

STATE LOTTERY DEPARTMENT

**REPORT ON AUDIT
FOR THE YEAR ENDED
JUNE 30, 2007**

APA

**Auditor of
Public Accounts**

COMMONWEALTH OF VIRGINIA

AUDIT SUMMARY

Our audit of the State Lottery Department for the year ended June 30, 2007, found:

- the financial statements are presented fairly, in all material respects;
- an internal control matter that we consider to be a significant deficiency; however, we do not consider this matter to be a material weakness; and
- one instance of noncompliance required to be reported under Government Auditing Standards.

-TABLE OF CONTENTS-

	<u>Pages</u>
AUDIT SUMMARY	
INTERNAL CONTROL AND COMPLIANCE FINDINGS AND RECOMMENDATIONS	1
MANAGEMENT'S DISCUSSION AND ANALYSIS	2-8
FINANCIAL STATEMENTS:	
Statement of Net Assets	10
Statement of Revenues, Expenses, and Changes in Net Assets	11
Statement of Cash Flows	12
Notes to Financial Statements	14-22
INDEPENDENT AUDITOR'S REPORT:	
Report on Financial Statements	23-24
Report on Internal Control over Financial Reporting and on Compliance and Other Matters	24-25
AGENCY RESPONSE	26-27
AGENCY OFFICIALS	28

INTERNAL CONTROL AND COMPLIANCE FINDINGS AND RECOMMENDATIONS

Strengthen Information System Security Program

The Virginia State Lottery Department (Lottery) should further develop its Information System Security Program in order to minimize risks related to the confidentiality, integrity, and availability of its information. To accomplish this, Lottery should correlate the essential business functions with the supporting information systems, determine how these dependencies will affect each plan, and make any modifications needed. Lottery should also enhance its Incident Response Plan, Information Security Awareness and Training Program, and Information Security Plan to include additional policies and procedures consistent with industry best practices. Lastly, Lottery should document its security requirements and baseline configurations; perform periodic reconciliation of its systems to verify proper system modification; and utilize all of the defensive capabilities of its systems.

As of July 1, 2007, the Lottery will need to comply with the Commonwealth's new security standards and during 2008, the Lottery will outsource its computerized gaming system services. To properly manage and ensure that its contractor provides the appropriate security, Lottery will have to complete not only the refined assessment above, but should entirely reassess its information security needs. We would recommend that they use the new standards to undertake this review.

Properly Complete Employment Eligibility Verification Forms

Lottery is not properly completing Employment Eligibility Verification forms (I-9) in accordance with guidance issued by the US Citizenship and Immigration Services of the U.S. Department of Homeland Security. A sample of thirteen I-9 forms completed in fiscal year 2007, found four I-9 forms incorrectly completed. We found the following errors: date of section 1 should be either earlier than date of employment or the same day as employment, in section 2 of the I-9, A or B must be completely filled out, and Section 3 of the form should have been completed when an employee comes back to work or when her name has changed.

U.S. Department of Homeland Security regulates the process for completing the I-9 forms and failure to complete the forms properly can result in significant penalties to both the employee and employer. Because of the potential sanctions, we recommend that the Human Resources Division train human resource employees on the requirements of completing I-9s and then develop a process for continuously reviewing Lottery's I-9 process.

The federal government has increased its enforcement efforts related to hiring illegal immigrants, which makes having a good I-9 process in place more important than ever before. Although we did not find this particular issue at Lottery, we recommend that Lottery be cautious in the amount of documents it requests from each employee because employers requesting more than the minimum amount of documentation from employees could be subject to fines and penalties, as the Department of Homeland Security considers it a form of harassment.

Additionally, the Departments of Accounts and Human Resource Management, which help regulate and coordinate the Commonwealth's efforts in obtaining I-9 form information, provide training, and we recommend Lottery take advantage of this effort.

MANAGEMENT'S DISCUSSION AND ANALYSIS

(Unaudited)

The State Lottery Department's (Virginia Lottery) Management's Discussion and Analysis (MD&A) is designed to assist the reader in focusing on significant financial issues and provides an overview of financial activity. All Virginia Lottery net income is transferred to the Commonwealth of Virginia (Commonwealth) each year in accordance with requirements in the Appropriation Act and the Code of Virginia. Therefore, the Virginia Lottery's Management's Discussion and Analysis focuses primarily on an overview of the financial results of operations. Please read it in conjunction with the accompanying financial statements.

Financial Highlights

Virginia Lottery ticket sales totaled \$1.362 billion for fiscal year 2007, the second highest total ever for Virginia Lottery sales. Net proceeds totaling \$437.2 million were transferred to the Lottery Proceeds Fund, all of which are constitutionally mandated to support local K-12 public education. Highlights of the fiscal year include:

- Sales decreased by \$3.0 million (less than 1 percent) from last year to \$1.362 billion.
- Net income was \$437.2 million, a decrease of \$17.8 million (four percent) from last year.
- Prize expense increased \$18.2 million to a total of \$791.8 million. Prizes increased because the on-line prize expense rate, which varies with the luck of the draw, was up nearly two percent. In particular, the prize expense rate for Pick 3 and Pick 4 was 50.5 and 48.7 percent compared to last year's rate of 45.4 and 44.5 percent, respectively.
- Retailers earned \$305,000 (one half percent) more in 2007, with compensation paid to retailers totaling a record \$76.5 million. Retailers earned, on average, 5.6 cents on each dollar sold.

Although by law, the Lottery may spend up to ten percent of sales on operating costs, which includes all expenses except prizes and retailer compensation, these costs were only 5.0 percent of sales for the fiscal year.

Overview of the Financial Statements

The activities of the Virginia Lottery are accounted for in an enterprise fund used to account for governmental operations that are financed and operated in a manner similar to private business enterprises. Enterprise fund accounting is used when the governing body has decided that periodic determination of revenues earned, expenses incurred, and net income is appropriate. The basis of accounting is an accrual basis where revenues are recognized when earned and expenses when incurred regardless of when cash is exchanged.

This annual report consists of a series of financial statements, along with explanatory notes to the financial statements. The report includes the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows. The Statement of Net Assets and the Statement

of Revenues, Expenses, and Changes in Net Assets report the Virginia Lottery's net assets and their changes. By law, the Virginia Lottery transfers all of its net income to the Commonwealth, specifically to the Lottery Proceeds Fund, each year. As a result, the net assets of the Virginia Lottery consist largely of capital assets (equipment) and investments held to fund future payments on annualized lottery prizes as shown in the Statement of Net Assets. To assess the Virginia Lottery's financial position and financial health, the reader of these statements should pay particular attention to changes in operating revenues, expenses, and transfers to the Lottery Proceeds Fund as shown in the Statement of Revenues, Expenses, and Changes in Net Assets. The Statement of Cash Flows presents information related to cash inflows and outflows summarized by operating capital, financing, and investing activities.

