms of the Multi-State Agreement dated September 16, 1987 and to any amendments to that agreement duly made by the board. The Colorado Lottery will remain a member indefinitely. Pursuant to this agreement, the Colorado Lottery will make payments to MUSL for administrative fees, Powerball Game Show production costs, weekly prize expenses, promotional purchases, miscellaneous reimbursements and assessments and contributions to the prize reserves. The total amount to be contributed to the prize reserves is $3,463,400 and is based on a percentage of sales. The total amount of the prize reserves funded as of June 30, 2003 was $2,542,880 shown as prepaid prize expense – MUSL on the statement of net assets.

Other Major Vendor Commitments – The Colorado Lottery entered into a long-term contract with an advertising agency to provide advertising services to promote the Colorado Lottery's products. The contract provided for expiration on June 30, 2002 with an option to renew up to three additional years through June 30, 2005. The total cost of the initial contract period shall not exceed $16,320,000. On May 15, 2002, the Colorado Lottery exercised its option to renew the contract for a period of two years, extending it until June 30, 2004. The maximum cost shall not exceed $8,500,000 in Fiscal Year 2003 and shall not exceed $17,000,000 for the extended contract period.

Litigation – In Fiscal Year 2001, a plaintiff has filed a class action suit claiming that the Colorado Lottery breached its contract with players by continuing to sell instant tickets in games in which the top prize had already been claimed. Although litigation continues, it is the opinion of Lottery's management that the ultimate outcome of this matter will not have a material impact on the Lottery's financial statements.

Note 12: Tax, Spending and Debt Limitations

In November 1992, the Colorado voters passed Section 20, Article X of the Colorado Constitution, commonly known as the Taxpayer's Bill of Rights (TABOR). TABOR contains revenue, spending, tax and debt limitations that apply to the State of Colorado and all local governments. In the same general election, Article XXVII was passed creating the State Board of the Great Outdoors Colorado Trust Fund. The simultaneous passage of these two constitutional amendments raised questions as to whether there are irreconcilable conflicts between the two amendments.

The General Assembly determined in Section 24-77-102 (17) (b) (IX), C.R.S., that the net proceeds from the Colorado Lottery are excluded from the scope of "State Fiscal Year spending" for purposes of TABOR. The Colorado Supreme Court, in response to an interrogatory from the General Assembly, approved that determination.

TABOR is complex and subject to further legislative and judicial interpretation. The Colorado Lottery believes it is in compliance with both of these constitutional amendments.

Note 13: Related Party Transactions

The Colorado Lottery, as an agency of the State of Colorado, paid fees to other agencies of the State for auditing, legal and other services and vehicle and office rent. The Colorado Lottery also pays fees to the Department of Revenue for indirect costs. Interagency charges were $955,627 and $1,044,758 for the Fiscal Years ended June 30, 2003 and 2002, respectively.

Note 14: Sale of Contributed Common Stock

During Fiscal Year 2002, the Colorado Lottery received notifications from various insurance companies with which it had purchased annuities for Lotto grand prize winners that the companies had converted from mutual or policy owned companies to public owned stock companies. As part of the "demutualization," the Lottery received shares of common stock in the newly formed companies. The State Treasurer sold the common stock received on behalf of the Lottery. The Lottery received $3,947,072 in 2002 from proceeds from the sale of the stock.

Supplementary Information

Colorado Lottery

Schedule of Revenue and Costs for Scratch and On-line Games
for the Fiscal Year Ended June 30, 2003
(With Comparative Totals for the Fiscal Year Ended June 30, 2002)

