we're game

2012 Virginia Lottery Annual Financial Report

for year ended June 30, 2012

Table of Contents

Management's Discussion and Analysis ..... 3 – 9

Opinion ..... 10 – 11

Financial Statements:

Statement of Net Assets 13

Statement of Revenues, Expenses, and Changes in Net Assets 14

Statement of Cash Flows 15

Notes to Financial Statements ..... 16 – 22

Management's Discussion and Analysis

(unaudited)

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

Financial Highlights

Virginia Lottery ticket sales totaled $1.616 billion for fiscal year 2012, the highest total ever for Virginia Lottery sales. Net proceeds totaling $487.1 million were earned for the Lottery Proceeds Fund, all of which are constitutionally mandated to support local K-12 public education. Highlights of the fiscal year include:

- **Sales increased by $133.3 million (9.0 percent) from last year to a record $1.616 billion.**
- **Net income was a record $487.1 million, an increase of $42.8 million (9.7 percent) from last year.**
- **Prize expense increased $81.3 million (9.2 percent) to a record total of $962.3 million.**
- **With the sales increase, retailers earned $6.8 million (8.1 percent) more than last year, with compensation paid to retailers totaling a new record of $90.7 million. Retailers earned, on average, 5.6 cents on each dollar sold, slightly less than last year's 5.7 cents.**

Although by law the Lottery may spend up to ten percent of sales on operating costs, which include all expenses except prizes and retailer compensation, these costs represented only 4.8 percent of sales for the fiscal year. The operating rate was the lowest in Lottery history, less than the previous low of 4.9 percent in fiscal year 2005.

Overview of the Financial Statements

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

This annual report consists of a series of financial statements, along with explanatory notes to the financial statements. The report includes the Statement of Net Assets; the Statement of Revenues, Expenses, and Changes in Net Assets; and the Statement of Cash Flows. The Statement of Net Assets and the Statement of Revenues, Expenses, and Changes in Net Assets report the Virginia Lottery's net assets and their changes. By law, the Virginia Lottery transfers all of its net income to the Commonwealth, specifically to the Lottery Proceeds Fund, each year. As a result, the net assets

of the Virginia Lottery consist largely of capital assets (equipment) and investments held to fund future payments on annuitized lottery prizes as shown in the Statement of Net Assets. To assess the Virginia Lottery's financial position and financial health, the reader of these statements should pay particular attention to changes in operating revenues, expenses, and transfers to the Lottery Proceeds Fund as shown in the Statement of Revenues, Expenses, and Changes in Net Assets. The Statement of Cash Flows presents information related to cash inflows and outflows summarized by operating capital, financing, and investing activities.

Statement of Net Assets

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

TABLE 1: STATEMENT OF NET ASSETS

Assets:	2012	2011	Change
Current Assets	$325.23	$330.62	$(5.39)
Investments	158.81	174.99	(16.18)
Fixed Assets, Net Of Accumulated Depreciation	7.89	9.47	(1.58)
Total Assets	491.93	515.08	(23.15)
Liabilities:	**2012**	**2011**	**Change**
Current Liabilities	332.37	339.24	(6.87)
Long-Term Liabilities	159.56	175.84	(16.28)
Total Liabilities	491.93	515.08	(23.15)
Net Assets:	**2012**	**2011**	**Change**
Invested In Capital Assets	7.89	9.47	(1.58)
Unreserved	(7.89)	(9.47)	1.58
Total Net Assets	$ ——	$ ——	$ ——

** $ in millions*

Current assets and liabilities decreased $5.39 million and $6.87 million respectively due to the change in cash held as collateral and obligations for the Lottery's Securities Lending. Investments decreased $16.18 million and consist of U.S. Treasury STRIPS purchased to fund individual jackpot and "For Life" prizes. Long-term liabilities decreased $16.28 million and consist mainly of prize liabilities for prizes paid in installments over several years. Investments and long-term prize liability both decreased because most current-year jackpot winners chose to take a one-time cash payment rather than the annuity payments, causing these balances to decline as the continued payments to previous winners outpaced the increase in investments for new winners.

