



**NEW YORK STATE LOTTERY**

Basic Financial Statements

March 31, 2004 and 2003

(With Independent Auditors' Report Thereon)

**NEW YORK STATE LOTTERY**

Basic Financial Statements

March 31, 2004 and 2003

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KPMG LLP  
515 Broadway  
Albany, NY 12207

## Independent Auditors' Report

New York State Lottery:

We have audited the accompanying financial statements of the New York State Lottery (Lottery) as of March 31, 2004 and 2003, and the related statements of revenue, expenses, and changes in 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. 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, the financial statements of the New York State Lottery are intended to present the financial position, and changes in financial position and cash flows, of only that portion of the financial reporting entity of the State of New York that is attributable to the transactions of the Lottery. They do not purport to, and do not, present fairly the financial position of the State of New York as of March 31, 2004 and 2003, and the changes in 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 New York State Lottery as of March 31, 2004 and 2003, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Management's Discussion and Analysis on pages 2 through 9 is not a required part of the basic financial statements but is supplementary information required by accounting standards generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

July 14, 2004



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**NEW YORK STATE LOTTERY**  
Management's Discussion and Analysis  
March 31, 2004 and 2003

The following discussion and analysis is of the New York State Lottery's (Lottery) financial position and activities for the fiscal year ended March 31, 2004. This document has been prepared by management and should be read in conjunction with the financial statements and footnotes attached hereto. The Lottery's financial statements for the years ended March 31, 2004 and 2003 are prepared in accordance with the requirements of Governmental Accounting Standards Board Statement 34.

**Financial Highlights**

New York Lottery revenues totaled \$5.847 billion, the highest total ever for the Lottery, while net proceeds earned for Lottery Aid to Education exceeded \$1.907 billion for fiscal year 2004. This amount surpassed fiscal year 2003 by more than \$127.0 million or 7.1%. In fiscal year 2003, Lottery ticket sales totaled more than \$5.395 billion, while net proceeds transferred to the Lottery Aid to Education exceeded \$1.78 billion. This amount surpassed fiscal year 2002 by more than \$190.6 million or 12.0%. Some additional highlights of the fiscal year were:

- Revenues increased by \$451.5 million, or 8.4% in fiscal year 2004. In fiscal year 2003 the revenue increase was \$642.3 million or 13.5%.
- Prize expense increased by \$244.6 million, an 8.0% increase during fiscal year 2004. In fiscal year 2003 prize expense increased by \$420.6 million a 15.9% increase. Prize expense increases directionally with increased sales.
- Operating income increased by \$167.5 million, or 9.4% in fiscal year 2004. This increase was \$174.9 million or 10.8% in fiscal year 2003.
- Nonoperating income decreased by \$139.3 million during the year ended March 31, 2004 when compared to the prior year. This was primarily due to a \$19.0 million decrease during the current year in the unrealized fair value of the securities used to pay prize winners as opposed to the prior year's \$119.0 million increase. This fair value increase last year was the main cause of fiscal year 2003's nonoperating income increase of \$172.6 million over the prior fiscal year.
- Working capital (current assets less current liabilities) increased by \$54.9 million to \$176.0 million during the current fiscal year. In fiscal year 2003 this annual change was \$9.0 million to reach \$121.1 million.

**Overview of the Financial Statements**

The New York Lottery presents its financial statements on an accrual basis of accounting as an enterprise fund of the State of New York, similar to a nongovernmental business entity. The three financial statements presented are:

- Statements of Net Assets, on page 10 – this statement presents information reflecting the Lottery's assets, liabilities, and net assets. Net assets present the amount of total assets less liabilities and is one way to measure the Lottery's financial position. Increases or decreases can be an indicator of financial improvement or deterioration.
- Statements of Revenues, Expenses, and Changes in Net Assets, on page 11 – this statement reflects the operating revenues and expenses and nonoperating revenues and expenses of the Lottery for the year. Income before transfers out is similar to net income before taxes for a business.

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- Statements of Cash Flows, on page 12 – this statement of cash flows is presented on the direct method of reporting which reflects cash flows from operating activities as well as noncapital financing, capital and related financing, and investing activities. Cash collections and payments are reflected in this statement to arrive at the net increase or decrease in cash for the year.

The financial statements as a whole provide information about the Lottery's overall financial condition.

This management discussion and analysis is meant to be an introduction to the financial statements and to assist readers in understanding the results of the operation and the financial standing of the New York Lottery. The notes to the financial statements include substantial additional data and explanations which should be used in concert with the financial statements.

The New York Lottery deposits its net proceeds into six accounts held in joint custody with the New York State Office of the State Comptroller. These six accounts and the purpose of the funds in each account are: the *Lottery Education* account which accumulates the required deposits for Aid to Education from revenues other than video gaming, the *Prize Pending* account which consists of Lottery prizes that are not yet paid from revenues other than video gaming, the *Administration* account which is utilized to pay the administrative costs of the Lottery not funded from video gaming, *Video Gaming Education* which accumulates the required Education proceeds of video gaming, the *Video Gaming Prize Pending* account which consists primarily of prizes awarded that have not been claimed and *Video Gaming Administration* which is utilized to pay the administrative costs of video gaming.

Unrestricted net assets listed on the statement of net assets are largely the result of increased fair market value of United States guaranteed marketable securities held by the Lottery to pay prize winners on an annuity basis. The New York Lottery's policy and practice is to hold these investments to maturity to meet these prize payment obligations. As such, the Lottery does not expect to realize any fair value gain on these investments. Investments consist of United States Government-backed obligations of zero coupon bonds and stripped securities that equal the face amount of the bond or security upon maturity.

Restricted Net Assets for Future Prizes consist of prize funds that are in excess of prizes actually claimed at the fiscal year end, but which are necessary to ensure future prize payments. For example, prize funds from past sales which are to be utilized to pay a Lotto or Mega Millions jackpot which has not yet been won is one example of the restricted net assets.