	Games in Progress				Fiscal Year 2003	Fiscal Year 2002
	Scratch	Lotto	Powerball	Cash 5	Total	Scratch and On-line
Gross ticket sales	$ 254,255,554	$ 48,270,758	$ 75,702,315	$ 13,245,013	$ 391,473,640	$ 407,966,534
Prize expense	(163,948,132)	(24,278,120)	(32,431,470)	(6,857,049)	(227,514,771)	(238,854,750)
Powerball prize variance	—	—	597,361	—	597,361	(1,467,844)
Net revenue after prizes	90,307,422	23,992,638	43,868,206	6,387,964	164,556,230	167,643,940
Commissions, bonuses, ticket costs and vendor fees						
Retailer commission	(17,767,979)	(2,859,656)	(4,543,538)	(794,812)	(25,965,985)	(26,972,691)
Retailer bonus	(2,631,181)	(311,578)	(496,457)	(123,770)	(3,562,986)	(3,769,234)
Cost of tickets sold	(3,175,336)	—	—	—	(3,175,336)	(2,990,729)
In-lane vendor fees	—	(71,283)	(111,791)	(19,559)	(202,633)	(219,157)
On-line vendor fees	(1,013,158)	(2,008,503)	(3,027,361)	(571,621)	(6,620,643)	(6,792,899)
Total	(24,587,654)	(5,251,020)	(8,179,147)	(1,509,762)	(39,527,583)	(40,744,710)
Gross profit on sale of tickets	$ 65,719,768	$ 18,741,618	$ 35,689,059	$ 4,878,202	$ 125,028,647	$ 126,899,230
Average daily ticket sales	$ 696,591	$ 132,249	$ 207,404	$ 36,288	$ 1,072,531	$ 1,117,717

Colorado Lottery

Schedule of Percent of Prize Expense to Gross Ticket Sales
for the Fiscal Year Ended June 30, 2003

	Games in Progress						
	Scratch	Lotto	Powerball	Cash 5	Powerball Prize Variance	Coupons/Free Plays	Fiscal Year 2003 Total
Prize expense	$ 163,948,132	$ 24,278,120	$ 32,431,470	$ 6,857,049	$ (597,361)	$ (9,820)	$ 226,907,590
(/) Ticket sales before coupons	254,266,132	48,272,866	75,705,463	13,245,564	—	(16,385)	391,473,640
Prize %	64.48%	50.29%	42.84%	51.77%		59.93%	57.96%

Note 1: Gross ticket sales excludes coupons

Note 2: Administrative costs of Lottery operations, including wages, advertising and other expenses are not shown.

Note 3: The average daily ticket sales for Powerball were calculated based on actual sales days of 365 days.

Note 4: Scratch total of $167,244,698 includes coupons/free plays of $24,772.

Colorado Lottery

Budgetary Comparison

for the Fiscal Year Ended June 30, 2003

	Fiscal Year 2003 Original Budget	Supplementals Pots Allocations & Internal Transfers	Fiscal Year 2003 Final Budget	Fiscal Year 2003 Actual Expenditures	Under Expended	Percent Under Expended
Personal services	$ 7,660,639	$ 427,029	$ 8,087,668	$ 7,805,105	$ 282,563	3.49%
Operating	1,946,994	—	1,946,994	1,945,115	1,879	0.10%
Vehicle lease payments	234,082	(56,973)	177,109	173,011	4,098	2.31%
Purch. Serve. Comp. Cen.	5,955	3,616	9,571	9,571	—	0.00%
Telecommunications	397,412	—	397,412	323,730	73,682	18.54%
MNT Payments	—	44,763	44,763	44,763	—	0.00%
Payments to other agencies	332,688	7,800	340,488	219,938	120,550	35.41%
Legal services	39,767	146,494	186,261	38,009	148,252	79.59%
Workmen's compensation	—	45,180	45,180	45,180	—	0.00%
Unemployment benefits	—	1,837	1,837	1,359	478	26.02%
Health and life	—	264,949	264,949	264,949	—	0.00%
Short-term disability	—	6,910	6,910	6,910	—	0.00%
Leased space	723,360	42,457	765,817	735,871	29,946	3.91%
Grand Junction – leased space	4,557	—	4,557	4,063	494	10.84%
Risk Management	—	21,001	21,001	21,001	—	0.00%
Info tech asset maintenance (PC's)						
Travel expenses	119,941	—	119,941	104,986	14,955	12.47%
Marketing and communications	9,097,225	—	9,097,225	9,093,018	4,207	0.05%
Indirect costs	372,155	—	372,155	372,155	—	0.00%
Ticket costs	3,654,300	295,780	3,950,080	3,175,335	774,745	19.61%
Vendor fees	8,646,120	(282,021)	8,364,099	7,341,244	1,022,855	12.23%
Prizes	284,558,533	(1,514,693)	283,043,840	227,514,768	55,529,072	19.62%
Powerball prize variance	4,370,000	480,000	4,850,000	3,908,334	941,666	19.42%
Retailer compensation	36,358,000	(374,620)	35,983,380	29,528,968	6,454,412	17.94%
Computer migration	8,233,614	(6,633,614)	1,600,000	139,205	1,460,795	91.30%
Multi-State Lottery fees	177,433	—	177,433	171,407	6,026	3.40%
Total	$366,932,775	$ (7,074,105)	$359,858,670	$ 292,987,995	$ 66,870,675	18.58%