The decrease in fixed assets reflects the fewer purchases of new capital assets in fiscal year 2012 than 2011.

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

TABLE 2: STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

Source	2012	2011	Change
Sales	$1,616.00	$1,482.69	9.00%
Prizes	(962.28)	(881.03)	9.20%
Retailer Compensation	(90.67)	(83.84)	8.10%
Ticket Printing & Gaming Services	(24.90)	(21.01)	18.60%
Operating Expenses	(53.05)	(53.91)	-1.60%
Income From Operations	485.10	442.90	9.50%
Non-Operating Revenue & Expenses	1.96	1.31	49.20%
Net Income	$487.06	$444.21	9.70%

* $ in millions

Sales

Virginia Lottery products fall into two major categories: scratch games and computer terminal (on-line) games. Scratch games are games in which players scratch off tickets to see whether they have won and include $1, $2, $3, $5, $10 and $20 games. Computer terminal games are games for which players buy tickets that are issued by a lottery terminal, for a chance to win prizes either instantly or from a future drawing. Computer terminal games include Pick 3, Pick 4, Cash 5, Win for Life, Mega Millions, Powerball, Decades of Dollars, Fast Play, and Raffle.

Table 3 compares sales for each lottery product for fiscal years 2012 and 2011. Total sales revenue for fiscal year 2012 was the highest ever. Scratch, Powerball and Pick 4 set individual sales records for those products.

TABLE 3: SCRATCH AND COMPUTER TERMINAL SALES

Source	2012	2011	Change
Scratch Sales	$842.12	$756.84	11.27%
Computer Terminal Sales			
Pick 3	243.27	241.96	0.54%
Pick 4	222.77	207.17	7.53%
Cash 5	26.68	26.66	0.08%
Fast Play	12.09	8.92	35.54%
Raffle	6.62	6.60	0.30%
Decades Of Dollars	15.48	8.38	84.73%
Win For Life	17.68	21.05	-16.01%
Powerball	89.05	66.61	33.69%
Mega Millions	140.24	138.50	1.26%
Total Computer Terminal Sales	$773.88	$725.85	6.62%
Total Combined Sales	$1,616.00	$1,482.69	8.99%

* $ in millions

Scratch Game sales (52.1 percent of total sales) were higher than fiscal year 2011. Growth in scratch game sales increased due to the continued offering of a variety of games designed to meet player preferences, and an increase in the number of retailer outlets selling Lottery products.

Daily Game sales (Pick 3, Pick 4, and Cash 5) represented 30.4 percent of total product sales for the fiscal year, an increase of $16.9 million from the prior year.

Mega Millions (8.6 percent of total sales) experienced slightly higher sales, up $1.74 million from last year's total. This product is a multi-state lotto style game with long odds of winning the top prize. Sales in this product are extremely dependent on the amount of the advertised jackpot, with sales increasing significantly as jackpots exceed $200 million. During fiscal year 2012, there were fourteen winning jackpot tickets sold, sharing in eleven jackpot prizes. Mega Millions reached the highest jackpot ever in fiscal year 2012, a record $656 million for the March 30, 2012 drawing. Twenty-nine states and the District of Columbia from the Multi-State Lottery Association (MUSL) joined the Mega Millions member states to sell tickets on January 31, 2010. The combined forty-two states, US Virgin Islands (joined in fiscal year 2011) and the District of Columbia sell Mega Millions tickets.

Powerball sales totaled $89.0 million (5.5 percent of total sales) in fiscal year 2012. This product is similar to Mega Millions, a lotto type game with long odds of winning the jackpot. During fiscal year 2012, there were thirteen winning jackpot tickets sold, sharing in thirteen jackpot prizes. On January 31, 2010, Virginia and ten other Mega Millions member states joined with the Multi-State Lottery Association (MUSL) to sell Powerball tickets. Forty-two states, the District of Columbia and United States Virgin Islands now sell Powerball.

Win for Life sales (1.1 percent of total sales) were down $3.4 million from the prior year. Win for Life has a top prize of $1,000 a week, payable to the winner for the rest of his or her lifetime. Win for Life was designed to generate more frequent grand prize winners than a traditional lotto-style game. Virginia had four of the six top prize winners sold among the two member states (Georgia and Virginia) in fiscal year 2012.

