Compliance audit, financial statements and report of independent certified public accountants

Colorado Lottery

June 30, 2002 and 2001

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September 19, 2002

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, 2002. 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 2-3-103, C.R.S., which authorizes the State Auditor to conduct or cause to be conducted audits of all departments, institutions and agencies of state government. The reports which we have issued as a result of this engagement are set forth in the table of contents which follows.

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REPORT SUMMARY

COLORADO LOTTERY
FINANCIAL AND COMPLIANCE AUDIT
FISCAL YEAR ENDED JUNE 30, 2002

Authority, Purpose and Scope

The audit of the Colorado Lottery was done under authority of Section 24-35-211, C.R.S., which requires 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, 2002.

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.

Financial Audit Opinion

We have issued an unqualified opinion dated August 8, 2002, on the Colorado Lottery's June 30, 2002, financial statements.

Current Year Findings and Recommendations

There are five current year findings and recommendations, all of which relate to the current and future operations of the computer systems of the Colorado Lottery.

The first recommendation relates to the need for stringent planning for and oversight of the planned changes to the Colorado Lottery's computer platforms and database management system. These changes are scheduled to take place on or about the same time that a new contract will become effective for the contractor (currently GTECH, Inc.) providing on-line system related products and services to the Colorado Lottery. Without the recommended stringent planning and oversight procedures, the potential exists for costly duplications of functions by the Colorado Lottery and the contractor.

The remaining four recommendations were developed in connection with our firm's performance of a SAS 70 audit of GTECH Colorado's system of controls as it relates to the processing of the Colorado Lottery's transactions. The findings and recommendations are as follows:

- We noted that a GTECH employee who had terminated employment still had physical access to the data center and that a group of Colorado Lottery employees responsible for testing the systems still had access to the computer room after such access was no longer required. 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.

- We noted certain key functions within the on-line gaming and the Gaming Environment Management System (GEMS) applications were accessible by an excessive number of high-level staff. The Colorado Lottery should limit the number of users that are given permanent access to high risk systems in on-line gaming and GEMS applications. Also, temporary access should be granted on an as-needed basis for emergency purposes only.

- We noted that a majority of communication lines serving the northern part of the State are aggregated on a T1 line, which is redundant (another line is available if a problem occurs). However, failures at certain key locations such as GTECH or the Qwest Central Office, could result in loss of communication with all retailers because of the lack of redundancy or backups at those locations. The Colorado Lottery should review the cost/benefit of built-in redundancy for all communication lines with retailers.

- We also noted areas for improvement in GTECH's Disaster Recovery Plan (Plan).

Summary of Progress in Implementing Prior Year Recommendation

The prior report for the year ended June 30, 2001 included one recommendation. That recommendation was that the Colorado Lottery require an annual audit (SAS 70 audit) of the system of internal controls of GTECH, Inc., its on-line vendor. This recommendation has been fully implemented. A copy of Grant Thornton LLP's SAS 70 report has been received by the Colorado Lottery. Also, the Colorado Lottery has included in its Request for Proposal for Vendor Provided On-line System Related Products and Services for State Lottery Games a requirement for annual SAS 70 audits of the contractor.

RECOMMENDATION LOCATOR

All recommendations are addressed to the Colorado Lottery

Rec. No.	Page No.	Recommendation Summary	Agency Response	Implementation Date
1	10	Ensure that periodic planning and update meetings are held with the contractors selected under the recently issued vendor provided on-line system, CMOS Project and Security Oversight RFPs.	Agree	June 30, 2003
2	11	Ensure physical access authority is cancelled on a timely basis when employees are terminated from employment or when access is no longer required.	Agree	Oct. 31, 2002
3	12	Limit the number of users that are given permanent access to key functions within the on-line gaming and GEMS applications.	Agree	March 31, 2003
4	13	Review the cost/benefit of built-in redundancy for all communication lines with retailers and consider the need for additional redundancy at key locations.	Agree	May 31, 2003
5	13/14	Improve the Disaster Recovery Plan by:		
		a. Reviewing the appropriateness of a two-week time period for bringing the systems back on line.	Agree	June 30, 2003
		b. Testing the disaster recovery plan on a periodic basis.	Agree	June 30, 2003
		c. Considering the circulation of back-up tapes offsite daily.	Agree	Oct. 31, 2002
		d. Documenting processes and procedures for utilizing data backup at the remote location.	Agree	Oct. 31, 2002

THE COLORADO LOTTERY

BACKGROUND

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 2002, the Lottery employed 124 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. 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 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 percent 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. Amounts exceeding the GOCO cap (the spill over) are distributed to the State Public School Fund Contingency Reserve.

MANAGEMENT'S DISCUSSION AND ANALYSIS
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

This discussion and analysis of the Lottery's financial performance is a required component of financial reporting under governmental accounting standards and was prepared by Colorado Lottery Management. It provides an overview of financial activities for the year ended June 30, 2002 and should be read in conjunction with the Lottery's financial statements, which begin on page 18. These financial statements reflect only activities of the Colorado Lottery, an enterprise fund of the State of Colorado.

FISCAL YEAR 2002 FINANCIAL HIGHLIGHTS

- The Lottery's overall sales performance of $408.0 million improved by $57.4 million over the previous year and was the Lottery's highest sales year ever since its inception in 1983. Record high scratch sales totaled $257.2 million, an $8.0 million increase from Fiscal Year 2001's record high sales. A decrease in Lotto sales of $31.2 million from the previous year was more than offset by sales from the Lottery's newest on-line game "Colorado Powerball" whose maiden year sales totaled $79.9 million. Cash 5 sales showed a modest increase of $.7 million, when for the first time, two additional draws per week spanned an entire year.
- The overall increase in sales contributed to record high proceeds distributions, which increased by $30.7 million from the prior year's distribution and was a $9.4 million increase from Fiscal Year 1995, the previous record high year. In all, the Lottery distributed, including funds available for distribution at year end, $110.0 million to the proceeds recipients. This amount included, for the first time, a spillover into the State Public School Fund Contingency Reserve of nearly $8.5 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.
- A major factor affecting the increase in proceeds distributions was the Lottery's receipt of a significant number of shares of common stock from the conversion of two insurance companies from mutual or policy owned companies to public owned stock companies (demutualization). The shares were subsequently sold for the Lottery by the State Treasurer's office for more than $3.9 million. More details on these shares is provided below.
- Gross profit as a percent of sales increased by 2.7%, a reflection of the decrease in the prize fund from 61.2% to 58.9% of sales.

USING THIS ANNUAL REPORT

This annual report consists of a series of financial statements. The Statements of Net Assets provide information about the Lottery's assets and liabilities and reflect the Lottery's financial position as of June 30, 2002 and June 30, 2001. The Statements of Revenues, Expenses, and Changes in Fund Net Assets report the activity of selling lottery products and the expenses related to such activity for the twelve-month periods ended June 30, 2002 and June 30, 2001. And finally, the Statements of Cash Flows outline the cash inflows and outflows related to the activity of selling lottery products for the same twelve-month periods.