Fiscal Year 2003 staffing (FTE)	128.00	(Appropriated)	123.10	(Actual)

Colorado Lottery

Budgetary Comparison (continued)

for the Fiscal Year Ended June 30, 2003

Reconciliation of Expenses per "Statement of Revenues, Expenses and Changes in Fund Net Assets" to Budgeted Expenditures:

Operating Expenses Per Statement of Revenues. Expenses and Changes in Fund Net Assets	
Prize expense	$ 227,514,771
Powerball prize variance	(597,361)
Commissions and bonuses	29,528,971
Cost of tickets and vendor fees	9,998,612
Other operating expenses	22,291,792
Total operating expenses per statement of revenues, expenses and changes in fund net assets	288,736,785
Plus Powerball variance classified as revenue	4,505,695
Less: non-appropriated expenses	
Depreciation	(463,741)
Accrued annual and sick leave	(79,075)
Book value of assets written-off	(23,125)
	292,676,539
Plus capitalized fixed assets	311,456
	$ 292,987,995

Independent Accountants' Report on Compliance and Internal Control Over Financial Reporting Based on the Audit of Financial Statements in Accordance with *Government Auditing Standards*

Members of the Legislative Audit Committee

We have audited the financial statements of the Colorado Lottery (Lottery) as of and for the year ended June 30, 2003, and have issued our report thereon dated August 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 Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under Government Auditing Standards.

Internal Control Over Financial Reporting

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

August 20, 2003
Colorado Springs, Colorado

Members of the Legislative Audit Committee:

As part of our audit of the financial statements of the Colorado Lottery (the Lottery) as of and for the year ended June 30, 2003, we wish to communicate the following to you.

Auditor's Responsibility under Generally Accepted Auditing Standards

An audit performed in accordance with generally accepted auditing standards (GAAS) is designed to obtain reasonable, rather than absolute, assurance about the financial statements. In performing GAAS procedures, we establish scopes of audit tests in relation to the financial statements taken as a whole. Our engagement does not include a detailed audit of every transaction.

Significant Accounting Policies

The Lottery's significant accounting policies are described in Footnote 1 of the financial statements.

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of financial statement preparation by management, based on its judgements. The following areas involve significant areas of such estimates for which we are prepared to discuss management's estimation process and our procedures for testing the reasonableness of those estimates:

Allowance for doubtful accounts
Fair value of investments
Prize liability
Useful lives of capital assets
Compensated absence liability

Audit Adjustments

During the course of any audit, an auditor may propose adjustments to financial statement amounts. Management evaluates our proposals and records those adjustments that, in its judgment, are required to prevent the financial statements from being materially misstated. An entry of $2,542,880 was proposed and made and is reflected on the Lottery's financial statements to reclassify cash to a prepaid expense. A second adjustment of $400,000 was proposed but was not recorded by the Lottery because management estimates its aggregate effect is not currently material; however, it involves areas in which adjustments in the future could be material, individually or in the aggregate. By not recording this adjustment, the prize liability and prize expense are overstated, thereby understating net assets. In Fiscal Year 2004, the entry was recorded by Lottery.

Colorado Lottery
Members of the Legislative Audit Committee

Areas in which adjustments were proposed are:

	Debit	Credit	
Reclass of Prepaid MUSL			Reflected on the Lottery's financial statements
Prepaid MUSL	$ 2,542,880		
Cash		$ 2,542,880	
Estimated Accrual			Not reflected on the Lottery's financial statements
Prize liability	$ 400,000		
Prize expense		$ 400,000	

The uncorrected misstatement pertaining to the latest period presented was determined by management to be immaterial, both individually and in the aggregate, to the financial statements as a whole.

This letter is intended for the information and use of the State of Colorado Legislative Audit Committee, the Lottery Commission and management of the Lottery and is not intended to be and should not be used by anyone other than these specified parties.

August 29, 2003

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