Fast Play is an instant-win computer terminal product line that plays like a Scratch game. There were five games in this category during fiscal year 2012. The Fast Play portfolio of games represents one half of one percent of total product sales.

Raffle is a computer terminal game with a limited offering of tickets and prizes. The Lottery had two Raffles during the year, the 6th annual Millionaire Raffle with a drawing held on January 1, 2012 and a promotional Bonus Raffle with a drawing held on March 1, 2012. Total raffle sales represent less than one percent of total product sales.

Decades of Dollars tickets are offered at a two dollar price point, a departure from the traditional one dollar per ticket price for this style of game. It is a game where players try to match six numbers from a field of forty-seven, with a top prize of $250,000 a year for 30 years. Decades of Dollars sales totaled $15.5 million in fiscal year 2012, representing one percent of total product sales. Virginia had two of the six top prize winners sold among the four member states (Georgia, Kentucky, Arkansas and Virginia) in fiscal year 2012.

Expenses

Prizes are the largest expense for the Virginia Lottery and vary with sales fluctuations and player luck. The fiscal year 2012 prize payout rate (percent of sales paid out in prizes) was 59.5 percent, up slightly from 59.4 percent from fiscal year 2011. The total prize dollars paid to winners increased $81.3 million, a record payout to Lottery players.

A summary of Virginia Lottery expenses for fiscal years ending June 30, 2012 and 2011 is shown in Table 4.

TABLE 4: EXPENSES

Source	2012	2011	Change
Prize Expense	$962.28 ..... 85.10%	$881.03 ..... 84.70%	$81.25 ..... 9.20%
Retailer Compensation	90.67 ..... 8.00%	83.84 ..... 8.10%	6.83 ..... 8.10%
Operating Expenses	53.04 ..... 4.70%	53.91 ..... 5.20%	.87 ..... 0.20%
Gaming Services	24.90 ..... 2.20%	21.01 ..... 2.00%	3.89 ..... 18.60%
Total Expenses	$1,130.89 ..... 100.00%	$1,039.79 ..... 100.00%	$91.10 ..... 8.80%

** $ in millions*

Retailer compensation increased as a result of higher sales. Retailers earned a record amount of compensation in fiscal year 2012. The overall retailer compensation rate was down slightly from the prior year, 5.6 percent of total sales.

Gaming services costs increased in fiscal year 2012, because such costs are mostly incurred as percentage of sales agreements. These costs primarily represent payments to the Lottery's two major contract partners, GTECH Incorporated, and Scientific Games International, Incorporated.

TABLE 5: OTHER INCOME

Source	2012	2011	Change
Interest Income	$1.28	$1.06	20.80%
Net Other Income	.68	.25	172.00%
Total Other Income	$1.96	1.31	49.60%

** $ in millions*

Interest income is earned primarily on cash balances held and invested by the Virginia Department of Treasury on behalf of the Virginia Lottery. As Table 5 shows, other income was up 50 percent in 2012. Interest income for 2012 was higher due to higher cash balances compared to the prior year. Yields were similar to last year.

Net other income is derived from securities lending income, as well as various fees assessed to retailers for licensing and processing fees, penalties for failure to remit monies owed when due, and other miscellaneous sources. Net other income was up 172 percent in 2012. Securities lending income increased due to the reduction in write offs in fiscal year 2012 compared to fiscal year 2011. The Lottery participates in the Commonwealth of Virginia's securities lending program and follows the investment guidelines promulgated by the Treasury Board.

Net Income

In fiscal year 2012, the Virginia Lottery generated $487.1 million in profits. As shown in Table 6, profits were higher than fiscal year 2011 by $42.9 million (9.7 percent). This was the highest net income in Virginia Lottery history. $464.1 million of fiscal year 2012 net income was transferred to the Lottery Proceeds Fund during the year, as anticipated by the Appropriations Act. An amount of residual income totaling $22,971,151 will be transferred in fiscal year 2013.

