

**AUDIT REPORT
OF THE
NEBRASKA LOTTERY**

JULY 1, 2001 THROUGH JUNE 30, 2002

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NEBRASKA LOTTERY

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NEBRASKA LOTTERY

BACKGROUND

The Legislature created the Lottery Division of the Nebraska Department of Revenue in 1991. Nebraska voters passed a constitutional amendment allowing the creation of a State lottery in November 1992, and the Legislature established the State lottery in 1993. As the 37th lottery in the nation, the Nebraska Lottery began scratch ticket sales on September 11, 1993. Sales of on-line products began on July 21, 1994.

The Nebraska Lottery is responsible for contracting for scratch ticket production, on-line equipment, advertising, security, and related services. In addition, the Nebraska Lottery recruits and screens Nebraska Lottery retailers, develops Nebraska Lottery products, and collects Nebraska Lottery revenues.

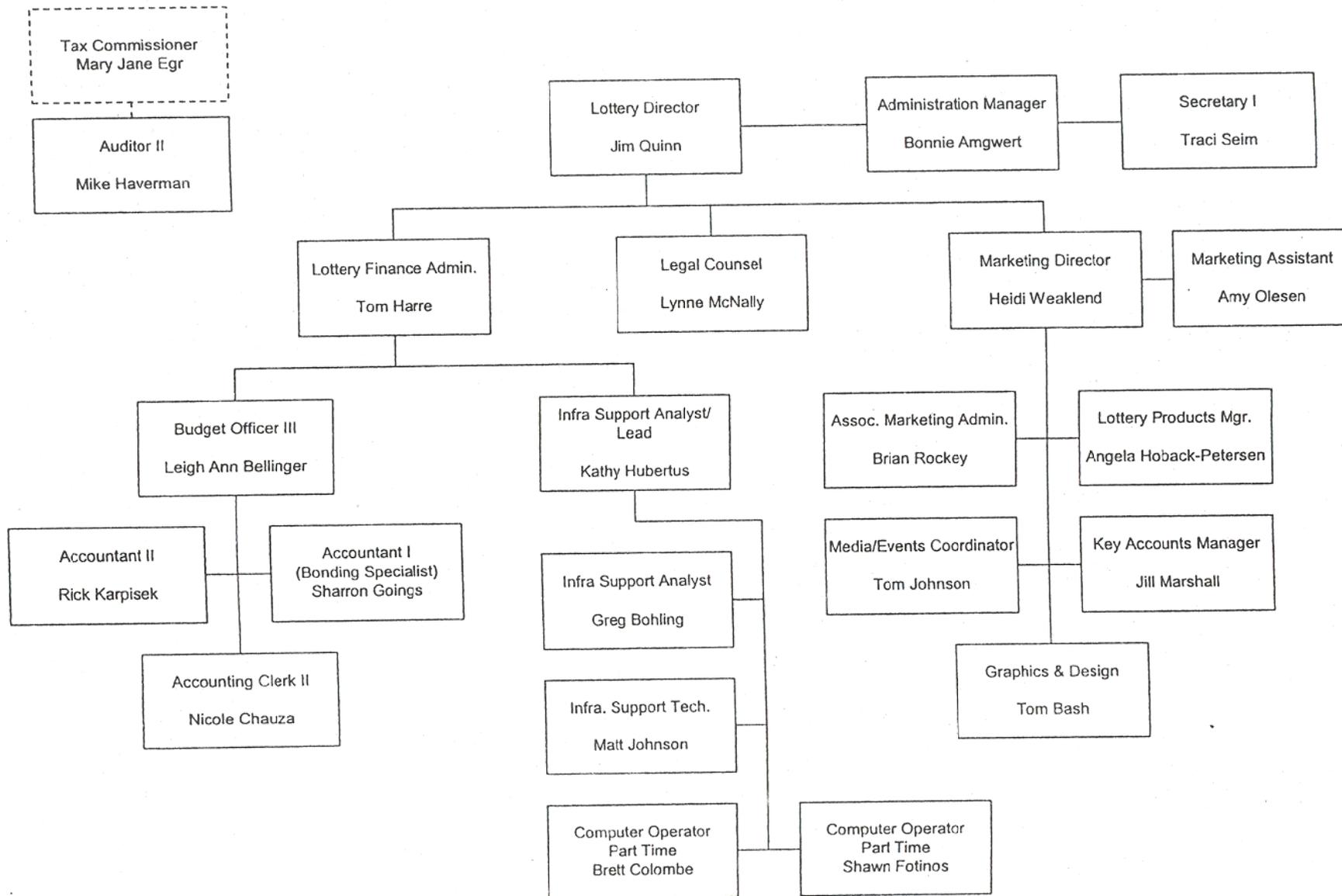
Currently, the Nebraska Lottery offers Powerball®, Pick5®, 2by2®, and instant games. The Rolldown® game was discontinued in April 2002.