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**Financial Analysis**

**Summary of Net Assets**

The comparative statement of net assets represents the Lottery's financial position as of the fiscal years ended for 2004, 2003, and 2002. The Lottery's assets, liabilities, and net assets are summarized as follows (in millions):

	FY 2004	FY 2003	FY 2002	FY 2004 vs. FY 2003		FY 2003 vs. FY 2002	
				Dollar change	Percent change	Dollar change	Percent change
Current assets	\$ 838	688	692	150	21.8%	(4)	(0.6)%
Noncurrent assets	1,370	1,460	1,389	(90)	(6.2)%	71	5.1%
Total assets	\$ 2,208	2,148	2,081	60	2.8%	67	3.2%
Current liabilities	\$ 662	567	580	95	16.8%	(13)	(2.2)%
Noncurrent liabilities	1,181	1,248	1,298	(67)	(5.4)%	(50)	(3.9)%
Total liabilities	\$ 1,843	1,815	1,878	28	1.5%	(63)	(3.4)%
Restricted net assets	\$ 142	91	80	51	56.0%	11	13.8%
Unrestricted net assets	223	242	123	(19)	(7.9)%	119	96.7%
Total net assets	\$ 365	333	203	32	9.6%	130	64.0%

**Current Assets**

Current assets consist of cash and cash equivalents, accounts receivable, instant ticket inventory and the current portion of annuity investments. The total current assets increased by 21.8% during the fiscal year 2004. The majority of the increase was caused by a \$142 million increase in cash. Most of this growth was in the two Education accounts due to the Lottery exceeding projected revenues. Accounts receivable increased by \$18 million during fiscal year 2004 due to increased sales of instant cash games. In comparison, fiscal year 2003 current assets showed no significant change from 2002. During that fiscal year an increase of \$40.6 million in accounts receivable due to increased instant cash games essentially offset a \$50.5 million decrease in cash and cash equivalents from increased payments to Aid to Education.

**Noncurrent Assets**

The Lottery funds installment prizes for games like Lotto, Mega Millions, Win for Life, and other select instant games through investment in United States Treasury Securities. The total market value of these securities was \$1.58 billion at March 31, 2004 (a decrease of \$105.5 million from March 31, 2003). The 6.3% decrease in the fair value of investments was primarily due to the increase in the yield on United State Treasury Securities in the market. Comparatively, the total fair value of these securities at March 31, 2003 was \$1.68 billion (an increase of \$77.0 million from March 31, 2002). This 4.8% increase was related to the decline in the yield on held securities.

\$1.37 billion and \$1.46 billion was invested in securities at March 31, 2004 and 2003, respectively, that were for prizes that are payable beyond one year from that date. The remaining value of securities at each fiscal year end is related to prizes that are due during the next fiscal year and that value is part of current assets.

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***Current Liabilities***

Current liabilities consist of the current portion of long-term prizes payable, prizes that have been awarded but not yet claimed, amounts due to Education on an accrual basis, accrued expenses, accounts payable, the sales value of tickets purchased by players for which a drawing has not yet been held, and the short-term portion of a capitalized lease. In total, these accounts increased by \$94.6 million during the fiscal year 2004. This increase is the result of amounts Due to Education being \$72.3 million more this year due to timing of receipts and cash draw downs for Aid to Education as well as an increase in Unclaimed Prizes of \$8.2 million which was due to an increase in ticket sales. Current liabilities fell by \$13.1 million in fiscal year 2003. This decrease was primarily the result of Due to Education being \$45.9 million less at March 31, 2003 due to timing of payments to the State, offset by an increase in Unclaimed Prizes of \$33.0 million. The unclaimed prize increase in fiscal 2003 was caused by increased ticket sales. Amounts due to prize winners to be transferred to Education are over 93.4% of the current liabilities at March 31, 2004. This percentage is down slightly from March 31, 2003 at 95.7% and March 31, 2002 at 95.1%.

***Noncurrent Liabilities***

In 2004, noncurrent liabilities consist of installment prizes due in fiscal years after 2005, the total amount due to employees for unused vacation and sick leave and the long-term portion of capitalized leases. There were no capitalized lease obligations in 2003 or 2002. During the fiscal year, long-term prizes payable fell by over \$70.4 million as a result of payments made to past winners and relatively few new jackpot winners being paid by installments. This liability reduction was similar in 2003 as long-term prizes payable fell by \$50.6 million.

***Net Assets***

Net assets represent the excess of the Lottery's assets over its liabilities. Restricted net assets for prizes include forfeited prizes and other prize assets that are to be used for future prize expenses. Unrestricted net assets are primarily the cumulative difference between the market value of the Lottery's United States Treasury Securities and the book value of prize liabilities that the securities are funding. Since the Lottery's policy and practice is to purchase and hold securities to maturity and then pay the associated installment prize, this cumulative fair value gain is not expected to be realized but essentially fluctuates daily based on the securities market.

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**Management's Discussion and Analysis**  
**March 31, 2004 and 2003**

***Summary of Revenues, Expenses, and Changes in Net Assets***

The results of the Lottery's operations are presented in the statement of revenues, expenses, and changes in net assets which is summarized as follows (in millions):

	FY 2004	FY 2003	FY 2002	FY 2004 vs. FY 2003		FY 2003 vs. FY 2002	
				Dollar change	Percent change	Dollar change	Percent change
Operating revenue:							
Lottery revenue, net	\$ 5,847	5,396	4,754	451	8.4%	642	13.5%
Operating expenses:							
Direct expenses	(3,788)	(3,502)	(3,039)	(286)	8.2%	(463)	15.2%
Indirect expenses	(105)	(107)	(103)	2	1.9%	(4)	3.9%
Total operating expenses	(3,893)	(3,609)	(3,142)	(284)	7.9%	(467)	14.9%
Operating income	1,954	1,787	1,612	167	9.3%	175	10.9%
Nonoperating income (expenses)	(16)	123	(49)	(139)	113.0%	172	351.0%
Income before transfers out	1,938	1,910	1,563	28	1.5%	347	22.2%
Transfers out – contribution for aid to education	(1,907)	(1,780)	(1,590)	(127)	7.1%	(190)	11.9%
Change in net assets	\$ 31	130	(27)	(99)	76.2%	157	581.5%