SALES ACTIVITIES

Revenues from the sale of lottery products for the Fiscal Year Ended June 30, 2002 were the highest in the Lottery's twenty-year history. As shown in the financial statements, sales increased 16.4% from the prior year, from $350.6 million in the Fiscal Year Ended June 30, 2001 to $408.0 million in the current year. The increases in scratch and Cash 5 sales along with the sales from the new on-line game, Powerball, more than offset the significant decrease in Lotto sales. Lotto sales are highly dependent on large jackpots. The current fiscal year had fewer large jackpots than recent years and was cannibalized by the new on-line game.

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

Product Sales	2002	2001	*Difference*	*Percentage*
Scratch	$257.2	$249.2	$ 8.0	3.2%
Powerball	79.9	0.0	79.9	n/a
Lotto	57.7	88.9	-31.2	-35.1%
Cash 5	13.2	12.5	0.7	5.6%
Total	$408.0	$350.6	$57.4	16.4%

TOTAL REVENUES

Non-operating revenues for the year ended June 30, 2002 totaled $6.4 million as compared with $2.4 million for the year ended June 30, 2001. Non-operating revenues include those revenues from other than the sale of lottery products. Fiscal Year 2002 non-operating revenues were comprised of $3.9 million from the sale of contributed capital stock (see Non-Recurring Revenue below), $2.3 million of interest income and $.2 million of other revenue. Fiscal Year 2001 non-operating revenues were comprised of $2.2 million of interest income and $.2 million of other revenue.

Total revenues were $414.4 million and $353.0 million for the years ended June 30, 2002, and June 30, 2001, respectively. As mentioned elsewhere, the two major contributors to the increase of approximately $61.4 million was an increase in lottery sales of $57.4 million and the increase in non-operating revenues of nearly $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 is a single year windfall and most likely will not recur in future periods.

MAJOR EXPENSES

Approximately $281.1 million of the Lottery's total operating expenses of $303.4 million for the Fiscal Year Ended June 30, 2002, 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, almost $251.1 million of the Lottery's total operating expenses of $273.1 million for the Fiscal Year Ended June 30, 2001, 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	2002	2001	*Difference*	*Percentage*
Prize Expense/Powerball Prize Variance	$ 240.3	$214.4	$25.9	12.1%
Retailer Compensation:				
Commissions	27.0	23.5	3.5	14.9%
Bonuses	3.8	3.4	0.4	11.8%
Ticket Costs	3.0	3.2	-0.2	-6.3%
Vendor Fees	7.0	6.6	0.4	6.1%
Total	$ 281.1	$251.1	$30.0	11.9%

The increase in overall game-related expenses is reflective of the increase in product sales. See the product sales schedule above. The large percentage decrease in ticket costs is a result of contract changes, which lowered the overall cost of purchasing scratch tickets. The large percentage increase in vendor fees results from the overall increase in on-line sales from $101.4 million for the year ended June 30, 2001 to $150.8 million for the year ended June 30, 2002. The other large percentage increases in prize expense/Powerball prize variance and retailer compensation are a direct result of the large increase in overall sales and the introduction of Powerball described above.

Of the $22.4 million in Fiscal Year 2002 other operating expenses that were not game-related, close to $9.1 million was used for promotions or for institutional and product advertising, and $7.9 million was used to compensate Lottery employees. In comparison, of the $22 million in Fiscal Year 2001 other operating expenses, just over $9.4 million was used for promotions or for institutional and project advertising, and $7.4 million was used to compensate Lottery employees. The decrease in advertising and promotion expenditures for Fiscal Year 2002 occurred because a portion of the original appropriation was permanently re-appropriated to cover administration fees to the Multi-State Lottery Association (MUSL).

OTHER FINANCIAL INFORMATION

The Lottery's total assets at June 30, 2002 were $45.0 million. Assets consisted primarily of cash and investments with the State Treasury of almost $25.8 million, Prepaid Prize Expense with MUSL of nearly $1.5 million, receivables from lottery retailers for the sale of lottery products of $13.7 million, and a net investment in fixed assets of $1.6 million.

Comparable figures at June 30, 2001 were $41.4 million in total assets, including more than $25.1 million in cash and investments with the State Treasury, $12.5 million in receivables from retailers, and $2.2 million in net investment in fixed assets.

The Lottery's total liabilities at June 30, 2002 were $42.4 million, consisting primarily of proceeds distributions due to recipients of $21.9 million and prize liability on all Lottery products of $17.1 million. Of the $42.4 million of total liabilities at June 30, 2002, $41.3 million are current liabilities.

The Lottery's total liabilities at June 30, 2001 were $39.6 million, which consisted primarily of proceeds distributions due to recipients of $20.0 million and prize liability on all Lottery products of $15.1 million. Of the $39.6 million of total liabilities at June 30, 2001, $38.7 million were current liabilities.

Increase in net assets for the year ended June 30, 2002 was $873,104 compared to $658,098 for the year ended June 30, 2001, or a 32.7% increase.

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 2001 and Fiscal Year 2002 consisted of a decrease in investment in capital assets from $2.2 million to $1.6 million, a minor increase in the bonding reserve from $411,629 to $464,096, a net increase in unrestricted net assets of $1.4 million as a result of a net increase in the adjustments on State Treasury investments of $217,901 and a necessary negative offset to report the prior year's net assets under the new reporting model.

Following is a schedule of net assets as of June 30:

	2002	2001
Investment in Capital Assets (Reserve approved by the Lottery Commission)	$1,602,736	$2,178,777
Licensed Agent Recovery Reserve	464,096	411,629
Unrestricted		
Unrealized Gain (Loss) on Investments	609,445	391,544
Reclassification from unrestricted net assets to investment in capital assets for adoption of GASB 34	-	(1,178,777)
Total Net Assets	$2,676,277	$1,803,173

DISTRIBUTIONS TO PROCEEDS' RECIPIENTS

The Lottery's efforts generated record net proceeds distributions of $110.0 million in the current fiscal year. Of these total proceeds, $46.5 million was allocated to Great Outdoors Colorado Trust Fund, $44.0 million to the Conservation Trust Fund, and $11.0 million to the Division of State Parks and Recreation per the distribution formula stated in Section 33-60-104, C.R.S. The maximum distribution to Great Outdoors Colorado of $46.5 million pursuant to Section 33-60-104

(1) (c), C.R.S. and Section 33-60-104 (2), C.R.S. was reached, thus creating a spill over into the State's Public School Fund Contingency Reserve of nearly $8.5 million pursuant to Section 22-54-117 (1.6) (a), C.R.S.

The Lottery's proceeds distributions for the prior year totaled $79.3 million. Of these total proceeds, $39.7 million was allocated to Great Outdoors Colorado Trust Fund, $31.7 million to the Conservation Trust Fund, and $7.9 million to the Division of State Parks and Recreation per the distribution formula stated in Section 33-60-104, C.R.S. The distribution to Great Outdoors Colorado did not reach the maximum allowable (cap) in Fiscal Year 2001.