Statement of Net Assets

Table 1 reflects the condensed Statement of Net Assets compared to the prior year.

Table 1

	<u>Statement of Net Assets</u>		
	<u>2007</u>	<u>2006</u>	<u>Change</u>
Assets:			
Current assets	\$ 444.53	\$ 478.46	\$(33.93)
Investments	254.35	288.10	(33.75)
Fixed assets, net of accumulated depreciation	<u>1.60</u>	<u>2.92</u>	<u>(1.32)</u>
Total assets	<u>700.48</u>	<u>769.48</u>	<u>(69.00)</u>
Liabilities:			
Current liabilities	445.46	480.52	(35.06)
Long-term liabilities	<u>255.02</u>	<u>288.96</u>	<u>(33.94)</u>
Total liabilities	<u>700.48</u>	<u>769.48</u>	<u>(69.00)</u>
Net assets:			
Invested in capital assets	1.60	2.31	(.71)
Unreserved	<u>(1.60)</u>	<u>(2.31)</u>	<u>.71</u>
Total net assets	<u>\$ _____</u>	<u>\$ _____</u>	<u>\$ _____</u>

* in millions

The decrease of \$69 million in assets and liabilities is mostly attributable to the change in investments.

Current assets and current liabilities decreased due to the change in cash collateral and obligations for the Lottery's Securities Lending. Investments, both current and long-term, consist of U.S. Treasury STRIPS purchased to fund individual jackpot and "For Life" prizes. Long-term liabilities consist mainly of prize liabilities for prizes paid in installments over several years. Investments and long-term prize liability both decreased because most current-year jackpot winners chose to take a one-time cash payment rather than the annuity payments, causing these balances to decline as the continued payments to previous winners outpaced the increase in investments for new winners.

There was no major capital asset activity in fiscal year 2007. In fiscal years 2001 and 2002, the Virginia Lottery acquired new on-line terminals (ISYS) through a five-year installment purchase agreement.

Footnotes 3 and 8 in the financial statements provide more detailed information regarding capital assets and long-term debt activity. The final installment purchase payment was made in June 2007.

The Virginia Lottery obtained a \$6 million advance from its line of credit with the Commonwealth. At year end, the Virginia Lottery is required to transfer all net income to the Commonwealth. This results in a short-term cash flow shortage at the beginning of the new fiscal year. The \$6 million loan payable was repaid on July 16, 2007.

Since the Virginia Lottery transfers all net income to the Commonwealth at the end of each fiscal year, changes in assets do not reflect the results of its operating activities. Those results are discussed later in this document.

Table 2

Statement of Revenues, Expenses, and Changes in Net Assets

	<u>2007</u>	<u>2006</u>	<u>Change</u>
Sales	\$1,362.34	\$1,365.33	(0.2)%
Prizes	(791.78)	(773.55)	2.4%
Retailer compensation	(76.48)	(76.19)	0.4%
Ticket printing and services	(8.50)	(8.95)	(5.2)%
Operating expenses	<u>(59.57)</u>	<u>(60.75)</u>	<u>(1.9)%</u>
Income from operations	426.01	445.89	(4.5)%
Non-operating revenue and expenses	<u>11.17</u>	<u>9.03</u>	<u>23.7%</u>
Net income	<u>\$ 437.18</u>	<u>\$ 454.92</u>	<u>(3.9)%</u>

* in millions

Sales

Virginia Lottery products fall into two major categories: scratch games and on-line games. Scratch games are games in which players scratch off tickets to see whether they have won and include \$1, \$2, \$5, \$10 and \$20 games. On-line games are games for which players buy tickets that are issued by a lottery terminal, for a chance to win prizes from a future drawing. The winning numbers for on-line games are drawn randomly by the Virginia Lottery and include Pick 3, Pick 4, Cash 5, Win for Life, and Mega Millions. The Lottery introduced two new online games during the year: Fast Play Bingo and Millionaire Raffle.

Table 3 compares sales for each lottery game for fiscal years 2006 and 2007. Total sales revenue for fiscal year 2007 were second highest ever, surpassed only by fiscal year 2006 sales. Pick 3, Pick 4, and scratch ticket sales set individual records for those products.

Table 3

	<u>Sales</u>		
	<u>2007</u>	<u>2006</u>	<u>Change</u>
Scratch sales	\$ 698.27	\$ 689.32	1.3 %
On-line sales:			
Pick 3	265.40	257.01	3.2 %
Pick 4	179.92	169.76	6.0 %
Cash 5	27.52	27.72	(0.7)%
Fast Play Bingo	13.01	-	100.0%
Millionaire Raffle	6.60	-	100.0%
Lotto South/Win for Life	41.32	61.85	(33.2)%
Mega Millions	<u>130.30</u>	<u>159.67</u>	<u>(18.4) %</u>
Total on-line sales	<u>664.07</u>	<u>676.01</u>	<u>(1.8) %</u>
Total sales	<u>\$1,362.34</u>	<u>\$1,365.33</u>	<u>(0.2) %</u>

* in millions

Total daily game sales (Pick 3, Pick 4, and Cash 5) represent 34.7 percent of total product sales. This category grew by four percent over the prior year. In fiscal year 2007, the Lottery added Sunday drawings for its daily games. This spurred Pick 3 and Pick 4 to record sales in fiscal year 2007.

The Lottery introduced two new online games in fiscal year 2007, Fast Play Bingo (February 2007) and Millionaire Raffle (April 2007). Fast Play Bingo is an on-line two dollar game and plays like a Scratch game with a top prize of \$10,000. Millionaire Raffle is a \$20 on-line game which had a limited offering of 330,000 tickets with three top prizes of \$1,000,000 each, and various secondary prizes. The drawing for Millionaire Raffle occurred June 14, 2007.

Win for Life sales (three percent of total sales) were down \$20.5 million from the prior year. Win for Life has a top prize of \$1,000 a week, payable to the winner for the rest of his or her lifetime. Win for Life was designed to increase the number of grand prize winners. Virginia had five of the eighteen top prize winners sold among the three member states (Georgia, Kentucky, and Virginia) in fiscal year 2007.

Mega Millions sales (10 percent of total sales) were down \$29.4 million over last year due to more unfavorable jackpot rolls in fiscal year 2007 and the introduction of Powerball in North Carolina. This product is a multi-state lotto style game with long odds of winning the top prize. Sales in this product are extremely dependent on the amount of the advertised jackpot, with sales increasing significantly as jackpots exceed \$200 million. During fiscal year 2007, there were fourteen separate jackpot winners. Twelve states sell Mega Millions tickets; Virginia had one Mega Millions jackpot winner in fiscal year 2007.