TABLE 6: NET INCOME AND PERCENT OF SALES

Source	2012	2011	Change
Net Income	$487.10 ..... 30.10%	$444.20 ..... 30.00%	$42.90 ..... 9.70%

* $ in millions

Statement of Cash Flows

The Statement of Cash Flows, summarized in Table 7, presents detailed information pertaining to the cash activity of the Virginia Lottery during the year. The first part of the statement reflects operating cash flows and shows the net cash provided by operating activities of the Virginia Lottery. Receipts from the sale of tickets and related services totaled $1.61 billion. Uses of cash include payment of prizes to winners ($1.01 billion) and payments to retailers, suppliers, and employees for goods and services ($154.2 million). The net cash provided by operating activities of $448.2 million represents a 7.7% increase.

The cash flows from the non-capital financing activities portion of the statement reflects the $472.4 million used for non-capital financing activities, the major portion being the $473.1 million in total transfers from the Virginia Lottery during the year. This amount represents the $464.1 million initial estimate of fiscal year 2012 Virginia Lottery profits for transfer to the Lottery Proceeds Fund prior to July 1, 2012, and the $9.0 million transfer of residual 2011 profits.

Cash flows from capital financing activities reflect the purchase of capital assets acquired during the period ($1.8 million). The $34.2 million cash flows from investing activities reflect purchases of investments to fund

TABLE 7: STATEMENT OF CASH FLOWS

Source	2012	2011	Change
Cash Flows From:			
Operating Activities	$448.19	$416.01	7.74%
Non-Capital Financing Activities	(472.41)	(444.00)	6.40%
Capital Financing Activities	(1.83)	(5.18)	-64.67%
Investing Activities	34.20	48.67	-29.73%
Net Change In Cash	8.15	15.50	-47.42%
Ending Cash And Cash Equivalents	$27.80	$19.65	41.48%

* $ in millions

win for life prizes due to Virginia Lottery winners ($9.6 million) and payable over time, proceeds from maturing investments previously purchased to fund Virginia Lottery prizes payable ($42.5 million), and investment income on cash balances ($1.3 million). The net increase in cash flows from activities totaled $8.1 million.

Potentially Significant Factors Impacting Next Year

Virginia will continue to actively participate in multi-state gaming consortia, to ensure that product offerings sufficiently meet consumer demand for jackpot games. These efforts may include the enhancement of current game offerings and the introduction of additional multi-state offerings.

In addition, Virginia continues to monitor competition from other gaming venues. In addition to competition from lotteries along all of Virginia's borders, there continues to be an expansion of video lottery gaming at racetracks and other venues in West Virginia and Maryland, as well as Pennsylvania, Ohio and New York.

Finally, internet gaming will be closely monitored in the lottery industry. A late 2011 Department of Justice ruling helped clarify the legality of internet gaming. While Virginia has a state statute that restricts internet gaming, several state lotteries have begun internet gaming or have defined plans to do so in the near future.

Contacting the Virginia Lottery

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

Commonwealth of Virginia

Auditor of Public Accounts

Walter J. Kucharski
Auditor of Public Accounts

P.O. Box 1295
Richmond, Virginia 23218

August 15, 2012

The Honorable Robert F. McDonnell
Governor of Virginia

The Honorable John M. O'Bannon, III
Chairman, Joint Legislative Audit
And Review Commission

Members
Virginia State Lottery Board

INDEPENDENT AUDITOR'S REPORT ON FINANCIAL STATEMENTS

We have audited the accompanying basic financial statements of the **Virginia State Lottery Department** (Lottery) as of and for the year ended June 30, 2012, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year summarized comparative information has been derived from the Lottery's 2011financial statements, and in our report dated August 15, 2011, we expressed unqualified opinions on the respective financial statements of the Lottery.

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

As discussed in Note 1A, the basic financial statements of the Lottery are intended to present the financial position and the changes in financial position and cash flows of only that portion of the business-type activities and the major enterprise fund of the Commonwealth of Virginia that is attributable to the transactions of the Lottery. They do not purport to, and do not, present fairly the Commonwealth of Virginia's overall financial position as of June 30, 2012, and the changes in its financial position and its cash flows, where applicable, for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Lottery as of June 30, 2012, and the changes in its financial position and its cash flows for the year ended in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America require that the Management Discussion and Analysis on page 3 through 9 be presented to supplement the basic

financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

In accordance with Government Auditing Standards, we have also issued our report dated August 15, 2012 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 grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be considered in assessing the results of our audit.