BUDGETARY HIGHLIGHTS

The Lottery's budget is determined by a variety of methods. The majority of the budget is set by the annual appropriations bill (called the Long Bill), which determines budgets for every agency within the State. The Long Bill and centrally appropriated funds 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 as well as year-end transfers of spending authority, if needed. In the third quarter of Fiscal Year 2002, the Legislature approved supplemental appropriations to adjust for changes in estimated sales levels and other unforeseen needs. Supplemental appropriations were approved in purchased services for the computer center, legal services, health/dental/life, ticket costs, prizes, Powerball prize variance, retailer compensation, and multi-state lottery fees, offset by reductions in the vehicle lease payments, information technology asset maintenance, marketing and communications, and vendor fees lines. In Fiscal Year 2002, a year-end transfer of $3,500 was made from the operating line to the travel line in order not to overspend the travel line. The final method of funding is special legislation. In Fiscal Year 2002, there was no special legislation that affected the Lottery.

The approved Lottery budget at the beginning of the year was $307.5 million. Supplemental appropriations and adjustments made by the third quarter increased the budget by $52.3 million to a total of $359.8 million. Total expenditures and roll-forwards for Fiscal Year 2002 came to $302.8 million, resulting in excess appropriations or savings of more than $57.0 million.

CURRENTLY KNOWN FACTS IMPACTING OPERATIONS

There are three currently known facts that will increase operating expenses for Fiscal Year 2003 compared to Fiscal Year 2002. These are comprised of increases in leased space costs and moving costs for a new warehouse, costs for new investigator radios, and an increase in computer maintenance costs.

CONTACTING THE LOTTERY'S FINANCIAL MANAGEMENT

This management's discussion and analysis (MD&A) 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 2002 and to demonstrate the Lottery's accountability for the money it received from the sale of lottery products. If you have questions about the MD&A or need additional information, contact the Colorado Lottery's Chief Financial Officer, 201 West 8th Street, Suite 600, Pueblo, Colorado 81003.

FINDINGS AND RECOMMENDATIONS

CONTRACT ADMINISTRATION UNDER RECENTLY ISSUED REQUESTS FOR PROPOSALS

During our testwork at the Colorado Lottery we noted that it is in the process of requesting proposals for project and security oversight over its planned migration of its current internal back office systems (Wang VS platforms) to new computer platforms (CMOS Project). The Colorado Lottery is also requesting a proposal for its on-line vendor which is responsible for system related products and services. The current on-line system vendor contract is with GTECH, Inc.

We noted during our review of these requests for proposals that there is no formal plan to ensure communication and coordination of efforts among the successful bidders for all proposals. Some decisions made with respect to changes to the nature and extent of services rendered by the on-line contractor chosen under the on-line system vendor request for proposal (RFP) will in turn impact the scope of the CMOS Project. An example of such a decision would be if the Lottery decided to move the scratch inventory and validation files and functions to the on-line vendor rather than internally retaining these files and functions. Accordingly, it is important from both a capital expenditure perspective and an operational efficiency perspective that duplicative efforts between the on-line contractor and the Colorado Lottery back office systems be avoided. We are not aware of any significant deficiencies on the part of the Colorado Lottery, however, significant problems have occurred in other governmental agencies due to the lack of a formal plan. Accordingly, the contracts should contain requirements for regular meetings and coordination of efforts.

The contractors selected under the CMOS project and on-line vendor RFPs will need to work in unison with the Colorado Lottery Information Technology personnel, including project managers, by meeting on a regular basis. The goal of these meetings should focus on minimizing Colorado Lottery capital expenditures and contract costs through a clear delineation of functions to be performed by the on-line contractor and the Colorado Lottery's back office system migration. These teams should work together through the system implementation date in designing the system and defining the Colorado Lottery's and each contractor's functions after system migration.

Recommendation No. 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.

Colorado Lottery Response: Agree. To be implemented by June 30, 2003.

INFORMATION SYSTEM CONTROLS

In addition to the audit of the Colorado Lottery financial statements for Fiscal Year 2002, under a separate contract, Grant Thornton LLP performed an audit of the general controls in place at the Colorado Lottery gaming data center. This audit was conducted in accordance with Statement on Auditing Standards (SAS) 70, as amended by SAS 88, *Service Organizations and Reporting on Consistency* issued by the American Institute of Certified Public Accountants. Operation of the center has been contracted to GTECH, Inc. (GTECH). GTECH provides data processing and other services to the Colorado Lottery. According to the contract between GTECH and the Colorado Lottery, GTECH is responsible for the design, development, installation and operation of an on-line lottery gaming system and to provide associated services.

This audit of GTECH focused on controls placed in operation and whether those controls were operating with sufficient effectiveness. The audit's purpose was to provide interested parties with information sufficient to obtain an understanding of those aspects of GTECH's internal controls and the effectiveness of those controls that may be relevant to a user organization's internal controls.

During the course of this audit work, we noted the following matters that, while not the responsibility of GTECH, represent areas where the Colorado Lottery may be able to improve its control infrastructure.

The findings addressed to GTECH have been issued under separate cover.

Physical Access To Data Center

GTECH controls access to the GTECH building and the computer room within the building by requiring that users have an access card and access code in order to gain entry. Colorado Lottery Security makes the decisions on who should have access and provides the necessary administration of the system that controls access.

After examining access through this system and the corresponding policies in place, we noted that approximately three days after a GTECH employee had terminated employment with GTECH, the individual still had access to the building. GTECH submitted notification of termination of employment to the Colorado Lottery within the stipulated policy timeline. According to GTECH and Colorado Lottery officials, removing the person from the system controlling access is the responsibility of the Colorado Lottery.

During our review we also noted that a group of Colorado Lottery employees responsible for testing the systems still had access to the computer room but subsequently access was no longer required. In the past, testing hardware was located in the computer room, but was removed to a location adjacent to the room. The Colorado Lottery's policy of reviewing physical access capabilities should have been revised as soon as the testing hardware was relocated in July 1998.

<u>Recommendation No. 2:</u>

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.

Colorado Lottery Response: Agree. To be implemented by October 31, 2002.

Application Security

We reviewed application security, specifically for those administrators with access to high-risk areas, for the key on-line gaming applications, and the Gaming Environment Management System (GEMS). We noted that certain key functions within these applications appear to be accessible by an excessive number of high-level staff. These functions include Retailer General Privileges (five groups aggregating seventeen personnel), Retailer Product Privileges (four groups aggregating seven personnel), Terminal General Privileges (five groups aggregating seventeen personnel), Terminal Product Privileges (three groups aggregating five personnel), and other functions having to do with entering winning numbers into the system.

Excessive access increases the risk that intentional or inadvertent unauthorized changes may be made within these application environments. This could compromise the integrity of the Lottery games or the retailer networks and could result in revenue losses.