Neb. Rev. Stat. Section 9-812(1) R.S.Supp., 2001 requires not less than forty percent of the dollar amount of lottery tickets sold be used for the payment of prizes. Nebraska Lottery retailers generally receive a five percent commission on their gross sales. Section 9-812(1) provides that at least twenty-five percent of Nebraska Lottery sales be divided as follows: (1) the first \$500,000 to the Compulsive Gamblers Assistance Fund, and thereafter (2) 49.5% to the Education Innovation Fund, (3) 49.5% to the Nebraska Environmental Trust Fund, and (4) 1.0% to the Compulsive Gamblers Assistance Fund.

MISSION STATEMENT

The Nebraska Lottery's mission is to offer winning opportunities to Nebraska citizens while maximizing dollars for Nebraska educational and environmental causes.

NEBRASKA LOTTERY
ORGANIZATIONAL CHARTS



NEBRASKA LOTTERY

SUMMARY OF COMMENTS

During our audit of the Nebraska Lottery, we noted certain matters involving the internal control over financial reporting and other operational matters which are presented here. Comments and recommendations are intended to improve the internal control over financial reporting, ensure compliance, or result in operational efficiencies.

1. ***Disaster Recovery Plan:*** No documented plan for testing the Nebraska Lottery's Disaster Recovery Plan for the Nebraska Lottery computer systems was completed and no documentation of disaster recovery plan testing was available as required by the Nebraska Lottery's Disaster Recovery Plan.
2. ***Meal and Lodging Reimbursements:*** We noted a portion of meal receipts submitted for reimbursement were not detailed, employees were reimbursed for meals in excess of the daily federal per diem amount, and employees had claimed in excess of the federal per diem rate for lodging.
3. ***Documentation for Destroyed Instant Game Tickets:*** Instant (Scratch) tickets remaining after the close of 25 games were destroyed with out documentation of the destruction being maintained.
4. ***Restricted Players:*** The Restricted Social Security Number List was not updated in a timely manner as required by Lottery Policy L-003.

More detailed information on the above items is provided hereafter. It should be noted this report is critical in nature since it contains only our comments and recommendations on the areas noted for improvement.

Draft copies of this report were furnished to the Nebraska Lottery to provide them an opportunity to review the report and to respond to the comments and recommendations included in this report. All formal responses received have been incorporated into this report. Responses have been objectively evaluated and recognized, as appropriate, in the report. Responses that indicate corrective action has been taken were not verified at this time but will be verified in the next audit.

We appreciate the cooperation and courtesy extended to our auditors during the course of the audit.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

1. Disaster Recovery Plan

Good internal control over information systems requires testing related to training and maintenance of a disaster recovery plan. The Nebraska Lottery disaster recovery plan (Plan) requires a comprehensive test plan be developed. The Plan requires an overall testing program to be defined and a schedule of tests to be developed. The Plan requires written reports to document testing and the maintenance of a test log to document which parts of the Plan have been tested. Testing to be performed should include tests to ensure recovery procedures are complete and workable, materials and data are available and usable for alternate processing, backup software, documentation, and data are adequate and current, and personnel are suitably trained. Written reports of testing shall be compiled and include the date of test, description of areas tested, results, and recommendations. The Plan requires an annual review of disaster recovery plan testing.

During our review of the Nebraska Lottery's computer systems, we noted no plan for disaster recovery plan testing had been developed. Although Nebraska Lottery staff noted disaster recovery plan testing was done on an ongoing basis, there was no documentation available to support this testing. Without proper documentation of testing, we were unable to verify the disaster recovery plan procedures would be adequate in the case of a disaster.