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**Revenues**

The New York Lottery provides Aid to Education in New York by selling Lottery tickets throughout the state at over 15,500 retail locations and in fiscal year 2004 by also providing video gaming at 3 licensed video gaming entertainment facilities. During fiscal year end 2004 the Lottery achieved \$3.09 billion in on-line sales, \$2.73 billion in instant sales and \$22 million in video gaming revenues for a new record revenue year of \$5.85 billion. During fiscal years 2003 and 2002 these revenues totaled \$5.40 billion and \$4.75 billion respectively. Based on total revenues, fiscal year 2004 saw a \$451.5 million (8.4%) revenue increase compared to fiscal year 2003's \$642.3 million (13.5%) increase. The majority of the increase in total revenues for both years was from Instant games, Mega Millions, as well as New York's Numbers and Win 4. A categorization of revenues by game and the percentage of total revenues in millions for fiscal year 2004 and 2003 are as follows:

Game	FY 2004		FY 2003		FY 2002	
	Revenue	Percent of total revenue	Revenue	Percent of total revenue	Revenue	Percent of total revenue
Mega Millions	\$ 474	8.1%	373	6.9%	—	0.0%
Lotto	356	6.1%	392	7.3%	565	11.9%
Take 5	363	6.2%	381	7.1%	435	9.1%
New York's Numbers	758	13.0%	754	14.0%	737	15.5%
Win 4	593	10.1%	579	10.7%	524	11.0%
Quick Draw	500	8.5%	476	8.8%	489	10.3%
Pick 10 and Instant Win	47	0.8%	52	1.0%	38	0.8%
Instant	2,734	46.8%	2,389	44.3%	1,966	41.4%
Subtotal traditional lottery	5,825	99.6%	5,396	100.0%	4,754	100.0%
Video Gaming, net	22	0.4%	—	0.0%	—	0.0%
Total revenues	\$ 5,847	100.0%	5,396	100.0%	4,754	100.0%

**Direct Expenses**

Direct expenses consist of prize expense for traditional Lottery games, commissions to Lottery retailers and video gaming facilities, fees to gaming contractors, expenses of providing instant tickets to players, and telecommunications. The largest of all categories of Lottery expenses is prizes. This expense, increased by \$244.6 million to \$3.306 billion during fiscal year 2004, and, along with retailer commissions, which increased by \$24.4 million to \$349.3 million and commissions to video gaming facilities which totaled \$6.3 million (\$0 in 2003), account for nearly all of the increase in direct expenses. During fiscal year 2003 prize expense increased by \$420.6 million to 3.062 billion and retailer commissions also increased during the year by 39.2 million to nearly \$325 million. These categories as well as gaming contractor fees rise and fall proportionately to the change in Lottery revenues. Nearly 65% of revenues went towards direct expenses in both 2004 and 2003.

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***Other Operating Expenses***

Other operating expenses include marketing, state agency charges, personal services, fringe benefits and other administrative costs. These costs decreased 1.9% during fiscal year 2004 compared to fiscal year 2003. Other operating expenses as a percentage of revenues fell from 2.0% in fiscal year 2003 to 1.8% in fiscal year 2004, as increased revenues out paced the costs incurred to administer the games. A similar change in percentages were seen in fiscal year 2003 compared to 2002 as other operating expenses fell from 2.2% of revenues to 2.0%.

***Nonoperating Income (Expense)***

Nonoperating income consists of small amounts of miscellaneous income plus the net growth or decline in the book and fair value of the United States Treasury Securities utilized to fund long-term prizes. Investment income (\$84.6 million in 2004, \$230.4 million in 2003 and \$65.5 million in 2002) consists of both the fair value adjustments of investments plus the normal growth of the value of Lottery investments as the securities move closer to maturity. Investment expense is a reflection of the Lottery expending the investment income to increase the valuation of the long-term prizes payable to winners. The annual fair value adjustment of investments, shown here as income, flows to the unrestricted net assets balance on the statement of net assets. As stated previously, this fair value adjustment is unrealized by the Lottery since it expects to hold investments to maturity.

***Income Before Transfers Out***

The revenues and expenses for fiscal year 2004 resulted in income before transfers out of \$1.938 billion. \$1.907 billion of this income transfers to the Due to Aid to Education account and \$31.4 million flowed through to the Statement of Net Assets as the change in net assets. The \$31.4 million increase is a combination of a \$50.4 million increase in net assets restricted for prizes and a \$19.0 million decrease in unrestricted assets. The comparative income before transfers out for fiscal year 2003 was \$1.911 billion. Of this amount, \$1.780 billion transferred to the Due to Aid to Education account and the remaining \$130.3 million flowed through to the Statement of Net Assets as the change in net assets. \$119.0 million was due to the unrealized gain on investments and categorized as an increase in the cumulative unrestricted total. Total net assets at the end of fiscal years 2004 and 2003 were \$364.7 million and \$333.3 million respectively.

***Summary and Outlook***

During the last quarter of the fiscal year, video gaming commenced at three facilities in New York: Saratoga Gaming & Raceway, Finger Lakes Gaming and Racetrack and Fairgrounds Gaming & Raceway. These facilities contributed only a small amount of revenues in 2004. In the upcoming fiscal year, however, it is anticipated that other facility openings and the full year operation of the first three facilities will result in an increase in the portion of Lottery revenues generated from this revenue source. On July 7, 2004 the Appellate Division of the Supreme Court of the State of New York, Third Department, ruled that the legislation authorizing the Lottery to license video gaming operations in the State is unconstitutional. An appeal was filed by New York State's Attorney General to the State's Court of Appeals. New York's video gaming operations are continuing during the appeal process which is anticipated to take nearly a year to complete.