The primary reason for these levels of permanent access cited by the Colorado Lottery is for purposes of having adequate backup access when personnel are on vacation or are away for other reasons. While such access may at times be needed for the reasons cited by the Colorado Lottery, temporary access rather than permanent access would be a stronger control feature.

Recommendation No. 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 be granted only on an as-needed basis.

Colorado Lottery Response: Agree. To be implemented by March 31, 2003.
Currently, Colorado Lottery supervisors authorize access for each of their assigned employees. Supervisors review their employees' access annually to assure that only applications that are needed to do their jobs are authorized. However, the Lottery agrees that there may be some users that may have access to applications that are used infrequently. To address infrequent use, Colorado Lottery supervisors will be responsible to determine if infrequent users need permanent or temporary access during the annual review.

Data Network Operations

Our audit at GTECH reviewed control procedures in place to ensure that the design of the network provides for alternate routing in case of a failure in the primary routing. GTECH has responsibility for managing this network. The level of alternate routing or redundancy built in is based on what is specified in Colorado Lottery's contract with GTECH.

We noted during our interviews with GTECH and the Colorado Lottery staff that the majority of communication lines serving the northern part of the State are aggregated on a T1 line, which is redundant (in other words, provisions have been made to have another line available quickly, if a problem occurred). However, failures at certain key locations such as GTECH itself, or the Qwest Central Office, could result in loss of communication with all retailers because of the current lack of redundancy or backups at those locations. GTECH personnel estimate that such an outage would not exceed approximately 3 hours, and that the overall risk of occurrence is low. However, if such an outage occurred, the Lottery would lose revenue.

Recommendation No. 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.

Colorado Lottery Response: Agree. To be implemented by May 31, 2003.
The Colorado Lottery feels that it does have practical redundant communication lines in all critical locations. As opportunities arise, the Lottery and its on-line vendor will review its communication network for cost effective alternatives that will avoid downtime risk and/or increase efficiency.

Back-up and Disaster Recovery

The Colorado Lottery contract with GTECH states that GTECH should provide a disaster recovery plan (the plan) which meets the specifications of the Colorado Lottery. Our interviews with Colorado Lottery management and GTECH indicated that the current plan does meet the existing requirements. However, we noted the following issues relating to the plan:

- The overall objective of the plan, as laid out in its overview, is to bring the online gaming functionality back within fourteen days in the event that a disaster occurred resulting in the normal data processing capabilities being unavailable. Fourteen days of down time appears excessively long and would result in considerable loss of revenue to the Lottery.

  In addition, the present contract between Colorado Lottery and GTECH does not attempt to bind GTECH to this level of service. In other words, GTECH is only required to make its "best attempt" to bring the system back in fourteen days.

- The overall plan has never been tested. If a disaster were to occur, the risk of not bringing the system back in the expected time period increases when the plan has not been tested.

- The location of the remote computing facilities, where Colorado Lottery data is mirrored, is only two city blocks from the GTECH facility. A disaster could impact both locations simultaneously. Currently back-up tapes from GTECH are circulated to a different offsite location on a daily basis except for Saturday and Sunday. If a disaster occurred on Sunday evening that impacted GTECH and the remote location where the data is mirrored, the Colorado Lottery could lose two days worth of sales data. Circulating back-ups offsite every day would help mitigate this risk.

- The recovery plan does not include processes and procedures for utilizing the data that is logged at the offsite location. These processes and procedures should be documented in order to minimize down time.

Recommendation No. 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. Lottery should also 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.

Colorado Lottery Response:

a. Agree. To be implemented by June 30, 2003.
b. Agree. To be implemented by June 30, 2003.
c. Agree. To be implemented by October 31, 2002.
d. Agree. To be implemented by October 31, 2002.

DISPOSITION OF PRIOR AUDIT RECOMMENDATION

The report for the year ended June 30, 2001 included the following recommendation.

Recommendation No.	Disposition
1. The Colorado Lottery should require that an independent certified public accounting firm perform an annual audit of the system of internal controls, that may be relevant to the Lottery's internal control, of the service organization contractor that provides the Lottery an extensive computerized wagering system. The audit should be performed in accordance with Statement of Auditing Standards (SAS) No. 70, Reports on the Processing of Transactions by Service Organizations. This audit requirement should be incorporated into any future contracts with such service organization providers.	Implemented. The Lottery engaged Grant Thornton LLP to perform the SAS 70 audit for the period ended June 30, 2002.

Report of Independent Certified Public Accountants

Members of The Legislative Audit Committee

We have audited the statements of net assets of the Colorado Lottery (Lottery) as of June 30, 2002 and 2001, and the related statements of revenues, expenses and changes in fund net assets and cash flows for the years then ended. 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 audits.

We conducted our audits 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 audits provide a reasonable basis for our opinion.

As discussed in Note 1 to the financial statements, 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 the 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 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 Colorado Lottery as of June 30, 2002 and 2001, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 15 to the financial statements, the Colorado Lottery adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* and No. 37, *Basic Financial Statements Discussion and Analysis – for State and Local Governments: Omnibus*, during the year ended June 30, 2002 which change the basic financial statements required for governmental entities.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 8, 2002, on our consideration of the Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole of the Colorado Lottery for the years ended June 30, 2002 and 2001. The supplementary schedules listed in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. These supplementary schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Colorado Springs, Colorado
August 8, 2002

COLORADO LOTTERY
STATEMENTS OF NET ASSETS
JUNE 30, 2002 AND 2001

ASSETS	2002	2001 (as restated)
Current Assets:		
Cash and Investments	$ 25,750,736	$ 25,127,648
Accounts Receivable, net of the allowance for doubt-ful accounts of $87,708 in 2002 and $109,012 in 2001	13,710,073	12,531,904
Game Prizes Inventory, at Cost	83,684	100,950
Consignment Inventory, at Cost	135,851	112,029
Warehouse Inventory, at Cost	1,290,127	933,844
Prepaid Expenses	536,474	36,233
Total Current Assets	41,506,945	38,842,608
Restricted Assets:		
Cash and Investments-Licensed Agent Recovery Reserve Receipts	464,096	411,629
Prepaid Prize Expense-Multi-State Lottery Association	1,458,127	-
Total Restricted Assets	1,922,223	411,629
Capital Assets:		
Equipment	5,356,715	5,909,997
Leasehold Improvements	330,936	330,936
Less Accumulated Depreciation and Amortization	(4,084,915)	(4,062,156)
Total Capital Assets	1,602,736	2,178,777
TOTAL ASSETS	45,031,904	41,433,014
LIABILITIES		
Current Liabilities:		
Accounts Payable	1,206,204	2,247,404
Prize Liability	17,090,156	15,131,994
Wages and Benefits	119,821	284,667
Retailer Bonus Liability	595,035	553,574
Funds Available for Distribution	21,939,014	20,049,451
Deferred Revenue	397,636	442,683
Total Current Liabilities	41,347,866	38,709,773
Long-Term Liabilities:		
Accrued Annual and Sick Leave	883,833	801,016
Expired Warrants Liability	123,928	119,052
Total Long-Term Liabilities	1,007,761	920,068
TOTAL LIABILITIES	42,355,627	39,629,841
NET ASSETS		
Investment in Capital Assets	1,602,736	2,178,777
Restricted-Licensed Agent Recovery Reserve	464,096	411,629
Unrestricted (deficit)	609,445	(787,233)
TOTAL NET ASSETS	$ 2,676,277	$ 1,803,173