We recommend the Nebraska Lottery develop a plan for testing their disaster recovery plan and review the test work completed on at least an annual basis to comply with their disaster recovery plan and to ensure procedures are suitable and working. Documentation of the testing should be maintained and include the date of testing, description of areas tested, test results, and recommendations.

Nebraska Lottery's Response: The first priority during the fiscal year was the conversion from vendor SGI to vendor GTECH for scratch tickets. Emphasis was placed on acceptance testing, systems modifications and disaster recovery planning at the vendor site to insure a smooth conversion for the retailer clients that would permit and encourage continued strong sales and provide the necessary information tracking and reporting through the vendor's systems. The vendor's system is the operating system that allows the processing, storage and reporting of sales, ticket shipments, validations and EFT transactions for all retailer activity. Important but less critical during fiscal 2002 was the need for full disaster recovery planning, testing and documentation at the lottery site.

The Lottery agrees with the recommendation and will proceed with continued development.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

2. Meal and Lodging Reimbursements

We tested 12 travel expense reimbursements for a total of \$23,218. Nebraska Lottery had \$88,619 in travel disbursements for the fiscal year. We noted the following related to meal and lodging reimbursements.

Meal Reimbursements

The Internal Revenue Service (IRS) requires employees to substantiate the cost of meals under an accountable plan. Adequate accounting requires the use of a log or receipts to document actual expenses. This is the guideline set forth by DAS as of December 15, 2000. Good internal control requires detailed receipts of meals claimed to ensure amounts claimed are correct and do not contain more than the number of meals claimed or alcoholic beverages. The Nebraska Accounting System Manual, Concept 5, states that no reimbursement shall be made for alcoholic beverages. Nebraska Department of Revenue Policy No. 200 followed by the Nebraska Lottery provides the framework for all travel expenditures of Lottery employees. The Revenue policy does not allow reimbursement for those meals provided by a conference and/or hotel/motel. Nebraska Lottery requires receipts to be provided for all meals.

During our review of meal reimbursements, we noted the following:

- On five of twelve documents tested, we noted a portion of the receipts submitted for reimbursement were not detailed. The receipts, which were not detailed, consisted of credit card receipts and restaurant stubs. These receipts did not list the detail of the meal claimed.
- One employee was reimbursed for two breakfast meals when breakfast was provided by the conference attended.
- One employee appeared to be claiming the daily federal per diem amount for meals. The expense reimbursement document noted \$42 per day for 5 days. We further noted three additional employees exceeding the federal per diem amount on three separate trips. The first employee exceeded the daily per diem amount by a total of \$52.61 for four days when traveling to a conference in Washington D.C. The federal per diem for Washington D.C. was \$46 per day. The second employee exceeded the daily per diem amount by a total of \$14.09 for two days when traveling to Williamsburg, VA. The federal per diem amount was \$38 per day. The third employee exceeded the federal daily per diem amount by \$6 on one day when traveling to San Diego, CA. The federal per diem amount was \$46 per day.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

2. Meal and Lodging Reimbursements (Continued)

- One employee was reimbursed for two meals but did not provide receipts.
- Tips for one employee's trip were coded incorrectly. They were coded to account 4751 – Miscellaneous Travel Expense rather than 4711 – Board and Lodging Expense.

Without an adequate review to ensure meal reimbursements are reasonable and accurate the risk the Nebraska Lottery will pay unreasonable and unsubstantiated meal expenses increases.

We recommend the Nebraska Lottery review its current travel policy regarding documentation for meal reimbursements. Detailed receipts should be obtained and reviewed by the Nebraska Lottery to ensure reimbursements are allowable. We further recommend all reimbursements be reviewed to ensure meals are not reimbursed when provided by the conference or hotel/motel, detailed receipts are submitted for payment, expenses are correctly coded, and the daily federal per diem amounts are not exceeded. Performing a detailed analysis of expense reimbursement documents will ensure all reimbursements are accurate and correct.

Lodging Reimbursements

Good internal control requires procedures to ensure lodging expenses are reasonable and economical for the Nebraska Lottery.

We noted two employees attended an instant ticket print in San Antonio, Texas and incurred lodging expenses in excess of the federal per diem rate. The federal per diem rate for San Antonio, Texas was \$91 per night while the employees claimed \$109. The difference in rates was \$18 per night for five nights, a total of \$90. The costs of travel associated with observing ticket prints are reimbursed to the Nebraska Lottery by their instant ticket vendor GTECH.