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**Contacting New York Lottery's Financial Management**

This financial report is designed to provide the State of New York, the public, and other interested parties an overview of the financial results of the New York Lottery's activities and to offer an explanation of the financial condition and results of operations of the Lottery. If you have any questions about this report or require additional financial information, contact the Press and Community Relations Office at The New York Lottery, One Broadway Center, Post Office Box 7500, Schenectady, NY 12301-7500.

**NEW YORK STATE LOTTERY**

Statements of Net Assets

March 31, 2004 and 2003

(In thousands)

<b>Assets</b>	<b>2004</b>	<b>2003</b>
<b>Current assets:</b>		
Cash and cash equivalents	\$ 272,594	130,830
Accounts receivable	343,234	324,770
Instant ticket inventory	8,344	7,982
Investments	213,400	224,464
<b>Total current assets</b>	<b>837,572</b>	<b>688,046</b>
Long-term investments, net	1,365,669	1,460,099
Other assets	4,497	247
<b>Total assets</b>	<b>2,207,738</b>	<b>2,148,392</b>
<b>Liabilities</b>		
<b>Current liabilities:</b>		
Prizes payable	216,766	221,890
Unclaimed prizes	220,400	212,159
Due to education	180,824	108,562
Accounts payable and accrued liabilities	33,223	14,038
Capital lease obligations	820	—
Deferred ticket sales	9,502	10,277
<b>Total current liabilities</b>	<b>661,535</b>	<b>566,926</b>
Compensated absences	5,263	5,049
Long-term capital lease obligations	3,461	—
Long-term prizes payable	1,172,751	1,243,112
<b>Total liabilities</b>	<b>1,843,010</b>	<b>1,815,087</b>
<b>Net Assets</b>		
Restricted for future prizes	141,935	91,474
Unrestricted	222,793	241,831
<b>Total net assets</b>	<b>\$ 364,728</b>	<b>333,305</b>

See accompanying notes to basic financial statements.

**NEW YORK STATE LOTTERY**

Statements of Revenue, Expenses, and Changes in Net Assets

Years ended March 31, 2004 and 2003

(In thousands)

	<u>2004</u>	<u>2003</u>
Operating revenue:		
Lottery revenue, net	\$ 5,847,500	5,395,955
Operating expenses:		
Prize expense	(3,306,335)	(3,061,744)
Retailer commissions	(355,656)	(324,891)
Gaming contractor fees	(61,511)	(55,647)
Instant ticket direct expenses	(32,511)	(32,259)
Telecommunications	(31,618)	(27,063)
Total direct expenses	<u>(3,787,631)</u>	<u>(3,501,604)</u>
Online games/jackpot marketing	(31,160)	(33,985)
Personal service and fringe benefits	(21,985)	(22,097)
Instant games marketing	(22,150)	(20,722)
All games marketing	(15,621)	(17,277)
Other administrative costs	(10,749)	(9,566)
State agency charges	(3,547)	(3,514)
Total operating expenses	<u>(3,892,843)</u>	<u>(3,608,765)</u>
Operating income	<u>1,954,657</u>	<u>1,787,190</u>
Nonoperating revenue and (expenses):		
Investment income	83,626	230,381
Other revenues, net	644	647
Investment expense	(100,102)	(107,581)
Total nonoperating (expense) income	<u>(15,832)</u>	<u>123,447</u>
Income before transfers out	1,938,825	1,910,637
Transfers out – contribution for aid to education	<u>(1,907,402)</u>	<u>(1,780,355)</u>
Change in net assets	31,423	130,282
Net assets beginning of year	<u>333,305</u>	<u>203,023</u>
Net assets end of year	\$ <u>364,728</u>	\$ <u>333,305</u>

See accompanying notes to basic financial statements.

**NEW YORK STATE LOTTERY**  
**Statements of Cash Flows**  
**Years ended March 31, 2004 and 2003**  
**(In thousands)**

	<u>2004</u>	<u>2003</u>
Cash flows from operating activities:		
Cash received from net Lottery revenue	\$ 5,826,616	5,358,289
Cash payments for prizes	(3,456,654)	(3,185,876)
Cash payments for commissions	(355,596)	(324,992)
Cash payments for contractor fees	(61,419)	(57,151)
Cash payments for telecommunications	(31,618)	(27,063)
Cash payments for instant ticket direct expenses	(32,790)	(32,043)
Cash payments for other operating expenses	(100,838)	(109,235)
Net cash provided by operating activities	<u>1,787,701</u>	<u>1,621,929</u>
Cash flows from investing activities:		
Proceeds from investment maturities	225,901	221,207
Purchases of investments	(39,373)	(71,199)
Interest on cash and cash equivalents	2,078	2,591
Net proceeds from swaps of investment securities	101	759
Other	644	647
Net cash provided by investing activities	<u>189,351</u>	<u>154,005</u>
Cash flows from noncapital financing activities:		
Cash transfer to education	(1,835,140)	(1,826,246)
Cash flows from capital financing activities:		
Cash payments for equipment and leasehold improvements	(148)	(183)
Net cash used by capital financing activities	<u>(148)</u>	<u>(183)</u>
Net decrease in cash and cash equivalents	141,764	(50,495)
Cash and cash equivalents, beginning of year	<u>130,830</u>	<u>181,325</u>
Cash and cash equivalents, end of year	\$ <u><u>272,594</u></u>	<u><u>130,830</u></u>
Reconciliation of operating income to cash provided by operating activities:		
Operating income	\$ 1,954,657	1,787,190
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	179	101
Change in operating assets and liabilities:		
Increase in accounts receivable, net	(18,464)	(40,555)
Increase in ticket inventory	(362)	(16)
Decrease in prizes payable	(175,174)	(153,780)
Increase in unclaimed prizes	8,241	32,899
Increase in compensated absences	214	307
Increase (decrease) in accounts payable and accrued liabilities	19,185	(5,797)
Increase (decrease) in deferred ticket sales	(775)	1,580
Net cash provided by operating activities	<u>\$ 1,787,701</u>	<u>1,621,929</u>
Noncash investing activities:		
Increase (decrease) in unrealized gains on investments	\$ (19,038)	119,043
Amortization of investment discount	100,072	107,988

See accompanying notes to basic financial statements.