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

COLORADO LOTTERY
STATEMENTS OF REVENUES, EXPENSES AND
CHANGES IN FUND NET ASSETS
FOR THE FISCAL YEARS ENDED JUNE 30, 2002 AND 2001

	2002	2001 (as restated)
OPERATING REVENUES		
Gross Ticket Sales	$ 407,966,534	$ 350,632,668
DIRECT OPERATING EXPENSES		
Prize Expense	238,854,750	214,416,164
Powerball Prize Variance	1,467,844	-
Retailer Commissions and Bonuses	30,741,925	26,826,812
Cost of Tickets and Vendor Fees	10,002,785	9,810,954
Total Direct Operating Expenses	281,067,304	251,053,930
GROSS PROFIT ON SALE OF TICKETS	126,899,230	99,578,738
OTHER OPERATING EXPENSES		
Marketing and Communications	9,095,334	9,354,947
Administration Fees Paid to MUSL	178,273	-
Wages and Benefits	7,885,989	7,413,304
Professional Services	131,730	412,281
State Agencies Services	296,421	209,766
Department of Revenue Services	372,333	347,686
Travel	121,639	135,314
Equipment (including $80,838 and $37,217, respectively, of loss on disposition of equipment)	136,175	172,310
Depreciation	614,064	603,190
Accrued Annual and Sick Leave	81,223	54,668
Space Rental	648,270	622,187
Rents for Equipment	692,802	637,838
Motorpool Leasing	332,950	346,191
Materials and Supplies	94,109	84,621
Telephone	169,280	172,486
On-Line Telecommunications	783,283	797,693
Data Processing Supplies and Services	97,555	107,455
Equipment Maintenance	269,321	268,942
Postage	80,699	76,415
Printing	61,471	58,247
Other	228,513	164,298
Total Other Operating Expenses	22,371,434	22,039,839
OPERATING INCOME	104,527,796	77,538,899
NONOPERATING REVENUES (EXPENSES)		
Other Revenue	163,696	158,451
Sale of Contributed Capital Stock	3,947,072	17,410
Interest Income	2,281,228	2,227,777
Funds Distributed for Current Year	(88,107,674)	(59,234,988)
Funds Available for Distribution for Current Year	(21,939,014)	(20,049,451)
Total Nonoperating Revenues (Expenses)	(103,654,692)	(76,880,801)
INCREASE IN NET ASSETS	$ 873,104	$ 658,098
NET ASSETS, BEGINNING OF YEAR	1,803,173	1,145,075
Increase in net assets	873,104	658,098
NET ASSETS, END OF YEAR	$ 2,676,277	$ 1,803,173

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

COLORADO LOTTERY
STATEMENTS OF CASH FLOWS
FOR THE FISCAL YEARS ENDED JUNE 30, 2002 AND 2001

	2002	2001 (as restated)
Cash flows from operating activities:		
Cash received from retailers	$ 404,641,668	$ 347,998,331
Cash paid in prizes	(238,569,253)	(214,263,303)
Cash paid in retailer commissions	(26,972,691)	(23,448,954)
Cash payments to suppliers	(24,945,792)	(22,627,794)
Cash payments to employees for services	(8,372,145)	(7,241,345)
Cash received from Lotto subscription sales	684,676	786,519
Cash paid in retailer bonus	(3,735,065)	(3,350,384)
Cash received (used) - other	(17,461)	(56,854)
Net cash provided by operating activities	102,713,937	77,796,216
Cash flows from non-capital financing activities:		
Distribution of net proceeds	(108,157,125)	(77,141,288)
Cash flows from capital and related financing activities:		
Acquisition of capital assets	(109,557)	(300,668)
Cash flows from investing activities:		
Sale of contributed capital stock	3,947,072	-
Interest received	2,063,327	1,620,165
Net cash provided by investing activities	6,010,399	1,620,165
Net increase in cash and investments	457,654	1,974,425
Change in fair market value of investments	217,901	607,612
Cash and investments, Beginning of Year (including $411,629 and $361,143, respectively, in restricted accounts)	25,539,277	22,957,240
Cash and investments, End of Year, (including $464,096 and $411,629, respectively, in restricted accounts)	$ 26,214,832	$ 25,539,277

Reconciliation of operating income to net cash provided by operating activities:

	2002	2001 (as restated)
Operating income	*$ 104,527,796*	*$ 77,538,899*
Adjustments to reconcile operating income to net cash provided by operating activities		
Depreciation	*614,064*	*603,190*
Loss on disposition of equipment	*80,838*	*37,217*
Other revenue	*163,696*	*175,861*
Change in:		
Accounts Receivable	*(1,178,169)*	*(1,964,162)*
Ticket Inventory	*(380,105)*	*457,708*
Prepaid Prize Expense with MUSL	*(1,458,127)*	*-*
Other Assets	*(482,975)*	*(106,946)*
Liabilities(excluding funds available for distribution)	*826,919*	*1,054,449*
Net cash provided by operating activities	*$ 102,713,937*	*$ 77,796,216*

Noncash capital and related financing activities:
During the year ended June 30, 2002, the Lottery acquired fixed assets valued at $9,304 through incurrence of accounts payable.

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

COLORADO LOTTERY
NOTES TO FINANCIAL STATEMENTS
JUNE 30, 2002 AND 2001

1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

The Colorado Lottery was incorporated 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, 2002 and 2001. 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:

A. 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.

B. 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 for 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.

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.

C. 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.

D. Budget

By October 24th of each year, the Department 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 statute 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 Legislature, the State Controller, and the Office of State Planning and Budgeting.

E. Allowance for Doubtful Accounts

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 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 $87,708 and $109,012 as of June 30, 2002 and June 30, 2001, respectively.

F. 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.

G. 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.

H. Warehouse Inventory

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

I. Supplies Inventory

The State of Colorado's threshold for recording supplies inventories is $35,000 per location. The supplies inventory of the Colorado Lottery consistently falls below the $35,000 threshold per location. Accordingly, no supplies inventory appears on the statement of net assets.

J. 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.

K. 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.

The Colorado Lottery enables all retailers to pay scratch prizes on barcoded games of less than $600 by validating them through the on-line terminal. 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 $3,525,079 for the Fiscal Year Ended June 30, 2002 and $5,131,470 for the Fiscal Year Ended June 30, 2001. The decrease in Fiscal Year 2002 unclaimed scratch prizes from the Fiscal Year 2001 unclaimed scratch prizes was the result of a decrease in the number of scratch games ended (closed out). Through the Fiscal Year Ended June 30, 2002, there were a total of twenty-eight games ended as compared with thirty-nine games ended through Fiscal Year 2001.