Without proper procedures to ensure the Nebraska Lottery does not reimburse employees in excess of the federal per diem rate, the risk the Nebraska Lottery will pay unreasonable lodging expenses increases.

We recommend the Nebraska Lottery review lodging rates to ensure they are within the federal per diem rates. Whenever possible the federal per diem rate for lodging should not be exceeded.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

2. Meal and Lodging Reimbursements (Concluded)

Nebraska Lottery's Response: All expense reimbursements are reviewed for reasonableness and appropriateness as a State expense and for compliance with the Department of Revenue policy. Some of the travel expenses, including meals and lodging expenses, are reimbursed per contract by the instant ticket vendor. Meal expense in excess of government per diem guidelines are reviewed for reasonableness based on the facts of the situation and the total meal cost for the trip. If meal costs exceed the federal per diem guideline, the required receipts have been provided. Some of the required meal receipts have not been detailed. Detailed receipts are not required by policy.

The Nebraska Lottery will review its current travel policy and continue to review lodging requests and meal reimbursement requests for compliance with Revenue Department policy.

3. Documentation for Destroyed Instant Game Tickets

Good internal control requires documentation be maintained for the destruction of instant (scratch) tickets when tickets for closed games are destroyed. Nebraska Lottery's policy regarding the destruction of instant game tickets provides procedures to be completed when destroying instant ticket inventory. The procedures include noting the destruction method on the ticket inventory reports, obtaining signatures of those assisting with ticket inventory of tickets to be destroyed, and a letter certifying the destruction of tickets. The results of the destruction are to be forwarded to the Lottery Director.

Beginning July 1, 2001, Nebraska Lottery changed their instant ticket vendor from Scientific Games International (SGI) to GTECH. During implementation of the new instant ticket system all instant tickets for closed games of SGI were destroyed. We noted 25 SGI games with instant tickets remaining after the close of the game. These instant tickets were destroyed but no documentation of destruction was maintained.

Without adequate documentation of instant (scratch) ticket destruction the risk of tickets being inappropriately accounted for increases.

We recommend documentation be maintained when any instant (scratch) game tickets are destroyed. The Nebraska Lottery should follow their ticket destruction policy when tickets remaining for closed games are destroyed. The reason for destruction, the disposition, and signatures of those present during destruction should be documented and a letter certifying destruction should be issued.

NEBRASKA LOTTERY

COMMENTS AND RECOMMENDATIONS

3. Documentation for Destroyed Instant Game Tickets (Concluded)

Nebraska Lottery's Response: The ticket destruction policy has been followed with the exception of those tickets destroyed after the switch from SGI to GTECH for instant tickets. Since the SGI tickets in question could not be validated on the GTECH system a financial exposure did not exist.

Future exceptions to the policy, if any, will be documented to show the reason for the exception.

4. Restricted Players

Neb. Rev. Stat. Section 9-810(2) R.R.S. 1997 prohibits the sale to and awarding of lottery prizes to the Tax Commissioner, Lottery director, and any employee of the Nebraska Lottery including members of the employee's household. Nebraska Lottery Policy Number L-003 further prohibits all employees of major Nebraska Lottery contractors who provide service on the Nebraska Lottery Account and persons residing in their households from playing the Nebraska Lottery. Nebraska Lottery Policy Number L-003 also requires the Lottery Systems Manager to maintain a listing of social security numbers of all Nebraska Lottery and major contractor employees and persons residing in their homes. The listing shall be updated on a quarterly basis.

The Nebraska Lottery Restricted Social Security Numbers listing was not updated in a timely manner as required by Nebraska Lottery Policy Number L-003. We were unable to determine the last time the list had been updated. We noted changes in status, of which the Nebraska Lottery had been notified in November 2000, had not been made as of July 17, 2002. We determined four Auditor of Public Accounts employees and 60 prior employees of contractors were not removed from the listing in a timely manner.

When the Restricted Social Security Numbers listing is not updated in a timely manner the risk of eligible players not being able to cash tickets or ineligible players being able to cash tickets is greater.

We recommend the Nebraska Lottery implement procedures to review the Restricted Social Security Numbers list on a quarterly basis to comply with their policy and ensure the listing is complete and accurate.