## NEW YORK STATE LOTTERY

### Notes to Basic Financial Statements

March 31, 2004 and 2003

#### (1) Summary of Significant Accounting Policies

The New York State Lottery (the Lottery) was established in 1967. The Lottery is currently administered by the Division of the Lottery, an independent unit of the Department of Taxation and Finance, which was created in 1976 and operates in accordance with the provisions of the New York State Lottery for Education Law (Tax Law Article 34). The purpose of the Lottery is to raise revenue for education in the State of New York (State) through the administration of lottery games.

Effective April 1, 2001, the Lottery adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements – and Management’s Discussion and Analysis – for State and Local Governments: Omnibus*; and GASB Statement No. 38 *Certain Financial Statement Note Disclosures*. GASB Statement No. 34 establishes financial reporting standards for state and local governments. Based on the provisions of GASB Statement No. 34, the Lottery is now included in the State of New York’s Basic Financial Statements as an enterprise fund. The financial statements present only the Lottery and do not present the financial position of the State of New York, and changes in its financial position and cash flows. Significant changes to the Lottery’s financial statements due to the adoption of GASB No. 34 and related statements are:

- The inclusion of a Management’s Discussion and Analysis section.
- The establishment of net assets and categorization as restricted or unrestricted.

The Lottery prepares its financial statements under the economic resources measurement focus whereby all inflows, outflows and balances affecting net assets are reported, and uses the accrual basis of accounting. Revenues are recognized when earned and expenses are recognized when incurred. The primary operating revenue of the Lottery is ticket sales from games. Nonoperating income consists mostly of investment income and unrealized gains on investments. Operating expenses consist of direct expenses for prizes, commissions to Lottery retailers, fees to gaming contractors, expenses for providing instant tickets to players, and telecommunications. Other operating expenses that are indirect to the results of each game include marketing, state agency charges, personal services, and fringe benefits. Nonoperating expense is the amortization of the discount on long-term prizes payable. The Lottery applies all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements: Statements and Interpretations of the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARB’s) of the Committee on Accounting Procedure. The Lottery has elected the option, under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Government Entities that Uses Proprietary Funds*, not to apply all FASB Statements and Interpretations issued after November 30, 1989. The more significant of the Lottery’s accounting policies are described below.

#### (a) Revenue Recognition

##### (i) On-Line Games

Revenue from ticket sales for Lotto, Quick Draw, Take Five, Pick 10, Mega Millions, Instant Win, New York’s Numbers and Win-4 games (on-line games) is recognized when the related drawing takes place. Receipts from subscription sales and other ticket sales for future drawings are recorded as deferred revenue and recognized when the related drawings take place.

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**(ii) Instant Cash Games**

Revenue from instant cash games is recognized based on the dollar value of the total number of tickets available for sale. Tickets are available for sale upon being activated on the Lottery Validation System at the retailer locations.

**(iii) Video Lottery**

Revenue from Video Lottery is recognized based on net machine income which is defined as amounts played less prizes won.

**(b) Commissions and Fees**

Retailers receive a commission of 6% based on the total tickets sold. For Video Lottery, video gaming entertainment facilities receive a commission of 29% of net machine income. The on-line game contractor and the Video Lottery central processing contractor receive fees equal to a contractual percentage of the sales generated through the network maintained by the respective contractor. The instant game contractor is paid a fee equal to a contractual percentage of instant sales. Video Lottery terminal contractors receive a fee equal to a contractual percentage of sales, adjusted for the units of service provided. All other gaming contractors are paid fees based on the units of service provided (see note 13).

**(c) Accounts Receivable**

Accounts receivable represents amounts due from the Lottery gaming contractors, net of commissions and fees, as well as amounts due from agents for instant cash game tickets which have been activated, but not yet settled. Instant ticket settlements occur not more than 45 days after a book of tickets is activated.

**(d) Allocation of Revenue from Ticket Sales**

The allocation of ticket sales is made in accordance with the provisions of the New York State Lottery for Education Law which requires:

- Allocations of ticket sales revenue to New York State for educational purposes to be at least 20% for the New York State Lottery instant cash games, 35% for Take Five, New York's Numbers, Win-4, Mega Millions and Pick 10, 45% for Lotto and Instant Win, and 25% for Quick Draw. In addition, the Lottery has legislative authority to issue up to three Instant Games per year with at least 10% for educational purposes. For Video Lottery, the required allocation to education is 61% of sales revenue after payout for prizes.
- Allocations of ticket sales revenue for the payment of lottery prizes not to exceed 65% for the New York State Lottery instant cash games, 50% for Take Five, New York's Numbers, Win-4, Mega Millions, and Pick 10, 40% for Lotto and Instant Win, and 60% for Quick Draw. In addition, the Lottery has legislative authority to issue up to three Instant Games per year with 75% allocated to prizes. Video Lottery is required to pay prizes that average no less than 90% of gross sales.

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- Allocations of ticket sales revenue from all traditional games for the payment of Lottery administrative expenses (including agent commissions and contractor fees) are not to exceed 15%. For Video Lottery, 10% of net sales (the total revenue wagered after payout for prizes) is allocated for Lottery Administration. Any excess of the maximum allocation over administrative expenses is allocated to education. Such allocations amounted to approximately \$289,528,000 and \$262,372,000 for fiscal years 2004 and 2003, respectively. Administrative expenses incurred by the Lottery represent telecommunications, advertising, salary and other operating costs.

**(e) Cash and Cash Equivalents**

For purposes of the statements of cash flows, the Lottery considers cash equivalents to be amounts held with banks and amounts held under the joint custody of the Commissioner of Taxation and Finance and the Comptroller of the State of New York through the Short-Term Investment Pool, which is used for the temporary investment of funds not required for immediate payments.