Scratch game sales (51.3 percent of total sales) continue along a growth trend, up \$9.0 million from fiscal year 2006 record levels. Growth in scratch game sales resulted from continuing efforts to produce a variety of games with different themes and price points to appeal to many types of players, and improvements in distribution to retail locations. The Lottery introduced its first \$20 Scratch ticket – \$1,000,000 Cash Spectacular – in July 2006.

Expenses

Prizes are the largest expense for the Virginia Lottery and vary with sales fluctuations and player luck. The fiscal year 2007 prize payout rate (percent of sales paid out in prizes) was 58.1 percent, over one percent higher than fiscal year 2006. The total prize dollars paid to winners increased \$18.2 million.

A summary of Virginia Lottery expenses for fiscal years ending June 30, 2006 and 2007 is shown in Table 4.

Table 4

	<u>Expenses</u>					
	<u>2007</u>		<u>2006</u>		<u>Change</u>	
Prize expense	\$791.78	84.6%	\$773.55	84.1%	\$18.23	2.4%
Retailer compensation	76.48	8.1%	76.18	8.3%	.30	.4 %
Operating expenses	59.57	6.3%	60.74	6.6%	(1.17)	(1.9) %
Scratch ticket printing	<u>8.50</u>	<u>1.0%</u>	<u>8.95</u>	<u>1.0%</u>	<u>(.45)</u>	<u>(5.0)%</u>
Total	<u>\$936.33</u>	<u>100.0%</u>	<u>\$919.42</u>	<u>100.0%</u>	<u>\$ 16.91</u>	<u>1.8 %</u>

* in millions

While overall sales declined slightly, retailer compensation was up due to additional retailer sales and cashing incentives. The retailer compensation rate was slightly less than the expected 5.7 percent of total sales. However in fiscal year 2007, total retailer compensation dollars was a new Virginia Lottery record.

Scratch ticket printing and distribution services costs decreased, although sales of this product increased. Fiscal year 2007 was the third full year of a new contractual agreement and the expense shown in this category includes warehousing, distribution costs, and ticket printing costs. The efficiencies and cost savings from this new contractual agreement continued in fiscal year 2007.

Operating spending was slightly lower than last year, primarily due to lower depreciation costs. In fiscal year 2007 the online terminals (ISYS) purchased in FY 2002 had fully depreciated.

Other Income

Table 5

	<u>Other Income</u>		
	<u>2007</u>	<u>2006</u>	<u>Change</u>
Interest income	\$10.2	\$8.1	27.0%
Net other income	<u>.9</u>	<u>1.0</u>	<u>(8.2%)</u>
Total	<u>\$11.1</u>	<u>\$9.1</u>	<u>22.0%</u>

* in millions

Interest income is earned primarily on cash balances held and invested by the Virginia Department of Treasury on behalf of the Virginia Lottery. As Table 5 shows, interest income was up 27 percent in 2007. Interest income for 2007 had a positive variance of 27 percent due to a 37 percent increase in the collected rate for the year. Even though average cash balances for the year decreased by five percent, the increase in the interest rate was the reason for the gain.

Net other income is derived from securities lending income, as well as various fees assessed to retailers for licensing, and administrative fees and penalties for failure to remit monies owed when due. In fiscal year 2007, net other income was down 8.2 percent, primarily due to the elimination of the clerk activation fees charged to low selling retailers.

Net Income

In fiscal year 2007, the Virginia Lottery generated \$437.2 million in profits. As shown in Table 6, profits were less than fiscal year 2006 by \$17.7 million (nearly four percent); however, this was the second highest net income transfer. Estimated net income of \$434.0 million was transferred to the Commonwealth on June 29, just prior to year-end. The remaining residual income will be transferred during 2008.

Table 6

	<u>Net Income</u>					
	<u>2007</u>		<u>2006</u>		<u>Change</u>	
Net income	<u>\$437.2</u>	<u>32.1%</u>	<u>\$454.9</u>	<u>33.3%</u>	<u>\$17.7</u>	<u>(3.9)%</u>

*in millions

Statement of Cash Flows

The Statement of Cash Flows, summarized in Table 7, presents detailed information pertaining to the cash activity of the Virginia Lottery during the year. The first part of the statement reflects operating cash flows and shows the net cash provided by operating activities of the Virginia Lottery. Receipts from the sale of tickets and related services totaled over \$1.35 billion. Uses of cash include payment of prizes to winners (\$854.0 million) and payments to retailers, suppliers, and employees for goods and services (\$131.6 million). The net cash provided by operating activities of \$369.8 million represents an eight percent decrease.

The cash flows from the non-capital financing activities portion of the statement reflects the \$436 million used for non-capital financing activities, the major portion being the \$435 million in total transfers from the Virginia Lottery during the year. This amount represents the initial estimate of fiscal year 2007 Virginia Lottery profits transferred to the Lottery Proceeds Fund prior to July 1, 2007. The Virginia Lottery required a Treasury loan of \$6 million to meet its year-end cash transfer and to allow sufficient cash balances on-hand to continue short-term operations.

Cash flows from capital financing activities reflect the payment of principal and interest on a financing agreement for capital equipment (\$0.6 million), plus the net cost of capital assets acquired during the period (\$0.7 million). The \$66.5 million cash flows from investing activities reflects purchases of investments to fund Win-For-Life prizes due to Virginia Lottery winners (\$4.2 million), proceeds from maturing investments previously purchased to fund Virginia Lottery prizes payable (\$60.4 million), and investment income on cash balances (\$10.2 million). The net decrease in cash flows from activities totaled \$1.0 million.

Table 7

Statement of Cash Flows

	<u>2007</u>	<u>2006</u>	<u>Change</u>
Cash flows from:			
Operating activities	\$ 369.80	\$ 401.50	(7.9) %
Non-capital financing activities	(436.00)	(460.00)	(5.2) %
Capital financing activities	(1.30)	(3.90)	(66.7) %
Investing activities	<u>66.50</u>	<u>61.60</u>	<u>8.0 %</u>
Net change in cash	<u>(1.00)</u>	<u>(.80)</u>	<u>25.0%</u>
Ending cash and cash equivalents	<u>\$ 7.30</u>	<u>\$ 8.30</u>	<u>(12.0) %</u>

* in millions

Potentially Significant Factors Impacting Next Year

In response to the increased competition from the North Carolina Education Lottery along the North Carolina/Virginia border, and to address the ongoing change in consumer purchasing habits, in May 2006 the Virginia Lottery entered into a historic contractual agreement with GTECH, Inc., to provide lottery equipment and a new gaming system. This agreement will allow the Virginia Lottery to expand its retailer network through increased equipment availability, expand the self-service equipment offerings available to Virginia Lottery consumers, and provide new and innovative in-store marketing messages at the point of purchase. The new system will also allow increased flexibility for new game offerings, player promotional capabilities, retailer accounting efficiencies, and player convenience, all of which is expected to help offset the impact of the increased product competition. To prepare for the new system and equipment, a significant portion of the 2007 fiscal year was dedicated to the planning and coordination of activities necessary to deploy the new equipment and gaming system, expected in October 2007.