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 fifty percent 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 fifty percent 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 $3,811,550 for the Fiscal Year Ended June 30, 2002 and $5,029,929 for the Fiscal Year Ended June 30, 2001.

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 Multi-State Lottery Association (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. In the event that Colorado’s total Powerball liability in any fiscal year should exceed the 50% accrual, MUSL would reimburse the excess to the Lottery and a revenue would be recognized.

L. 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.

M. 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.

N. 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, 2002	June 30, 2001	Increase
Annual Leave	$699,331	$636,961	$ 62,370
Sick Leave	180,040	161,187	18,853
Total Annual & Sick Leave	879,371	798,148	81,223
Compensatory Time	4,462	2,868	1,594
Total Compensated Leave	$883,833	$801,016	$ 82,817

O. Expired Warrants Liability

Expired Warrants Liability represents the expiration of aged uncashed warrants and impress checks over one (1) year old. In accordance with Section 15-12-914, 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.

P. 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, 2002 and 2001, is as follows:

	2002	2001
Subscription	$239,493	$279,710
Advance play-Lotto	76,517	149,721
Advance play-Powerball	53,438	-
Advance play-Powerball	11,203	-
Advance play-Cash 5	16,985	13,252
Total Deferred Revenue	$397,636	$442,683

Q. 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, 2002 and 2001, 41,203 and 17,778 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, 2002 and 2001, 51,200 and 73,304 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, 2002 and 2001, $62,413 and $60,315, 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.

R. Reclassifications

Certain Fiscal Year Ended June 30, 2001 information has been reclassified to conform with the current year presentation.

2. CASH AND INVESTMENTS

A. 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:

	2002	2001
Petty Cash	$ 2,450	$ 1,550
Change Funds	50,300	90,300
Imprest Fund	303,257	278,649
Depository Account	18,515	18,621
Cash on Deposit with State Treasurer	25,376,214	24,738,528
TOTAL UNRESTRICTED CASH	25,750,736	25,127,648
Cash Restricted - Licensed Agent Recovery Reserve Receipts	464,096	411,629
TOTAL RESTRICTED CASH	464,096	411,629
TOTAL CASH	$26,214,832	$25,539,277

B. 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 average annual yield on the average daily cash balance during Fiscal Year 2002 was approximately 5.3 percent. The current yield is approximately 4.6 percent.

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.

C. 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, 2002, the Colorado Lottery had cash with a carrying value of $321,772, and a bank balance of $336,289 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.

D. 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.

E. 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 $336,289 (see C. above) is categorized as follows as of June 30, 2002:

Category 1	$100,000
Category 2	236,289

For Cash on Deposit with State Treasurer, the State Treasurer's investments as of June 30, 2002 are Category 1 investments and its cash deposits are principally Category 2 deposits.

3. SCHEDULE OF CHANGES IN FIXED ASSETS

Capital Assets being depreciated:

	June 30, 2001	Increases	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

	June 30, 2000	Additions	Deletions	June 30, 2001
Equipment	$5,993,933	$ 300,668	$384,604	$5,909,997
Leasehold Improvements	330,936	-	-	330,936
Total capital assets being depreciated	6,324,869	300,668	(384,604)	6,240,933
Less: accumulated depreciation for Equipment	(3,624,531)	(588,627)	347,387	(3,865,771)
Leasehold Improvements	(181,822)	(14,563)	-	(196,385)
Total accumulated depreciation	(3,806,353)	(603,190)	347,387	(4,062,156)
Total capital assets, being depreciated, net	$2,518,516	$ (302,522)	$ (37,217)	$2,178,777

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 the City of Pueblo. The Lottery entered into a lease extension agreement, which began July 1, 1997 and expires on June 30, 2002. There is no provision for renewal. The Lottery leases additional warehouse space from Musso & Cardinale. The Lottery entered into a lease extension agreement, which began July 1, 1997 and expires on June 30, 2002. There is no provision for renewal. The Colorado Lottery entered into two short-term renewal contracts with the City of Pueblo and Musso and Cardinale from July 1, 2002 through August 31, 2002, while the Lottery secures new warehouse space.

Interlott - The Colorado Lottery entered into a rental agreement with International Lottery, Inc. to rent Scratch Ticket Vending Machines (STVMs). The agreement covers 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.

Operating lease expense incurred for the Fiscal Years Ended June 30, 2002 and 2001 and future minimum lease payments for Fiscal Years Ending June 30, 2003 through 2006 are as follows:

Location	Expense		Future Minimum Lease Payments			
	2001	2002	2003	2004	2005	2006
Pueblo Office	$ 238,318	$ 250,336	$ 262,692	$275,900	$289,773	$ -
Pueblo Warehouse	32,637	32,637	5,840	-	-	-
Interlott	589,104	656,846	653,400	653,400	217,800	-
Co Sprgs Warehouse	12,612	13,195	13,812	-	-	-
Denver Office	185,411	191,392	197,373	203,354	209,335	215,316
Denver Warehouse	107,049	96,274	97,805	100,612	16,844	-
Fort Collins	20,966	36,132	-	-	-	-
Grand Junction	4,883	4,942	-	-	-	-
	$1,190,980	$ 1,281,754	$1,230,922	$1,233,266	$733,752	$215,316

5. OTHER REVENUE

A schedule of other revenue for the Fiscal Years Ended June 30, 2002 and 2001 follows:

	2002	2001
License Fees	$ 44,349	$ 45,519
Fines & Penalties	11,400	27,450
Assignment Fees	11,532	10,033
Net Licensed Agent Recovery Reserve Receipts	52,467	50,486
Other	43,948	24,963
Total	$163,696	$158,451

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, the Lottery Commission approved a reserve of $1 million of net assets for Fiscal Year 1989. This remained in effect until the implementation of GASB 34 required a net asset balance sufficient to cover the net value of an agency's capital assets. Accordingly, at the June 2002 commission meeting, the Lottery Commission approved a balance in net assets "equal to net value of the Lottery's capital assets." For presentation purposes for the prior year, this reporting requirement created a negative unrestricted net asset balance. The unreserved net asset balances for the Fiscal Years Ended June 30, 2002 and June 30, 2001 are composed of the following:

	2002	2001
Reclassification from unrestricted net assets to investment in capital assets for adoption of GASB 34	$ -	$(1,178,777)
Plus: Unrealized Gain on Investments	609,445	391,544
	$ 609,445	$ (787,233)

7. DISTRIBUTION OF NET PROCEEDS

In accordance with Section 33-60-104, C.R.S., distributions 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:

	2002	2001
Income Before Distributions	$110,919,792	$79,942,537
Less: Increase in licensed agent recovery reserve	(52,467)	(50,486)
Plus: Change in fair market value of investments	(217,901)	(607,612)
Less: Other increases in net assets	(602,736)	-
Income Available for Distribution	110,046,688	79,284,439
Less: Prior Distributions	(88,107,674)	(59,234,988)
Income Available for Distribution	$21,939,014	$20,049,451

The following is a schedule of funds available for distribution for the fiscal year end, the proceeds distributions expense by fund for the fiscal year end, and distributions paid by fund for the fiscal year end:

	Accrued at June 30, 2001	Proceeds Distributions Expense	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 & 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

	Accrued at June 30, 2000	Proceeds Distributions Expense	Distributions Paid	Accrued at June 30, 2001
Great Outdoors Colorado	$ 7,702,861	$ 39,642,222	$ (37,320,357)	$ 10,024,726
General Fund	1,250,290	-	(1,250,290)	-
Conservation Trust Fund	7,162,520	31,713,775	(30,856,514)	8,019,781
Division of Parks & Outdoor Recreation	1,790,629	7,928,442	(7,714,127)	2,004,944
	$ 17,906,300	$ 79,284,439	$ (77,141,288)	$ 20,049,451

8. PENSION PLAN

A. 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.

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.