**(f) Investments**

Investments, consisting of U.S. Government-backed obligations (zero coupon bonds and stripped Government securities), are carried at fair value. Investment income represents amortized discount, interest on deposits, realized gains and losses, and change in net unrealized gains on investments.

**(g) Inventory**

Instant cash game tickets are purchased from printers. Tickets not activated for sale are held in inventory and are valued at cost by game. Tickets are charged to instant ticket direct expense under the first-in, first-out (FIFO) accounting method when activated for sale by the agents. At the conclusion of an instant cash ticket game, unused inventory is charged to instant ticket direct expense.

**(h) Capital Assets**

Capital assets consists of equipment and leasehold improvements which are carried at cost and are recorded in Other Assets. Depreciation of equipment is computed using the straight-line method over five years, the estimated useful lives of the assets. Leasehold improvements and equipment acquired under capital leases are amortized using the straight-line method over ten and five years, respectively, which is the lesser of their useful lives or the term of the leases.

When assets are retired or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts and any resulting gain or loss is reflected in Other Revenue, Net in the period of disposal.

**(i) Prizes Payable**

Lotto and Mega Millions jackpot players have the option of selecting a lump sum payment in lieu of long-term annuity payments. Prizes payable represents the liability for those prizes which are payable in annual installments. Such prize payments are funded by the Lottery's investment in U.S. Government-backed securities. The periodic amortization of discount is recorded as investment expense in these financial statements. Any excess of investment maturities over prize payments is made available for prizes.

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**(j) Unclaimed Prizes**

Unclaimed prizes at March 31, 2004 and 2003 were \$220,400,000 and \$212,159,000, respectively. Prizes unclaimed for one year after the drawing date (lapsed) are forfeited by the ticket holder. Total prizes lapsed amounted to approximately \$84,114,000 and \$52,339,000 for fiscal years 2004 and 2003, respectively. These forfeited prizes are netted against prize expense in the statement of Revenues, Expenses, and Changes in Net Assets.

Under the Tax Law, the Lottery retains forfeited prizes for supplemental prizes in subsequent lottery games. During the fiscal years 2004 and 2003, these supplemental prizes were used for Lotto, Mega Millions, Instant Win, Numbers, Win 4, and various Instant Games.

**(k) Restricted Net Assets**

Restricted net assets for prizes includes forfeited prizes and other prize assets that are restricted under New York State Tax Law Sections 1612 and 1614 for the purpose of meeting future prize expense.

**(2) Cash and Cash Equivalents**

Lottery deposits of cash and cash equivalents are made in accordance with New York State statutes. Lottery sales receipts are allocated and deposited in separate fund accounts for prizes, education, and administration under the joint custody of the Commissioner of Taxation and Finance and the Comptroller of the State of New York. The account for prizes earns interest through participation in a short-term investment pool administered by the State Comptroller. The interest is used for future lottery prizes. The carrying amount of the accounts included in cash and cash equivalents were \$275,113,000 and \$134,155,000 at March 31, 2004 and 2003, respectively. The carrying value of cash equivalents approximates market value.

The Lottery also maintains sole custody accounts which are used for daily cash management purposes. The Lottery manages the investment of its cash balances to minimize its uninvested funds. At March 31, 2004 and 2003 the amount of accounts included in cash and cash equivalents related to the sole custody accounts were \$(2,519,000) and \$(3,325,000), respectively.

The Lottery's deposits are collateralized under a program administered by the Office of the State Comptroller of the State of New York. To manage credit risk, the State requires that its depository banks pledge collateral based on available bank balances. All securities pledged as collateral are held by the State's fiscal agent in the name of the State. The Lottery's deposits with financial institutions were fully collateralized at fiscal year-end. The Lottery manages custodial credit risk by using several financial institutions.

**(3) Investments**

The Lottery is authorized by State statute to invest in U.S. Government-backed obligations (U.S. Treasury strips), which will provide for the payment of prizes payable (see note 4). During fiscal years 2004 and 2003, approximately \$100,072,000 and \$107,988,000, respectively, of amortized discount was included in investment income.

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These investments consisted of the following at March 31 (in thousands):

	2004	2003
Maturity value	\$ 2,072,916	2,234,327
Less unamortized discount	716,640	791,595
Total at amortized cost	1,356,276	1,442,732
Less investments, maturing within one year, at amortized cost	207,024	217,557
Long-term investments, at amortized cost	\$ 1,149,252	1,225,175
Total fair value of investments reported	\$ 1,579,069	1,684,563

Maturities of the investments in each of the five fiscal years following March 31, 2004, and the total thereafter, are as follows (in thousands):

2005	\$ 214,711
2006	200,163
2007	184,321
2008	172,156
2009	159,644
2010-2014	566,280
2015-2019	258,487
2020-2024	205,776
2025-2029	92,463
2030-2034	18,915
	\$ 2,072,916

The Lottery periodically enters into certain transactions whereby stripped government securities are exchanged for other stripped government securities with substantially identical terms and characteristics. During fiscal year 2004, the face value of the securities swapped amounted to \$6,010,000 resulting in a gain of approximately \$101,000. This gain is included in investment income in the statement of revenue and expenses.

Custodial credit risk for investments is the risk that in the event of the failure of the counterparty to a transaction, the Lottery will not be able to recover the value of investment securities that are in the possession of an outside party. In order to manage this risk, all of the Lottery's investments are insured or registered or securities held by the Lottery or its agent in the Lottery's name.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. The Lottery's policy for managing this risk is to hold investment securities to maturity, at which time the fair value of the investment is equal to its stated maturity value.