AUDITOR OF PUBLIC ACCOUNTS

Financial Statements

(audited)

for fiscal year ended June 30, 2012 with comparative information for 2011

VIRGINIA STATE LOTTERY: STATEMENT OF NET ASSETS

For fiscal year ended June 30, 2012 with comparative information for 2011

Assets:	Year Ended 2012	Year Ended 2011
Current Assets:		
Cash and Cash Equivalents (2)	$27,800,193	$19,652,492
Cash Held as Collateral: (2)		
Lottery Securities Lending	204,518,393	219,406,473
Treasury Securities Lending	4,187,061	3,817,963
Accounts Receivable	52,826,613	45,799,131
Deferred Expenses	230,871	532,091
Short-term Investments (2)	35,669,654	41,416,156
Total Current Assets	325,232,785	330,624,306
Investments (2)	158,810,763	174,992,281
Capital Assets (3)		
Equipment and Intangible Assets	24,183,446	28,959,888
Less: Accumulated Depreciation/Amortization	(16,295,725)	(19,493,323)
Net Capital Assets	7,887,721	9,466,565
Total Assets	$491,931,269	$515,083,152

Liabilities and Net Assets:	Year Ended 2012	Year Ended 2011
Current Liabilities:		
Accounts Payable	$8,949,909	$9,479,528
Treasury Loan (4)	0	0
Due to the Lottery Proceeds Fund (5)	22,971,151	9,011,285
Accrued Compensated Absences (6)	1,101,099	1,058,109
Obligations Under Securities Lending: (2)		
Lottery	204,518,393	219,406,473
Treasury	4,187,061	3,817,963
Prizes Payable: (7)		
Jackpot Prizes Payable - Current	35,669,654	41,416,156
Other Prizes Payable	52,132,375	51,838,543
Deferred Revenue	2,837,739	3,208,332
Total Current Liabilities	332,367,381	339,236,389
Noncurrent Liabilities:		
Jackpot Prizes Payable (7)	158,810,763	174,992,281
Accrued Compensated Absences (6)	753,125	854,482
Total Liabilities	491,931,269	515,083,152
Net Assets:		
Invested in capital, net of related debt	7,887,721	9,466,565
Unreserved	(7,887,721)	(9,466,565)
Total Net Assets	0	0
Total Liabilities and Net Assets	$491,931,269	$515,083,152

VIRGINIA STATE LOTTERY:
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS

For fiscal year ended June 30, 2012 with comparative information for 2011

	Year Ended 2012	Year Ended 2011
Operating Revenues:		
Ticket Sales	$1,616,001,647	$1,482,688,452
Less:		
Prize Expense	962,281,899	881,025,801
Retailer Compensation	90,674,306	83,844,563
Instant Ticket & Gaming Services	24,901,790	21,005,518
Gross Margin	538,143,652	496,812,570
Operating Expenses:		
Advertising and Promotion	22,371,333	23,522,758
General and Administrative	27,267,778	27,605,152
Depreciation	3,406,330	2,787,870
Total Operating Expenses	53,045,441	53,915,780
Income from Operations	485,098,211	442,896,790
Nonoperating Revenues(Expenses)		
Interest Income	1,277,270	1,061,964
Net Other Income	684,385	252,531
Total Nonoperating Revenues(Expenses)	1,961,655	1,314,495
Net Income	487,059,866	444,211,285
Transfer to the Lottery Proceeds Fund	(464,088,715)	(435,200,000)
Due from (to) the Lottery Proceeds Fund	(22,971,151)	(9,011,285)
Net Assets, July 1	0	0
Net Assets, June 30	$0	$0