Contacting the Virginia Lottery

This financial report is designed to provide the legislative and executive branches of government, the public, and other interested parties with an overview of the financial results of the Virginia Lottery's activities and to demonstrate the Virginia Lottery's accountability for its revenues. If there are any questions about this report or any Virginia Lottery financial issue, please contact the Director of Finance at the Virginia Lottery, 900 East Main Street, Richmond, Virginia 23219.

FINANCIAL STATEMENTS

STATE LOTTERY DEPARTMENT

STATEMENT OF NET ASSETS

For Fiscal Year Ended June 30, 2007 with Comparative Information for 2006

	2007	2006
ASSETS		
Current assets:		
Cash and cash equivalents (Note 2)	\$ 7,318,360	\$ 8,290,326
Cash held as collateral: (Note 2)		
Lottery securities lending	324,978,714	364,542,244
Treasury securities lending	2,042,833	2,122,252
Accounts receivable	50,759,576	43,894,583
Deferred expenses	669,542	1,078,581
Short-term investments (Note 2)	58,766,299	58,528,284
	<u>444,535,324</u>	<u>478,456,270</u>
Total current assets		
Investments (Note 2)	<u>254,346,360</u>	<u>288,108,158</u>
Fixed assets (Note 3)		
Furniture, fixtures and equipment	39,515,764	38,848,618
Less: Accumulated depreciation	(37,919,223)	(35,928,667)
Net fixed assets	<u>1,596,541</u>	<u>2,919,951</u>
Total assets	<u>700,478,225</u>	<u>769,484,379</u>
LIABILITIES		
Current Liabilities:		
Accounts payable	6,810,047	7,082,420
Treasury loan (Note 4)	6,000,000	8,000,000
Due to the lottery proceeds fund (Note 5)	3,180,128	931,308
Accrued compensated absences (Note 6)	910,789	699,224
Obligations under securities lending: (Note 2)		
Lottery	324,978,714	364,542,244
Treasury	2,042,833	2,122,252
Prizes payable:		
Jackpot prizes payable (Note 7)	58,766,299	58,528,284
Other prizes payable	39,932,124	35,195,763
Deferred revenue	2,840,969	2,810,802
Installment notes payable (Note 8)	-	610,390
	<u>445,461,903</u>	<u>480,522,687</u>
Total current liabilities		
Noncurrent liabilities:		
Jackpot prizes payable (Note 7)	254,346,360	288,108,158
Accrued compensated absences (Note 6)	669,962	853,534
Total noncurrent liabilities	<u>255,016,322</u>	<u>288,961,692</u>
Total liabilities	<u>700,478,225</u>	<u>769,484,379</u>
NET ASSETS		
Net assets:		
Invested in capital, net of related debt	1,596,541	2,309,561
Unreserved	(1,596,541)	(2,309,561)
Total net assets	<u>-</u>	<u>-</u>
Total liabilities and net assets	<u>\$700,478,225</u>	<u>\$769,484,379</u>

The accompanying notes to financial statements are an integral part of this statement.

STATE LOTTERY DEPARTMENT
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
For Fiscal Year Ended June 30, 2007 with Comparative Information for 2006

	2007	2006
Operating revenues:		
Ticket sales	\$ 1,362,342,592	\$ 1,365,326,441
Less:		
Prize expense	791,785,078	773,551,631
Retailer compensation	76,484,392	76,178,502
Instant ticket printing and services	8,496,026	8,946,847
Gross margin	485,577,096	506,649,461
Operating expenses:		
Advertising and promotion	26,075,819	23,749,536
General and administrative	31,500,685	32,182,283
Depreciation	1,990,556	4,813,614
Total operating expenses	59,567,060	60,745,433
Income from operations	426,010,036	445,904,028
Non-operating revenues(expenses)		
Interest income	10,230,895	8,056,903
Interest expense	(9,898)	(63,797)
Other income (net)	949,095	1,034,174
Total non-operating income	11,170,092	9,027,280
Net income	437,180,128	454,931,308
Transfer to the Lottery Proceeds Fund	(434,000,000)	(454,000,000)
Due from (to) the Lottery Proceeds Fund	(3,180,128)	(931,308)
Net assets at July 1	-	-
Net assets at June 30	\$ -	\$ -

The accompanying notes to financial statements are an integral part of this statement.

STATE LOTTERY DEPARTMENT
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2007 with Comparative Information of 2006

	2007	2006
Cash flows from operating activities:		
Cash received from ticket sales	\$1,355,507,766	\$1,367,220,898
Cash payments for prizes	(843,293,027)	(827,418,386)
Discounts for retailer compensation	(76,484,392)	(76,178,502)
Cash payments to supplier of instant tickets	(8,496,026)	(8,629,876)
Cash payments to suppliers of other goods and services	(26,938,478)	(20,643,961)
Cash payments to employees for services	(19,726,096)	(19,060,869)
Cash payments to the Literary Fund for unclaimed prizes (Note 9)	(10,747,271)	(14,033,804)
Net cash provided by operating activities	<u>369,822,476</u>	<u>401,255,500</u>
Cash flows from noncapital financing activities:		
Proceeds from other income	949,095	1,034,174
Repayment of Treasury Loan	(8,000,000)	(15,000,000)
Proceeds from Treasury Loan	6,000,000	8,000,000
Transfers to the General Fund of the Commonwealth	(434,931,308)	(454,021,322)
Net cash used by noncapital financing activities	<u>(435,982,213)</u>	<u>(459,987,148)</u>
Cash flows from capital financing and related activities:		
Acquisition of capital assets	(667,146)	(579,289)
Disposal of capital assets	0	819
Principal payments on installment notes	(610,390)	(3,062,342)
Interest payment on installment notes	(9,898)	(63,797)
Net cash used for capital financing activities	<u>(1,287,434)</u>	<u>(3,704,609)</u>
Cash flows from investing activities:		
Purchase of investment securities	(4,195,690)	(6,605,491)
Sale of investment securities	0	0
Proceeds from maturing securities	60,440,000	60,131,000
Interest proceeds from cash balances	10,230,895	8,056,903
Net cash used for investing activities	<u>66,475,205</u>	<u>61,582,412</u>
Net increase (decrease) in cash and cash equivalents	(971,966)	(853,845)
Cash and cash equivalents at July 1	<u>8,290,326</u>	<u>9,144,171</u>
Cash and cash equivalents at June 30	<u>\$7,318,360</u>	<u>\$8,290,326</u>
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	426,010,036	445,904,028
Adjustments to reconcile operating income to net cash:		
Depreciation	1,990,556	4,813,614
Accreted interest on investment securities	(22,720,527)	(25,121,078)
Changes in assets and liabilities:		
(Increase) Decrease in accounts receivable	(6,864,993)	2,388,565
Decrease in instant ticket inventory	0	316,971
Decrease in deferred expenses	409,039	1,106,315
(Decrease) Increase in accounts payable	(272,373)	1,051,679
Increase in current prizes payable	4,974,376	42,882
Increase (Decrease) in deferred revenue	30,167	(494,108)
Increase in accrued compensated absences	27,993	35,191
(Decrease) in noncurrent prizes payable	(33,761,798)	(28,788,559)
Net cash provided by operating activities	<u>\$369,822,476</u>	<u>\$401,255,500</u>