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**(4) Prizes Payable**

Prizes payable consisted of the following at March 31 (in thousands):

	<u>2004</u>	<u>2003</u>
Total obligation	\$ 2,104,366	2,254,423
Unamortized discount	<u>(714,849)</u>	<u>(789,421)</u>
Total carrying amount	1,389,517	1,465,002
Less prizes payable within one year	<u>216,766</u>	<u>221,890</u>
Long-term prizes payable	<u>\$ 1,172,751</u>	<u>1,243,112</u>

The amortized discount on the prizes payable is based on interest rates which range from 0.96% to 13.55% and reflect the interest rates earned by the investments held to fund the related liabilities. The amortization of discount is recorded as investment expense in the statements of revenues expenses, and changes in net assets and amounted to \$99,689,000 and \$107,581,000 for fiscal years 2004 and 2003, respectively. Also included in investment expense for the year ended March 31, 2004 is approximately \$412,000 of interest expense related to a lapsed Mega Millions jackpot.

The aggregate amount of prizes payable due in each of the five fiscal years following March 31, 2004, and the five year incremental totals thereafter, is as follows in thousands:

2005	\$ 220,259	
2006	201,005	
2007	185,452	
2008	173,339	
2009	160,919	
2010-2014	569,567	
2015-2019	248,578	
2020-2024	159,933	
2025-2029	24,287	
Thereafter	<u>161,027</u>	
	<u>\$ 2,104,366</u>	

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**(5) Long-Term Liabilities**

The Lottery's long-term liabilities, as of March 31, 2004 and 2003 are comprised of the following, (in thousands):

	<u>Balance at March 31, 2003</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at March 31, 2004</u>	<u>Current portion</u>
Capital lease obligations (note 12) \$	—	4,359	(78)	4,281	820
Compensated absences (note 11)	5,049	304	(90)	5,263	—
Prizes payable (note 4)	1,465,002	99,689	(175,174)	1,389,517	216,766
	<u>Balance at March 31, 2002</u>	<u>Additions</u>	<u>Deductions</u>	<u>Balance at March 31, 2003</u>	<u>Current portion</u>
Compensated absences (note 11) \$	4,742	353	(46)	5,049	—
Prizes payable (note 4)	1,511,201	107,581	(153,780)	1,465,002	221,890

**(6) Aid to Education**

The required allocation and contribution transferred out for aid to education during the fiscal years ended March 31, 2004 and 2003, are as follows (in thousands):

	<u>2004</u>	<u>2003</u>
Cash transferred to education	\$ 1,835,140	1,826,246
Prior year payable	<u>(108,562)</u>	<u>(154,453)</u>
Cash transferred related to current year operations	1,726,578	1,671,793
Current year payable	<u>180,824</u>	<u>108,562</u>
Required allocation to education	\$ <u><u>1,907,402</u></u>	\$ <u><u>1,780,355</u></u>

**(7) Pension Benefits**

Substantially all employees of the Lottery are members of the New York State and Local Employees' Retirement System (ERS) and the Public Employees' Group Term Life Insurance Plan (System), a cost-sharing, multiple employer public employee retirement system. The State Comptroller is sole trustee and administrative head of the System. The System issues a publicly available financial report that includes financial statements and required supplementary information which may be obtained by writing to New York State and Local Employees' Retirement Systems, 110 State Street, Albany, New York 12236.

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The System provides retirement benefits as well as death and disability benefits. All benefits vest after five years of accredited service. Retirement benefits are established by the New York State Retirement and Social Security Law. Retirement benefits and contributory requirements depend upon the point in time at which an employee last joined the System. Most members of the System who joined before July 27, 1976 are enrolled in a noncontributory plan; the Lottery contributes the entire amount determined to be payable to the System. Personnel who joined the System after July 27, 1976 are required by law to contribute 3% of their gross salary for their first ten years of employment; the Lottery contributes the balance payable to the System for these employees.

The Lottery paid to the New York State Comptroller's Office \$798,000 for 2004, \$836,000 for 2003, and \$553,000 for 2002, to cover required employer contributions for retirement benefits. These payments made represent 5.29%, 5.38%, and 3.67% of covered payroll for each of the years, respectively.

**(8) Operating Income**

Composition of operating income for fiscal 2004 and 2003 by type of lottery game is as follows (in thousands):

	2004					
	Revenue	Expenses				Instant direct expense
		Prizes	Commissions	Fees		
Mega Millions	\$ 474,432	(212,091)	(28,466)	(6,096)	--	227,779
Lotto	356,428	(152,268)	(20,519)	(4,382)	--	179,259
Take five	363,106	(179,567)	(21,786)	(4,666)	--	157,087
Pick 10	34,111	(14,665)	(2,047)	(438)	--	16,961
New York's Numbers	757,533	(377,041)	(45,452)	(9,734)	--	325,306
Win 4	592,757	(263,233)	(35,565)	(7,617)	--	286,342
Instant	2,733,939	(1,798,472)	(164,701)	(20,317)	(32,511)	717,938
Instant Win	13,224	(8,374)	(793)	(170)	--	3,887
Quick Draw	500,194	(300,624)	(30,012)	(6,428)	--	163,130
Total traditional lottery	\$ 5,825,724	(3,306,335)	(349,341)	(59,848)	(32,511)	2,077,689
Video Lottery	21,776	--	(6,315)	(1,663)	--	13,798
	<u>5,847,500</u>	<u>(3,306,335)</u>	<u>(355,656)</u>	<u>(61,511)</u>	<u>(32,511)</u>	2,091,487
Telecommunications						(31,618)
Other operating expenses						(105,212)
Total operating income						<u>\$ 1,954,657</u>

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	2003					Net
	Expenses					
	Revenue	Prizes	Commissions	Fees	Instant direct expense	
Mega Millions	\$ 373,435	(186,422)	(22,656)	(4,673)	—	159,684
Lotto	392,046	(160,868)	(23,221)	(4,540)	—	203,417
Take five	381,277	(185,850)	(22,877)	(4,900)	—	167,650
Pick 10	34,155	(16,276)	(2,049)	(439)	—	15,391
New York's Numbers	754,224	(363,642)	(45,254)	(9,692)	—	335,636
Win 4	579,329	(286,785)	(34,762)	(7,445)	—	250,337
Instant	2,388,729	(1,566,204)	(144,506)	(17,627)	(32,259)	628,133
Instant Win	16,466	(10,704)	(988)	(211)	—	4,563
Quick Draw	476,294	(284,993)	(28,578)	(6,120)	—	156,603
	<u>\$ 5,395,955</u>	<u>(3,061,744)</u>	<u>(324,891)</u>	<u>(55,647)</u>	<u>(32,259)</u>	1,921,414
Telecommunications						(27,063)
Other operating expenses						(107,161)
Total operating income						<u>\$ 1,787,190</u>

**(9) Deferred Compensation**

New York State offers its employees, including Lottery employees, a deferred compensation plan created in accordance with Internal Revenue Code Section 457. The plan, available to all employees, permits them to defer a portion of their salary until future years. The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency. All amounts of compensation deferred under the plan are placed in trust for the participants and their beneficiaries.