VIRGINIA STATE LOTTERY: STATEMENT OF CASH FLOWS

For fiscal year ended June 30, 2012 with comparative information for 2011

	Year Ended 2012	Year Ended 2011
Cash flows from operating activities:		
Cash received from ticket sales	$1,608,603,572	$1,492,121,249
Cash payments for prizes	(994,910,599)	(920,796,204)
Discounts for retailer compensation	(90,674,306)	(83,844,563)
Cash payments to supplier of instant and online services	(24,901,790)	(21,005,518)
Cash payments to suppliers of other goods and services	(16,678,114)	(18,914,636)
Cash payments to employees for services	(21,949,973)	(20,695,772)
Cash payments to the Literary Fund for unclaimed prizes (9)	(11,297,790)	(10,852,335)
Net cash provided by operating activities	448,191,000	416,012,221
Cash flows from noncapital financing activities:		
Proceeds from other income	684,385	252,531
Repayment of Treasury Loan	0	(9,000,000)
Proceeds from Treasury Loan	0	0
Transfers to the Lottery Proceeds Fund	(473,100,000)	(435,251,063)
Net cash used by noncapital financing activities	(472,415,615)	(443,998,532)
Cash flows from capital financing and related activities:		
Acquisition of capital assets	(1,890,791)	(5,186,098)
Disposal of capital assets	63,305	0
Principal payments on installment notes	0	0
Interest payment on installment notes	0	0
Net cash used for capital financing activities	(1,827,486)	(5,186,098)
Cash flows from investing activities:		
Purchase of investment securities	(9,587,468)	(5,217,261)
Sale of investment securities	0	0
Proceeds from maturing securities	42,510,000	52,831,000
Interest proceeds from cash balances	1,277,270	1,061,964
Net cash used for investing activities	34,199,802	48,675,703
Net increase in cash and cash equivalents	8,147,701	15,503,294
Cash and cash equivalents at July 1	19,652,492	4,149,198
Cash and cash equivalents at June 30	$27,800,193	$19,652,492
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	485,098,211	442,896,790
Adjustments to reconcile operating income to net cash:		
Depreciation	3,406,330	2,787,869
Accreted interest on investment securities	(10,994,512)	(13,268,344)
Changes in assets and liabilities:		
(Increase) Decrease in accounts receivable	(7,027,482)	9,038,897
Decrease (Increase) in deferred expenses	301,220	(87,370)
Increase (Decrease) in accounts payable	(529,619)	651,816
(Decrease) in current prizes payable	(5,452,670)	(2,112,214)
(Decrease) Increase in deferred revenue	(370,593)	393,900
(Decrease) Increase in accrued compensated absences	(58,367)	100,722
(Decrease) in noncurrent prizes payable	(16,181,518)	(24,389,845)
Net cash provided by operating activities	$448,191,000	$416,012,221

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

Notes to Financial Statements

(as of June 30, 2012)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A. Reporting Entity

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

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

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

B. Basis of Accounting

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

C. Revenue and Expense Classifications

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

Non-operating revenues include interest income from its cash balances held with the Treasurer of Virginia.

D. Fund Accounting

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

accounting is used where the governing body has decided that periodic determination of revenues earned, expenses incurred, and net income is appropriate.

E. Cash, Cash Equivalents, and Investments

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

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

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

F. Capital Assets

Equipment and intangible assets are capitalized and depreciated/amortized on a straight-line basis over their useful lives and are valued at historical or amortized cost. The Virginia Lottery capitalizes all equipment and intangible assets that have a cost or value equal to or greater than $5,000 and an expected useful life of at least three years. During fiscal year 2010, the Lottery began capitalizing intangible assets in accordance with Governmental Accounting Standards Board (GASB) Statement 51 *Accounting and Financial Reporting for Intangible Assets*.

G. Significant Contracts

The Virginia Lottery has contracted for the printing and distribution of instant scratcher tickets since 2004. A renewed service contract with Scientific Games International (SGI) began on June 11, 2011, and continues through June 10, 2014. In addition to providing instant scratcher ticket warehousing and distribution services, SGI provides marketing and sales support services.

The estimated contract value is $30,000,000 for the entire contract period. SGI receives a fee of 1.2005 percent of the retail value of net instant scratcher tickets distributed and then activated for sale by retailers.