The accompanying notes to financial statements are an integral part of this statement.

NOTES TO FINANCIAL STATEMENTS

VIRGINIA STATE LOTTERY
NOTES TO FINANCIAL STATEMENTS
AS OF JUNE 30, 2007

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

The State Lottery Department (Virginia Lottery) was established by Chapter 531 of the 1987 Acts of Assembly and operates as an independent agency in accordance with the provisions of Chapter 40 of Title 58.1 of the Code of Virginia.

The Virginia Lottery participates in two multi-state games, Win for Life and Mega Millions. Win for Life member lotteries include Georgia, Kentucky, and Virginia. Mega Millions member lotteries include California, Georgia, Illinois, Maryland, Massachusetts, Michigan, New Jersey, New York, Ohio, Texas, Virginia, and Washington. The financial activity included in the financial statements reflects only Virginia's portion of these multi-state games. Separate agreed-upon procedures reports are issued for Win for Life and Mega Millions.

A separate report is prepared for the Commonwealth, which includes all agencies, boards, commissions, and authorities over which the Commonwealth exercises or has the ability to exercise oversight authority. The Virginia Lottery is an agency of the Commonwealth of Virginia and is included in the basic financial statements of the Commonwealth.

B. Basis of Accounting

The basis of accounting is an accrual basis where revenues are recognized when earned and expenses when incurred. On-line ticket revenue is recognized as corresponding drawings are held. Instant ticket revenue is recognized when tickets are activated for sale by retailers to the public.

C. Revenue and Expense Classifications

Operating revenues and expenses include activities related to the sale of lottery tickets. Operating expenses include prizes to winners, compensation to retailers, and instant ticket printing costs. Non-operating revenues and expenses include activities that have the characteristics of investing transactions and capital and non-capital financing activities as defined by Governmental Accounting Standards Board (GASB) Statement 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, and GASB Statement 34.

Non-operating revenues include interest income from its cash balances held with the Treasurer of Virginia. Non-operating expenses include interest on debt related to the purchase of capital assets.

D. Fund Accounting

The activities of the Virginia Lottery are accounted for in an enterprise fund, used to account for governmental operations that are financed and operated in a manner similar to private business enterprises. Enterprise fund accounting is used where the governing body

has decided that periodic determination of revenues earned, expenses incurred, and net income is appropriate.

E. Cash, Cash Equivalents, and Investments

The Virginia Lottery's cash and cash equivalents are considered to be cash on hand, cash with the Treasurer of Virginia, deposits, and overnight repurchase agreements.

Statutes authorize the Virginia Lottery to invest in obligations of the Commonwealth, federal government, other states or political subdivisions thereof, the International Bank for Reconstruction and Development, the Asian Development Bank, and the African Development Bank. In addition, the Virginia Lottery may invest in prime quality commercial paper rated prime 1 by Moody's Investment Service or A-1 by Standard and Poor's, Incorporated; overnight term or open repurchase agreements; and money market funds comprised of investments, which are otherwise legal investments of the Virginia Lottery.

Investments, both current and long-term, consist of U.S. Treasury STRIPS purchased to fund individual jackpot and "For Life" prizes. Investments are valued at cost plus accrued interest. Market values are reported for informational purposes as it is management's intention to hold these securities to maturity.

F. Property, Plant, and Equipment

Fixed assets are capitalized and depreciated on a straight-line basis over their useful lives and are valued at historical or estimated historical cost. Donated fixed assets are capitalized at estimated market value at the date of contribution. The Virginia Lottery capitalizes all property, plant, and equipment that have a cost or value equal to and greater than \$3,000 and an expected useful life of at least three years.

G. Contractor Fees

The Virginia Lottery has contracted with Oberthur Gaming Technologies (OGT) for the printing and distribution of instant tickets. OGT receives a fee of 1.1325 percent of the retail value of net tickets distributed and then activated by retailers.

2. CASH AND CASH EQUIVALENTS AND INVESTMENTS

Cash and cash equivalents represent cash with the Treasurer of Virginia, deposits, and overnight repurchase agreements. Cash with the Treasurer of Virginia is held pursuant to Section 2.2-1800, et seq., Code of Virginia. These funds are held in pooled accounts and, accordingly, are not categorized as to credit risk as defined by GASB Statement 40. Cash on deposit is held in demand deposit accounts maintained for prize payments and is covered by federal depository insurance with the balance in excess of this insurance collateralized in accordance with the Virginia Security for Public Deposits Act. Under this Act, banks holding public deposits in excess of the amounts insured by FDIC pledge collateral in the amount of 50 percent of deposits in excess of FDIC insurance coverage to a collateral pool held in the name of the State Treasury Board. For June 30, 2007, the total cash and cash equivalents equaled \$7,318,360. This included cash held overnight for repurchase agreements totaling \$1,157,006 and petty cash on hand of \$1,140.

In accordance with the State Treasurer and the Virginia Lottery's investment policy, funds are invested in U.S Treasury obligations for the purpose of payment of deferred prizes to winners.

These investments held for future prize payments are available for lending to broker-dealers and other entities (borrowers) for cash collateral that will be returned for the same securities in the future. Cash balances not managed by the Treasurer of Virginia are invested overnight under a Repurchase Agreement, whereby the Lottery purchases an interest in securities that are direct obligations of, or fully guaranteed as to principal and interest by, the U.S. government. These interests are repurchased by the custodial bank at the opening of the following banking day.