B. Funding Policy

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

During Fiscal Year 2002, the state contributed 9.9 percent (12.6 percent for state troopers and 13.5 percent for the Judicial Branch) of the employee's gross covered wages, which was allocated by PERA before January 1, 2002, as follows:

- 1.42 percent was allocated to the Health Care Trust Fund.
- 8.48 percent was allocated to the defined benefit plan.

After January 1, 2002, the state contribution was allocated to three separate programs by PERA according to a statutory change in funding policy:

- 1.64 percent was allocated to the Health Care Trust Fund.

- The amount needed to meet the match requirement established by the PERA Board was allocated to the Matchmaker Program (See Note 9 below).

- 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, 2002, 2001 and 2000, were $623,072, $611,262 and $646,744, respectively. These contributions met the contribution requirement for each year.

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 percent of up to 3 percent of employees' gross covered wages paid during the month (7 percent 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 fifty percent of any reduction in the overall contribution rate due to overfunding of the pension plan was available for the match. 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.

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, 2002, 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 percent 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.B.

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, 2001, there were approximately 34,235 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 they may continue coverage into retirement. Premiums are collected monthly by payroll deduction or other means.

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	$633,488,969
Lifetime prize payments	48,562,000
Total guaranteed minimum prize payments	$682,050,969

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 & Automobile	Each person $150,000 Each occurrence $600,000

During Fiscal Years 1999 (most recent information available), 1998, and 1997, medical claims against the State Employees and Officials Insurance Fund (SEOGI) exceeded the premiums collected. This resulted in decreases in the medical reserve fund equity of approximately $4.7 million, $3.8 million and $6.5 million, respectively. In Fiscal Year 2000, SEOGI began purchasing insurance to address the continuing decrease in the medical reserve fund equity. The fund includes several medical plan options ranging from provider of choice to managed care.

The fund also provides an employer paid short-term disability plan. This program provides employees 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.

There were no significant reductions or changes in insurance coverage from the prior year. With the exception of the short-term disability program of SEOGI, settlements did not exceed insurance coverage in any of the past three fiscal years.

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 contracts expire June 30, 2004 with one annual renewal available on each contract. Ticket rates are based upon ticket volume, physical size and design. The total costs of the contracts 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 Multi-State Lottery Association (MUSL) on February 26, 2001 and thus entered into an agreement with MUSL on June 6, 2001 to become a member. 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 $5,153,452. The total amount of the prize reserves funded as of June 30, 2002 was $1,458,127 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.

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.

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 $1,044,758 and $947,762 for the Fiscal Years Ended June 30, 2002 and June 30, 2001, respectively.

14. SALE OF CONTRIBUTED COMMON STOCK

During 2001 and 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 $17,410 and $3,947,072 in Fiscal Years 2001 and 2002, respectively, from proceeds from the sale of the stock.

15. ADOPTION OF ACCOUNTING PRONOUNCEMENTS

Effective July 1, 2001, the Colorado Lottery adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments* and No. 37, *Basic Financial Statements Discussion and Analysis – for State and Local Governments: Omnibus.* GASB 34 and 37 establish the required basic financial statements and supplementary information for governmental entities. The information formerly reported on the Balance Sheet and the Statement of Revenues, Expenses and Changes in Retained Earnings is now reported on the Statement of Net Assets and the Statement of Revenues, Expenses and Changes in Fund Net Assets, respectively. Required supplementary information for the Colorado Lottery includes its Management's Discussion and Analysis. GASB 34 also requires that the government's net assets be displayed in three components – invested in capital assets (net of related debt), restricted and unrestricted. The June 30, 2001 financial statements have been restated to comply with adoption of these pronouncements. However, adoption of GASB 34 and GASB 37 had no effect on total net assets as of June 30, 2000 or 2001 or on increase in net assets for the year ended June 30, 2001.

SUPPLEMENTARY

SCHEDULES

COLORADO LOTTERY
SCHEDULE OF REVENUE AND COSTS FOR SCRATCH AND ON-LINE GAMES
FOR THE FISCAL YEAR ENDED JUNE 30, 2002
(WITH COMPARATIVE TOTALS FOR THE FISCAL YEAR ENDED JUNE 30, 2001)

	Games in Progress				Fiscal Year 2002	Fiscal Year 2001
	Scratch	Lotto	Powerball	Cash 5	Total	Scratch and On-Line
GROSS TICKET SALES (Note 1)	$257,213,494	$57,645,776	$79,885,753	$13,221,511	$407,966,534	$350,632,668
PRIZE EXPENSE (Note 4)	(167,219,926)	(28,412,166)	(36,312,531)	(6,910,127)	(238,854,750)	(214,416,164)
POWERBALL PRIZE VARIANCE	N/A	N/A	(1,467,844)	N/A	(1,467,844)	-
NET REVENUE AFTER PRIZES	89,993,568	29,233,610	42,105,378	6,311,384	167,643,940	136,216,504
COMMISSIONS, BONUSES, TICKET COSTS & VENDOR FEES (Note 2)						
Retailer Commission	(17,968,389)	(3,413,199)	(4,797,508)	(793,595)	(26,972,691)	(23,448,954)
Retailer Bonus	(2,754,330)	(368,772)	(523,659)	(122,473)	(3,769,234)	(3,377,858)
Cost of Tickets Sold	(2,990,729)	N/A	N/A	N/A	(2,990,729)	(3,185,929)
In-Lane Vendor Fees	-	(83,802)	(116,134)	(19,221)	(219,157)	(209,270)
On-Line Vendor Fees	(1,057,907)	(2,256,446)	(2,940,913)	(537,633)	(6,792,899)	(6,415,755)
TOTAL	(24,771,355)	(6,122,219)	(8,378,214)	(1,472,922)	(40,744,710)	(36,637,766)
GROSS PROFIT ON SALE OF TICKETS	$65,222,213	$23,111,391	$33,727,164	$4,838,462	$126,899,230	$99,578,738
AVERAGE DAILY TICKET SALES (Note 3)	$704,695	$157,934	$239,897	$36,223	$1,117,717	$960,637