The Virginia Lottery has contracted with GTECH Corporation to provide and operate the gaming network that consists of retailer ticket terminals and associated software. The service contract began on June 13, 2006, and continues through October 27, 2014. GTECH has established a facilities management agreement with the Lottery, through which GTECH installs and manages retailer equipment, and manages transaction processing systems to record transactions originating throughout the Commonwealth. GTECH also provides various professional services, software development and testing support, backup data processing, and a comprehensive satellite communications network to support gaming systems operations.

The estimated contract value is $105,000,000 for the entire contract period. Under the contract, GTECH receives a fee of 0.7699 percent of the retail value of the net instant scratcher and retailer terminal games ticket sales.

H. Summarized Comparative Data

The basic financial statements include certain prior-year partial comparative information in total but not at the level of detail required for a presentation in conformity with generally accepted accounting principles. Accordingly, such information should be read in conjunction with the Lottery's financial statements for the year ended June 30, 2011, from which the summarized information was derived.

2. CASH AND CASH EQUIVALENTS AND INVESTMENTS

Cash and cash equivalents represent cash with the Treasurer of Virginia, deposits, and overnight repurchase agreements. Cash with the Treasurer of Virginia is held pursuant to Section 2.2-1800, et seq., Code of Virginia. These funds are held in pooled accounts and, accordingly, are not categorized as to credit risk as defined by GASB Statement 40. Cash on deposit is held in demand deposit accounts maintained for prize payments and is covered by federal depository insurance with the balance in excess of this insurance collateralized in accordance with the Virginia Security for Public Deposits Act. Under this Act, banks holding public deposits in excess of the amounts insured by FDIC pledge collateral in the amount of 50 percent of deposits in excess of FDIC insurance coverage to a collateral pool held in the name of the State Treasury Board. For June 30, 2012, the total cash and cash equivalents equaled $27,800,193. This included petty cash on hand of $1,100.

In accordance with the State Treasurer and the Virginia Lottery's investment policy, funds are invested in U.S Treasury obligations for the purpose of payment of deferred prizes to winners. These investments held for future prize payments are available for lending to broker-dealers and other entities (borrowers) for cash collateral that will be returned for the same securities in the future.

Custodial Credit Risk - Custodial credit risk is the risk that, in the event of the failure of the counterparty, the state and Virginia Lottery will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. All security loan agreements are collateralized at loan inception at no less than 100 percent of market value by cash or U.S. government obligations and adjusted to market daily, at a minimum, to cover market value fluctuations. Collateral cash is invested in accordance with the investment policies of the State Treasury Board of the Commonwealth of Virginia, and credit rating categories are detailed as part of this footnote. Management assumes reasonable credit risk in these investments, and fluctuations in market conditions may value the invested cash Collateral less than the original investment.

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

Investments consist of the following:

	CREDIT RATING	*(unrated)*
Prize annuities:		
Treasury bonds		*$194,480,417*
Total		*$194,480,417*

INVESTMENT SECURITIES

	Less Then 1 Year	1-5 Years	6-10 Years	11-20 Years	Over 20 Years
Prize Annuities:					
Treasury Bonds (1)	35,669,654	80,589,403	32,866,464	40,798,401	4,556,495
	$35,669,654	$80,589,403	$32,866,464	$40,798,401	$4,556,495

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

Securities Lending

Securities Lending – Collateral for securities lending reported on the statement of net assets represents cash collateral received by the Lottery that is subsequently reinvested through the State Treasury's securities lending program. The Commonwealth's policy is to record unrealized gains and losses for the State Treasury's securities lending program in the General Fund in the Commonwealth's basic financial statements.

When the Commonwealth realizes gains or losses, or determines that a security is other than temporarily impaired, the State Treasury allocates the actual gains and losses to the affected agencies for recording. Detailed information related to the credit risk of these investments and the State Treasury's securities lending program is available on a statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

3. CAPITAL ASSETS

The following schedule presents the changes in capital assets.