Custodial Credit Risk - Custodial credit risk is the risk that, in the event of the failure of the counterparty, the state and Virginia Lottery will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. All security loan agreements are collateralized at loan inception at no less than 100 percent of market value by cash or U.S. government obligations and adjusted to market daily to cover market value fluctuations; therefore, management believes there is no assumed credit risk.

Interest Rate Risk - Interest rate risk is the risk that investment's fair value decreases as market interest rates increase. The investments in prize annuities are subject to fluctuations in fair value due to interest rate risk, but these bonds are held to maturity to satisfy annual installment obligations to the prize winners. The fair value at maturity is the face value of the bonds, regardless of the fluctuations in the value during the time period that the investments are outstanding.

Repurchase agreements (overnight investments) held in the Virginia Lottery name, are not insured or guaranteed by the U.S. government, the Federal Deposit Insurance Corporation, or any other government agency and involve investment risk, including loss of principal. Under the repurchase agreement with Bank of America, Bank of America agrees to sell to the Virginia Lottery an interest in securities that are direct obligations of, or fully guaranteed as to principal and interest by, the U.S. government. When the transactions occur, the sweep occurs in the name of the Virginia Lottery and the investment is collateralized.

Investments and repurchase agreements consist of the following:

	<u>Credit Rating</u>			
	<u>Unrated</u>	<u>AAA</u>	<u>A-1+</u>	<u>A-1</u>
Bank of America:				
Repurchase agreements ⁽¹⁾	\$ 1,157,006	\$ -	\$ -	\$ -
Prize annuities:				
Treasury bonds ⁽²⁾	313,112,659	-	-	-
Securities lending:				
Master note	-	-	2,399,997	25,263,124
Open tri-party Set 3	-	-	8,210,515	27,410,489
Open tri-party Set 4	-	-	252,631	5,810,518
Floating Rate Note	-	29,257,101	1,262,677	-
Fixed Deposits	-	-	1,092,853	-
Corporate bond	-	-	-	-
Commercial paper	-	-	-	403,397
Asset-backed	<u>3,789,469</u>	<u>145,235,444</u>	<u>-</u>	<u>-</u>
Total	<u>\$318,059,134</u>	<u>\$174,492,545</u>	<u>\$ 13,218,673</u>	<u>\$58,887,528</u>
Bank of America:				
Repurchase agreements ⁽¹⁾	<u>A</u> \$ -	<u>A+</u> \$ -	<u>AA</u> \$ -	<u>AA-</u> \$ -
Prize annuities:				
Treasury bonds ⁽²⁾	-	-	-	-
Securities lending:				
Master note	-	-	-	-
Open tri-party Set 3	-	-	-	-
Open tri party Set 4	-	-	-	-
Floating Rate Note	5,743,959	4,484,204	8,842,093	51,478,143
Fixed Deposits	-	-	-	-
Corporate bond	-	2,147,366	1,894,734	-
Commercial paper	-	-	-	-
Asset-backed	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Total	<u>\$ 5,743,959</u>	<u>\$ 6,631,570</u>	<u>\$10,736,827</u>	<u>\$ 51,478,143</u>

Investment Securities

	<u>Less than 1 year</u>	<u>1-5 years</u>	<u>6-10 years</u>	<u>11-20 years</u>	<u>Over 20 years</u>
Bank of America:					
Repurchase agreements ⁽¹⁾	\$ 1,157,006	\$ -	\$ -	\$ -	\$ -
Prize annuities:					
Treasury bonds ⁽²⁾	58,766,299	190,536,287	40,981,074	17,226,312	5,602,687
Securities lending:					
Master note	27,663,121	-	-	-	-
Open tri-party Set 3	35,621,004	-	-	-	-
Open tri-party Set 4	6,063,150	-	-	-	-
Floating Rate Note	3,031,575	98,036,603	-	-	-
Fixed Deposits	1,092,853	-	-	-	-
Corporate bond	-	4,042,100	-	-	-
Commercial paper	403,397	-	-	-	-
Asset-backed	<u>3,961,387</u>	<u>43,696,812</u>	<u>26,018,681</u>	<u>12,410,042</u>	<u>62,937,989</u>
Total	<u>\$137,759,792</u>	<u>\$336,311,802</u>	<u>\$ 66,999,755</u>	<u>\$ 29,636,354</u>	<u>\$ 68,540,676</u>

*Credit quality ratings obtained from Standard & Poor's

⁽¹⁾ Repurchase agreements (overnight investments) held in the Virginia Lottery name, are not insured or guaranteed by the U.S. government, the Federal Deposit Insurance Corporation, or any other government agency and involve investment risk, including loss of principal. Under the repurchase agreement with Bank of America, Bank of America agrees to sell to the Virginia Lottery an interest in securities that are direct obligations of, or fully guaranteed as to principal and interest by, the U.S. government or agency thereof.

⁽²⁾ Virginia Lottery prize investments are insured or registered, or for which the securities are held by the Virginia Lottery or its safekeeping agent in the Virginia Lottery's name. All investments are made through U.S. government and agency securities that are explicitly guaranteed by the U.S. government.

A. Securities Lending

As authorized by Section 2.2-4506 of the Code of Virginia, the Virginia Lottery, through its master custodian JP Morgan Chase Bank, N.A, N.Y., and Dresdner Bank AG, N.Y., lends securities to various security brokers and lenders on a temporary basis for a fee. Up to 100 percent of the securities may be available for loan. Prior to or simultaneously with the Transfer of Securities to a Counterparty, the Bank shall obtain Collateral on the Lottery's behalf. The principal amount of cash Collateral and the Market Value (at the time of delivery by the Counterparty) of Collateral in the form of Securities shall, in each case, be not less than 100 percent of the aggregate Market Value of the Transferred Securities or the principal amount of such cash Collateral.

In accordance with GASB Statement 28, balances for *Cash held as collateral* and *Obligations under securities lending*, reflect the recommended reporting. For the year ended June 30, 2007, the market value of investment account securities on loan was \$321,002,808 secured by \$324,978,714 in cash deposits.

Cash held as collateral from treasury security lending represents the Virginia Lottery's share of cash collateral received on security lending transactions associated with their investment of Virginia Lottery cash held in the General Account of the Commonwealth. For the year ended June 30, 2007, treasury security lending balances were \$2,042,833. Information related to the credit risk of these securities lending transactions is available on a statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

3. FIXED ASSETS

The following schedule presents the changes in fixed assets by category.