**(10) Postretirement Benefits**

In addition to the pension benefits described in note 7, the State provides health insurance coverage and survivor benefits for retired employees and their survivors. Substantially all of the State's employees may become eligible for these benefits if they reach normal retirement age while working for the State. Health care benefits are provided through an insurance company whose premiums are based on the benefits paid during the year. The State recognizes the cost of providing health insurance by recording its share of insurance premiums as an expenditure in the general fund in the year paid. Additionally, the survivor's benefit program provides for a death benefit to be paid by the State to a retiree's designated beneficiary. The Lottery is not directly charged for these benefits to or on behalf of its former employees.

**(11) Employees' Compensated Absences**

Under the terms of the Lottery's personnel policies and its union agreements, vacation pay benefits may be paid upon termination up to a maximum of 225 hours. In addition, unused sick leave benefits may be paid upon retirement up to a maximum of 1,500 hours. The Lottery recognizes employees' compensated absence benefits when earned. The liability for employees' compensated absences was approximately \$5,263,000 and \$5,049,000 as of March 31, 2004 and 2003, respectively, and is recorded as a long-term liability in the statements of net assets.

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**(12) Leases**

The Lottery leases surveillance equipment at its video gaming facilities under a capital lease with Key Municipal Finance. Fixed asset amounts for capital leases, which are included in other assets on the statement of net assets, were approximately \$4,349,000 and \$0 at March 31, 2004 and 2003, respectively. Accumulated depreciation on these fixed assets was approximately \$72,000 and \$0 at March 31, 2004 and 2003, respectively.

The Lottery has entered into leases for equipment and building space. Rental expense was approximately \$4,709,000 and \$4,664,000 in 2004 and 2003, respectively.

Future minimum lease payments under all noncancelable leases having initial or remaining terms in excess of one year as of March 31, 2004 are as follows:

	Operating leases	Capital leases
2005	\$ 4,771,000	\$ 938,000
2006	2,640,000	938,000
2007	910,000	938,000
2008	767,000	938,000
2009	748,000	860,000
2010 – 2014	540,000	—
Total minimum payments required	\$ 10,376,000	4,612,000
Less amounts representing interest		331,000
Present value of minimum lease payments		4,281,000
Less current portion		820,000
Long-term capital lease obligations		\$ 3,461,000

**(13) Commitments and Contingencies**

**(a) Contractual Arrangements**

The Lottery maintains a gaming network of over 15,000 on-line locations where all traditional Lottery games are sold. GTECH Corporation (GTECH) is responsible for operating all traditional Lottery games under a contract expiring on March 1, 2007. Instant cash game sales are also supported by the services of three contractors:

- (1) Under a contract expiring March 25, 2006, Pollard Banknote Limited is responsible for production of instant cash tickets.
- (2) Under a contract expiring October 15, 2006, Scientific Games, Inc, is a back-up ticket supplier.

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- (3) Instant cash tickets are also sold through approximately 3,700 vending machines at approximately 2,700 locations. A contract with Interlott, Inc., which expires on April 30, 2007, provides for maintenance of the vending machines.

Video Lottery Games are offered on approximately 3,300 Video Gaming Machines spread over three gaming facilities. Multimedia Games, Inc. provides a central processing system for the operation of Video Lottery Games under a contract expiring on January 27, 2010. Video Gaming Machines are provided under contracts expiring December 31, 2007 with four different companies (Bally Gaming, International Game Technology, Sierra Design Group, Inc., and Spielo USA, Inc.).

**(b) Insurance Contracts**

Prior to 1983, the Lottery had entered into agreements with New York insurance companies under which the Lottery purchased contracts that provide payments corresponding to the Lottery's obligation to the prizewinners. The types of contracts entered into include agreements that pay installments for a specific term (investment contracts) as well as agreements to make installment payments to prizewinners over the winners' lifetime. Because it is the intent of the Lottery that the insurance companies make future installment payments directly to each prize winner, the present value of the future payments under these contracts are not reflected in the accompanying financial statements. The Lottery may be liable for such future payments if the insurance companies were to default on their payments. All amounts under the investment contracts have been paid. For contracts other than investment contracts, the insurance companies are making annual payments to approximately 69 individuals totaling approximately \$1,245,000 as of March 31, 2004.

**(c) Litigation**

The Lottery has been named as a defendant in several lawsuits. While the ultimate outcome of these lawsuits cannot be predicted at this time, it is the opinion of management and in-house counsel that the disposition of any litigation in which the Lottery is involved will not have a material adverse effect on the financial position of the Lottery.

**(14) Subsequent Events**

On July 7, 2004 the Appellate Division of the Supreme Court of the State of New York, Third Department, ruled that the legislation authorizing the Lottery to license video gaming operations in the State is unconstitutional. The basis for the ruling was the fact that the authorizing legislation required the distribution of the "net proceeds" of video gaming to purposes other than the constitutionally mandated support of education. An automatic stay immediately took effect by reason of the court's interpretation of the State constitution. An appeal was filed by New York State's Attorney General to the State's Court of Appeals. Video gaming operations will continue during the appeal process. The Lottery anticipates that the appeal process will take almost one year to complete. The July 7, 2004 decision did declare that video gaming was a lottery and therefore constitutional. The decision also held that the Mega Millions game was a legal New York lottery game.