	Balance As Of July 1, 2011	Additions	Reductions	Balance As Of June 30, 2012
Equipment & Intangible Assets:	$28,959,888	$1,890,791	$6,667,233	$24,183,446
Less: Accumulated Depreciation/Amortization	19,493,323	3,406,330	6,603,928	16,295,725
Net Capital Assets	$9,466,565	$(1,515,539)	$63,305	$7,887,721

4. LINE OF CREDIT

The State Comptroller has provided the Virginia Lottery with a line of credit not to exceed $40 million in accordance with Section 3-2.03 of Chapter 2, 2012, Special Session I, to fund administrative and operating expenses in the event unreserved cash is insufficient to cover these short-term costs. There were no borrowings as of June 30, 2012.

5. DUE FROM/(TO) THE LOTTERY PROCEEDS FUND

The amount due from/(to) the Lottery Proceeds Fund represents Virginia Lottery net income payable to the Commonwealth of Virginia's Lottery Proceeds Fund in accordance with 2012 Amendments to the 2011 Appropriation Act, and Section 58.1-4022, Code of Virginia. The Lottery Proceeds Fund is a special non-reverting fund established

solely for the purpose of public education in the Commonwealth. For the year ended June 30, 2012 the net income was $487,059,866, with a net income transfer through June 30 of $464,088,715 and a balance due to the Lottery Proceeds Fund of $22,971,151

6. COMPENSATED ABSENCES

Compensated absences represent the amounts of vacation, sick, and compensatory leave earned by employees of the Virginia Lottery, but not taken at June 30, 2012 and 2011. Compensated absences were calculated in accordance with GASB Statement 16, *Accounting for Compensated Absences*. The amount reflects all earned leave payable under the Virginia Lottery's leave payout policies. Information on the Commonwealth's leave policy is available at the statewide level in the Commonwealth of Virginia's Comprehensive Annual Financial Report.

Balance As Of July 1, 2011	Increases	Decreases	Balance As Of June 30, 2012	Due Within 1 Year
$1,912,591	$1,126,588	$1,184,955	$1,854,224	$1,101,099

7. PRIZES PAYABLE

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

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

INVESTMENTS/PRIZES PAYABLE
Balance as of June 30, 2012

Note Prizes Payable	INSTANT Jackpot	ONLINE For Life	For Life	Total
Due within 1 year	31,065,238	3,630,674	973,742	35,669,654
Due in subsequent years	98,068,581	46,966,713	13,775,469	158,810,763
Total (present value)	129,133,819	50,597,387	14,749,211	194,480,417
Add: Interest to maturity	42,196,181	32,883,613	7,680,789	82,760,583
Total at maturity	$171,330,000	$83,481,000	$22,430,000	$277,241,000

Other prizes payable represents prizes won but not yet claimed, from drawings or other games which may or may not have ended, and where these prizes are redeemable for up to 180 days after the drawing or game end. "For Life" prizes, for which bonds have not yet been purchased, are also reported as other prizes payable.

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

The following schedule presents the changes in prizes payable.

CHANGES/PRIZES PAYABLE

Balance As Of July 1, 2011	Increases	Decreases	Balance As Of June 30, 2012
$216,408,437	$9,587,468	$31,515,488	$194,480,417

8. OPERATING LEASE COMMITMENTS

The Virginia Lottery is committed under various operating lease agreements. The operating leases are for customer service centers. Expenses under operating lease agreements were $1,285,379 for the year ended June 30, 2012. A summary of future obligations under these agreements as of June 30, 2012, follows:

Year Ended June 30, 2012 Obligation	Operating Lease Principal
2013	1,236,688
2014	161,228
2015	92,717
2016	82,323
2017	27,710
Total	$1,600,666

9. LITERARY FUND AND SETOFF DEBT COLLECTION PAYMENTS

Prizes unclaimed after 180 days are paid to the Literary Fund of the Commonwealth. Payments totaled $11,297,790 for the year ended June 30, 2012.

The Virginia Lottery participates in the Setoff Debt Collection Act whereby certain prize payments are withheld to set-off state obligations the prizewinner owes. Payments totaled $1,525,507 for the year ended June 30, 2012. The Literary Fund and state debt setoff payments are reported as prize expense on the financial statements.

10. PENSION PLAN AND OTHER POST RETIREMENT BENEFITS

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

11. RISK MANAGEMENT

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

12. CONTINGENCIES

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