	<u>Balance as of</u> <u>July 1, 2006</u>	<u>Additions</u>	<u>Reductions</u>	<u>Balance as of</u> <u>June 30, 2007</u>
Furniture, fixtures, and equipment	\$ 38,848,618	\$ 667,146	\$ -	\$39,515,764
Less: Accumulated depreciation	<u>35,928,667</u>	<u>1,990,556</u>	<u>-</u>	<u>37,919,223</u>
Net fixed assets	<u>\$ 2,919,951</u>	<u>\$(1,323,410)</u>	<u>\$ -</u>	<u>\$ 1,596,541</u>

4. LINE OF CREDIT

The State Comptroller has provided the Virginia Lottery with a line of credit not to exceed \$25 million in accordance with Section 3-2.03 of Chapter 847, 2007, Acts of Assembly, to fund administrative and operating expenses in the event unreserved cash is insufficient to cover these short-term costs. There was a \$6 million loan payable under this arrangement as of June 30, 2007, that was repaid on July 16, 2007.

5. DUE TO THE LOTTERY PROCEEDS FUND

The amount due to the Lottery Proceeds Fund represents Virginia Lottery net income payable to the Commonwealth of Virginia's General Fund in accordance with Section 3-1.01 of Chapter 847, 2007, Acts of Assembly, and Section 58.1-4022, Code of Virginia. The Lottery Proceeds Fund is a special non-reverting fund established solely for the purpose of public education in the Commonwealth. For the year ended June 30, 2007, the net income was \$437,180,128, with a net income transfer through June 30 of \$434,000,000 and a balance due to the Lottery Proceeds Fund of \$3,180,128.

6. COMPENSATED ABSENCES

Compensated absences represent the amounts of vacation, sick, and compensatory leave earned by employees of the Virginia Lottery, but not taken at June 30, 2007 and 2006. Compensated absences were calculated in accordance with GASB Statement 16, *Accounting for Compensated Absences*. The amount reflects all earned leave payable under the Virginia Lottery's leave payout policies. Information on the Commonwealth's leave policy is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

Balance as of			Balance as of	Due Within
<u>July 1, 2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>June 30, 2007</u>	<u>One Year</u>
<u>\$1,552,758</u>	<u>\$944,675</u>	<u>\$916,682</u>	<u>\$1,580,751</u>	<u>\$910,789</u>

7. PRIZES PAYABLE

Jackpot prize annuities are paid in 20, 25, 26, or 30 installments. The first installment is paid on the day the prize is claimed. The subsequent annual payments are funded with U.S. Treasury STRIPS purchased by the Virginia Lottery on the first business day following the winning draw. Jackpot winners also have the option of accepting their winnings in a lump sum cash payout. When a winner selects this option, the securities purchased are sold and the winner receives the cash value. "For Life" prizes payable represents estimated prizes payable monthly, quarterly or annually for the life of the winner based on life expectancy tables from the Virginia Bureau of Insurance and funded with a pool of U.S. Treasury STRIPS.

Jackpot prizes payable represent the future annual prize payments valued at cost plus accrued interest (present value of securities held to maturity) of the investment securities funding the payments.

Note Prizes Payable	Jackpot	Instant For Life	Online For Life	Total
Due within one year	\$ 56,423,312	\$ 1,991,542	\$ 351,445	\$ 58,766,299
Due in subsequent years	<u>223,036,370</u>	<u>25,842,044</u>	<u>5,467,946</u>	<u>254,346,360</u>
Total (present value)	279,459,682	27,833,586	5,819,391	313,112,659
Add: Interest to maturity	<u>78,858,318</u>	<u>23,653,414</u>	<u>5,521,609</u>	<u>108,033,341</u>
Total at Maturity	<u>\$358,318,000</u>	<u>\$51,487,000</u>	<u>\$11,341,000</u>	<u>\$421,146,000</u>

Other prizes payable represent unclaimed prizes from drawings or games, which have ended and are redeemable up to 180 days after the drawing or game end. "For Life" prizes, for which bonds have not been purchased, are reported as other prizes payable.

Prizes payable increases when jackpot winners select annuities and securities are purchased. Prizes payable decreases when securities mature to pay prior jackpot winners.

The following schedule presents the changes in prizes payable.

Balance as of			Balance as of
<u>July 1, 2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>June 30, 2007</u>
<u>\$346,636,442</u>	<u>\$4,195,690</u>	<u>\$37,719,473</u>	<u>\$313,112,659</u>

8. INSTALLMENT PURCHASE AND OPERATING LEASE COMMITMENTS

The Virginia Lottery is committed under an installment purchase agreement and various operating lease agreements. The installment purchase agreement is for new on-line terminals (ISYS). This is a five-year installment loan with interest rates ranging from 2.68 to 2.98 percent. The final installment purchase payment was made in June 2007. The operating leases are for regional offices. Expenses under operating lease agreements were \$1,373,358 for the year ended June 30, 2007. A summary of future obligations under these agreements as of June 30, 2007, follows:

<u>Year Ending June 30,</u>	<u>Operating Lease Obligation</u>
2008	\$ 1,366,851
2009	219,759
2010	160,883
2011	97,241
2012	<u>100,164</u>
Total	<u>\$ 1,944,898</u>

The following schedule presents the changes in installment purchases.

<u>Balance as of July 1, 2006</u>	<u>Increases</u>	<u>Decreases</u>	<u>Balance as of June 30, 2007</u>
<u>\$610,390</u>	<u>\$ -</u>	<u>\$610,390</u>	<u>\$ -</u>

9. LITERARY FUND AND SETOFF DEBT COLLECTION PAYMENTS

Prizes unclaimed after 180 days are paid to the Literary Fund of the Commonwealth. Payments totaled \$10,747,271 for the year ended June 30, 2007.

The Virginia Lottery participates in the Setoff Debt Collection Act whereby certain prize payments are withheld to set-off state obligations the prizewinner owes. Payments totaled \$1,231,535 for the year ended June 30, 2007. The Literary Fund and state debt setoff payments are reported as prize expense on the financial statements.

10. PENSION PLAN AND OTHER POST RETIREMENT BENEFITS

Employees of the Virginia Lottery are employees of the Commonwealth. The employees participate in a defined benefit retirement plan administered by the Virginia Retirement System (VRS). The VRS also administers life insurance and health-related plans for retired employees. Information relating to these plans is available at the statewide level only in the Commonwealth of Virginia's Comprehensive Annual Financial Report. The Commonwealth, not the Virginia Lottery, has the overall responsibility for contributions to these plans.