COLORADO LOTTERY
SCHEDULE OF PERCENT OF PRIZE EXPENSE TO GROSS TICKET SALES
FOR THE FISCAL YEAR ENDED JUNE 30, 2002

	Games in Progress						Fiscal Year
	Scratch	Lotto	Powerball	Cash 5	Powerball Prize Variance	Coupons/ Free Plays	2002 Total
Prize Expense (Note 4)	$167,244,698	$28,412,166	$36,312,531	$6,910,127	$1,467,844	($24,772)	$240,322,594
(/)Ticket Sales before coupons	257,239,472	57,651,698	79,893,821	13,222,846	N/A	(41,303)	407,966,534
Prize %	65.02%	49.28%	45.45%	52.26%		59.98%	58.91%

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 333 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, 2002

	Fiscal Year 2002 Original Budget	Supplementals Pots Allocations & Internal Transfers	Fiscal Year 2002 Final Budget	Fiscal Year 2002 Actual Expenditures	Under Expended	Percent Under Expended
Personal Services	$7,217,137	$396,729	$7,613,866	$7,607,435	$6,431	0.08%
Operating	1,903,994	(3,500)	1,900,494	1,897,152	3,342	0.18%
Vehicle Lease Payments	222,785	(24,226)	198,559	191,293	7,266	3.66%
Purch. Serv. Comp. Cen.	3,748	2,182	5,930	5,679	251	4.23%
Telecommunications	397,412	-	397,412	281,690	115,722	29.12%
Payments to Other Agencies	257,688	-	257,688	227,258	30,430	11.81%
Legal Services	38,856	28,469	67,325	67,325	-	0.00%
Workmen's Compensation	-	35,222	35,222	35,222	-	0.00%
Unemployment Benefits	-	1,837	1,837	-	1,837	100.00%
Health and Life	-	312,488	312,488	312,488	-	0.00%
Short Term Disability	-	3,760	3,760	3,760	-	0.00%
Leased Space	690,888	8,797	699,685	665,755	33,930	4.85%
Grand Junction - Leased Space	4,944	-	4,944	4,942	2	0.04%
Risk Management	-	20,690	20,690	20,690	-	0.00%
Info Tech Asset Maint (PC's)	-	41,103	41,103	40,892	211	0.51%
Travel Expenses	119,941	3,500	123,441	121,639	1,802	1.46%
Marketing and Communications	9,160,352	(63,127)	9,097,225	9,095,335	1,890	0.02%
Indirect Costs	379,698	-	379,698	372,333	7,365	1.94%
Ticket Costs	3,007,500	610,400	3,617,900	2,990,732	627,168	17.34%
Vendor Fees	8,975,168	(291,707)	8,683,461	7,541,556	1,141,905	13.15%
Prizes	239,000,000	46,273,462	285,273,462	238,854,753	46,418,709	16.27%
Powerball Prize Variance	-	4,370,000	4,370,000	1,467,844	2,902,156	66.41%
Retailer Compensation	35,928,450	534,050	36,462,500	30,741,918	5,720,582	15.69%
Multi-State Lottery Fees	109,078	68,355	177,433	177,433	-	0.00%
Rollforwards	56,575	-	56,575	56,350	225	0.40%
TOTAL	$307,474,214	$52,328,484	$359,802,698	$302,781,474	$57,021,224	15.85%

Fiscal Year 2002 Staffing (FTE) 128.00 (Appropriated) 124.300 (Actual)

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	$238,854,750
Powerball Prize Variance	1,467,844
Commissions and Bonuses	30,741,925
Cost of Tickets & Vendor Fees	10,002,785
Other Operating Expenses	22,371,434
Total Operating Expenses per Statement of Revenues, Expenses and Changes in Fund Net Assets	303,438,738
Less: Non-appropriated expenses	
Depreciation	(614,064)
Accrued Annual and Sick Leave	(81,223)
Book Value of Assets Written-Off	(80,838)
Sub-Total	302,662,613
Plus: Capitalized Fixed Assets	118,861
	$302,781,474

Report of Independent Certified Public Accountants on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed 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, 2002, and have issued our report thereon dated August 8, 2002. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether the 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.

Colorado Springs, Colorado
August 8, 2002

COLORADO LOTTERY
SUMMARY OF REQUIRED COMMUNICATIONS
FISCAL YEAR ENDED JUNE 30, 2002

The following specific matters are required to be discussed with the Legislative Audit Committee in accordance with Statement on Auditing Standards No. 61, *Communication with Audit Committees*. The matters discussed herein are those that we have noted as of August 8, 2002, and we have not updated our procedures regarding these matters since that date to the current date. Accordingly, we advise you of the following with respect to the Colorado Lottery (Lottery) for the year ended June 30, 2002:

Auditors' Responsibility Under Auditing Standards Generally Accepted in the United States of America and *Government Auditing Standards*

Our responsibility, as prescribed by auditing standards generally accepted in the United States of America promulgated by the American Institute of Certified Public Accountants and *Government Auditing Standards* issued by the Comptroller General of the United States, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. An audit in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* does not provide absolute assurance or guarantee the accuracy of the financial statements and is subject to the inherent risk that errors or fraud (or illegal acts), or noncompliance with the provisions of laws, regulations, contracts and grants, if existing, have not been detected. Such standards also require that we obtain a sufficient understanding of the Lottery's internal controls to plan the audit. However, such understanding and any tests performed with respect to such internal controls, or as to compliance with laws, regulations, contracts and grants, were for the purpose of expressing our opinion on the Lottery's financial statements and not to opine or provide any assurance concerning such internal controls or compliance.

Auditors' Responsibility for Other Information in Documents Containing Audited Financial Statements

Pursuant to professional standards, the auditors' responsibility for other information in documents containing the Lottery's audited financial statements does not extend beyond the financial information identified in the audit report, and the auditor is not required to perform procedures to corroborate such other information. However, in accordance with such standards, we are required to read the information in such documents and consider whether such information, or the manner of its presentation, is materially inconsistent with its presentation in the financial statements. Our responsibility also includes calling to management's attention any information which we believe is a material misstatement of fact. No such inconsistencies or misstatements came to our attention.

Significant Audit Adjustments

For purposes of these required communications, professional standards define an audit adjustment, whether or not recorded, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through our auditing procedures. The definition includes adjustments that were not recorded by the Lottery because they are not material to the current financial statements, but might be potentially material to future financial statements. No such adjustments were identified during our audit.

Disagreements with Management

For purposes of these required communications, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter which could be significant to the Lottery's financial statements or the audit report. We are pleased to report that no such disagreements arose during the course of our audit.

The electronic version of this report is available on the Web site of the
Office of the State Auditor
www.state.co.us/auditor

A bound report may be obtained by calling the
Office of the State Auditor
303-869-2800

Please refer to the Report Control Number below when requesting this report.

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