11. RISK MANAGEMENT

The Virginia Lottery is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; non-performance of duty; injuries to employees; and natural disasters. The Virginia Lottery participates in insurance plans maintained by the Commonwealth of Virginia. The state employee health care and worker's compensation plans are administered by the Department of Human Resource Management and the risk management insurance plans are administered by the Department of Treasury, Division of Risk Management. Risk management insurance includes property, general liability, medical malpractice, faithful performance of duty bond, automobile, and air and watercraft plans. The Virginia Lottery pays premiums to each of these departments for its insurance coverage. Information relating to the Commonwealth's insurance plans is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

12. CONTINGENCIES

The Virginia Lottery is named as a party in a legal proceeding. It is not possible at the present time to estimate ultimate outcome or liability, if any, of the Virginia Lottery in respect to this proceeding; however, it is believed that any ultimate liability resulting from this lawsuit will not have a material, adverse effect on the financial condition of the Virginia Lottery.



Commonwealth of Virginia

Walter J. Kucharski, Auditor

**Auditor of Public Accounts
P.O. Box 1295
Richmond, Virginia 23218**

August 15, 2007

The Honorable Timothy M. Kaine
Governor of Virginia

The Honorable Thomas K. Norment, Jr.
Chairman, Joint Legislative Audit
And Review Commission

Members of the Virginia State Lottery Board
900 East Main Street
Richmond, Virginia

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying basic financial statements of the State Lottery Department as of and for the year ended June 30, 2007, as listed in the Table of Contents. These financial statements are the responsibility of the State Lottery Department's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As discussed in Note 1A, the basic financial statements of the State Lottery Department are intended to present the financial position and the changes in financial position and cash flows of only that portion of the business-type activities and the major enterprise fund of the Commonwealth of Virginia that is attributable to the transactions of the Department. They do not purport to, and do not, present fairly the Commonwealth of Virginia's overall financial position as of June 30, 2007, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the State Lottery Department as of June 30, 2007, and the changes in its financial position and its cash flows for the year ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages two through eight is not a required part of the basic financial statements, but is supplementary information required by the accounting principles generally accepted in the United States of America. 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.

INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Department's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Department's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Department's internal control over financial reporting.

Our consideration of internal controls over financial reporting was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control over financial reporting that might be significant deficiencies or material weaknesses. However, as discussed below we identified a deficiency in internal control over financial reporting that we consider to be a significant deficiency.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control over financial reporting. We consider the deficiency entitled "Strengthen Information System Security Program", which is described in the section titled Internal Control and Compliance Findings and Recommendations, to be a significant deficiency in internal control over financial reporting.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control over financial reporting.

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in the internal control over financial reporting that might be significant deficiencies and, accordingly, would not necessarily disclose all significant deficiencies that are also considered to be material weaknesses. However, we believe that the significant deficiency described above is not a material weakness.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Department's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, 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 an instance of noncompliance that is required to be reported under Government Auditing Standards. This instance of noncompliance, entitled "Properly Complete Employment Eligibility Verification Forms", is described in the section titled Internal Control and Compliance Findings and Recommendations. There were no other matters that are required to be reported.

The Department's response to the findings identified in our audit is included in the section titled Agency Response. We did not audit the Department's response and, accordingly, we express no opinion on it.

The "Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters" is intended solely for the information and use of the Governor and General Assembly of Virginia, the Virginia State Lottery Board and Lottery management, and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

Exit Conference

We discussed this report with management at an exit conference held on September 19, 2007.

AUDITOR OF PUBLIC ACCOUNTS

Timothy M. Kaine

Governor

September 25, 2007

Shella Hill-Christian

Executive Director

Mr. Walter J. Kucharski
Auditor of Public Accounts
101 North 14th Street
Richmond, Virginia 23219

Dear Mr. Kucharski:

Attached are the Virginia Lottery's responses to the Auditor of Public Accounts Internal Control and Compliance Findings and Recommendations for inclusion in the auditor's report for the period ended June 30, 2007.

Strengthen Information System Security Program

The Lottery continues to place a high reliance on systems security, data integrity, and controls in the design, development, and deployment of all applications. Because data and systems integrity are critical to our business operations, and are the basis for our ability to continue to generate Lottery revenues for the Commonwealth, the Lottery is committed to the security and integrity of our systems, from the Executive Director down through the ranks of all Lottery employees. It is our intention to continue to improve the documentation to support this commitment.

While we strongly believe that the Lottery does have an effective Information System Security Program, we do acknowledge that the consolidation of policies and documentation of a fully-coordinated program could be improved. We are committed to working toward that end. Our business systems – including applications, hardware, and infrastructure – are all designed with redundancy, restoration, and security as primary considerations. Security measures currently in place to protect against data loss, invalid results, and unauthorized transactions are, in our opinion, highly effective and proven over 19 years of operations. This does not make us complacent, and we accept that continuous improvement is required to maintain this assurance.

In calendar year 2008, after the major systems conversion efforts are completed, the Lottery has committed budget resources to employ consulting services to assist with the development and documentation of a consolidated Crisis Management and Business Recovery Plan. This will be a living document and will demonstrate our commitment through maintenance and periodic re-evaluation for effectiveness. The Lottery will also review the role

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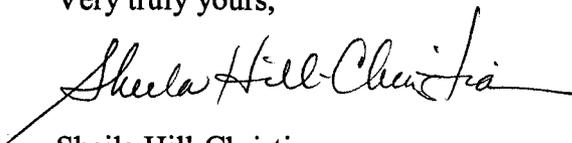
of the Information Security Committee and Information Security Officer in association with changes anticipated with the outsourcing of several components of its Information Technology operations. As a part of this review, we will also recommend changes to the Lottery's policies and procedures as needed to meet the changing business environment.

Properly Complete Employment Eligibility Verification Forms

In July 2007, the Lottery created a separate Human Resources Department, with a direct reporting relationship to the Executive Director. This will ensure that adequate and fully trained resources will execute the Lottery human resource functions and requirements, including the maintenance of required employee documentation. The Human Resources Department has completed a full review of all current employee files to ensure the presence of a fully-completed I-9 form. Staff will also continue to take advantage of training offered by the Department of Accounts and Department of Human Resource Management.

Please contact me if you have any questions.

Very truly yours,

A handwritten signature in cursive script that reads "Sheila Hill-Christian". The signature is written in black ink and is positioned above the printed name.

Sheila Hill-Christian

STATE LOTTERY DEPARTMENT

STATE LOTTERY BOARD

As of June 30, 2007

Susan Smith Feaster
Chairman

David H. Hallock, Jr.
Vice-Chairman

Gilliam M. Cobbs Cynthia D. Lawrence
James M. Wofford

Sheila Hill-Christian
Executive Director

Richard E. Williams, Jr.
Deputy Director