Nebraska Lottery's Response: The restricted players list must be kept accurate. Newly determined restricted players have been added on a timely basis and adding new restricted players to the list is the more critical step. The delay in removing names and social security numbers from the list does not create a financial exposure but it does create a potential public relations concern. A process will be put in place to insure timely updates of the restricted player list.

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NEBRASKA LOTTERY

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We have audited the accompanying financial statements of the business type activities of the Nebraska Lottery, as of and for the year ended June 30, 2002, which collectively comprise the Nebraska Lottery's basic financial statements as listed in the Table of Contents. These financial statements are the responsibility of the Nebraska Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As discussed in Note 1, the financial statements of the Nebraska Lottery, a division of the Nebraska Department of Revenue, are intended to present the financial position, results of operations, and cash flows of the State of Nebraska that is attributable to the transactions of the Nebraska Lottery. They do not purport to, and do not, present fairly the financial position of the State of Nebraska as of June 30, 2002, and its results of operations, and cash flows for the year then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the business-type activities of the Nebraska Lottery, as of June 30, 2002, and the respective changes in financial position and cash flows thereof for the year then ended in conformity with accounting principles accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 3, 2002, on our consideration of the Nebraska Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Nebraska Lottery's basic financial statements. The schedules are presented for purposes of additional analysis and are not a required part of the basic financial statements. The schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Handwritten signature of Timothy J. Channer CPA in black ink.

Assistant Deputy Auditor

October 3, 2002

NEBRASKA LOTTERY
STATEMENT OF NET ASSETS
JUNE 30, 2002

ASSETS:

CURRENT ASSETS

Cash and Cash Equivalents		\$ 7,070,423
Accounts Receivable, Net of Allowance (Note 3)		3,629,022
Prepaid Prizes		187,540
Prepaid Contract Cost - Instant		144,202
Reserves on Deposit (Note 6)		23,565
TOTAL CURRENT ASSETS		<u>11,054,752</u>

NON CURRENT ASSETS

Reserves on Deposit (Note 6)		2,434,504
Furniture, Fixtures, and Equipment (Note 2)	443,905	
Less: Accumulated Depreciation	<u>334,867</u>	
Capital Assets, Net		<u>109,038</u>
TOTAL NON CURRENT ASSETS		<u>2,543,542</u>

TOTAL ASSETS

13,598,294

LIABILITIES

CURRENT LIABILITIES

Accounts Payable		239,341
Vendors Payable		479,094
Compensated Absences Payable		141,735
Accrued Payroll Payable		50,438
Withheld Taxes on Prizes Paid		18,940
Prize Payable		3,177,343
Due to Other Funds		928,560
Other Accrued Liabilities		56,386
TOTAL CURRENT LIABILITIES		<u>5,091,837</u>

TOTAL LIABILITIES

5,091,837

NET ASSETS

Invested in Capital Assets	109,038	
Restricted for Future Prizes	2,458,069	
Unrestricted (Note 8)	<u>5,939,350</u>	
TOTAL NET ASSETS		<u>\$ 8,506,457</u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

NEBRASKA LOTTERY
STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
 FOR THE YEAR ENDED JUNE 30, 2002

OPERATING REVENUE:

Sales		\$ 74,813,473
Less: Sales Returns		856,564
TOTAL OPERATING REVENUE		<u>73,956,909</u>

OPERATING EXPENSES:

Prize Expense	39,449,981	
Retailer Commissions	4,270,052	
Contractual Services Expense	7,900,723	
Marketing	2,737,551	
Lottery Operating	<u>1,774,808</u>	
TOTAL OPERATING EXPENSES		<u>56,133,115</u>

OPERATING INCOME 17,823,794

NON-OPERATING REVENUE

Interest Income	494,279	
Multi-State Lottery Association Income	<u>145,975</u>	
TOTAL NON-OPERATING REVENUE		<u>640,254</u>

INCOME BEFORE OPERATING TRANSFERS 18,464,048

TRANSFERS TO OTHER FUNDS (18,485,474)

CHANGE IN NET ASSETS (21,426)

TOTAL NET ASSETS, BEGINNING OF YEAR 8,527,883

TOTAL NET ASSETS, END OF YEAR \$ 8,506,457

NEBRASKA LOTTERY
STATEMENT OF CASH FLOWS
For the Year Ended June 30, 2002

CASH FLOWS FROM OPERATING ACTIVITIES:

Ticket Sales	\$ 73,094,639	
Prizes Paid to Winners	(39,879,716)	
Commissions Paid to Retailers	(4,271,218)	
Paid to Contractors for Goods and Services	(10,808,673)	
Paid to Employees	(1,232,489)	
Other Operating Expenses	(457,901)	
POWERBALL® Grand Prize Winner Receipts from MUSL	5,030,000	
Payments to POWERBALL® Grand Prize Winners	(5,030,000)	
Reserves on Deposit	363,069	
Advances for Vendors	24,830	
Prepaid Prize Expense	<u>(21,030)</u>	
Net Cash Provided by Operating Activities		\$ 16,811,511

CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES:

Paid to Education Innovation Fund	(8,779,297)	
Paid to Environmental Trust Fund	(8,779,296)	
Paid to Compulsive Gamblers Assistance Fund	<u>(677,360)</u>	
Net Cash Used in Non-capital Financing Activities		(18,235,953)

CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES:

Purchase of Property and Equipment		(25,605)
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CASH FLOWS FROM INVESTING ACTIVITIES:

Interest on Cash	494,279	
Multi-State Lottery Association Income	<u>105,365</u>	
Net Cash Provided by Investment Activities		<u>599,644</u>

NET DECREASE IN CASH AND CASH EQUIVALENTS

(850,403)

CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR

7,920,826

CASH AND CASH EQUIVALENTS AT END OF YEAR

\$ 7,070,423

**RECONCILIATION OF OPERATING INCOME TO
NET CASH PROVIDED BY OPERATING ACTIVITIES:**

Operating Income		\$ 17,823,794
Adjustments to Reconcile Income from Operations to Net Cash Provided by Operating Activities:		
Reserves on Deposit		363,069
Prepaid Prize Expense		(21,030)
Advances for Vendors		24,830
Depreciation		70,826
Changes in Assets and Liabilities:		
(Increase) Decrease in:		
Accounts Receivable (Net)		(876,345)
Advance Sales		9,038
Accounts Payable and Accrued Liabilities		(233,036)
Prizes Payable		(374,470)
Compensated Absences Payable		<u>24,835</u>
Net Cash Provided by Operating Activities		<u><u>\$ 16,811,511</u></u>

The accompanying Notes to the Financial Statements are an integral part of this statement.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

A. **Basis of Presentation**

The accompanying financial statements of the Nebraska Lottery have been prepared in conformance with generally accepted accounting principles (GAAP) as applied to governmental units. As the Nebraska Lottery is a business type activity, the financial statements are in the format of fund financial statements as required by Governmental Accounting Standards Board (GASB) Statement Number 34. The GASB is the accepted standard-setting body for establishing governmental accounting and financial reporting principles.

The financial statements have been prepared primarily from data maintained by the Nebraska Lottery on computer systems provided by the instant and on-line games vendor, and from accounts maintained by the State Accounting Administrator of the Department of Administrative Services.

B. **Reporting Entity**

The Nebraska Lottery was established on February 24, 1993, by the Nebraska Legislature as a division of the Nebraska Department of Revenue, which is a State agency established under and governed by the laws of the State of Nebraska. As such, the Nebraska Lottery is exempt from State and Federal income taxes. The Nebraska Lottery is to provide an instant win and a random number selection on-line lottery. The net proceeds as outlined in Neb. Rev. Stat. Section 9-812 R.S.Supp., 2001, are to be used for education, the environment, and compulsive gamblers assistance. The financial statements include only the Nebraska Lottery and are not intended to present the financial position of the Nebraska Department of Revenue or the results of operations and changes in fund balance of the Department as a whole. The Nebraska Department of Revenue is part of the primary government for the State of Nebraska.

The Nebraska Lottery has also considered all potential component units for which it is financially accountable, and other organizations, which are fiscally dependent on the Nebraska Lottery, or the significance of their relationship with the Nebraska Lottery, are such that exclusion would be misleading or incomplete. GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) the ability of the Nebraska Lottery to impose its will on that organization or (2) the potential for the organization to provide specific benefits to, or impose specific burdens on the Nebraska Lottery. No component units were identified.

C. **Basis of Accounting, Measurement Focus**

Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported in the financial statements. Basis of accounting relates to the timing of the measurements made, regardless of the measurement focus applied.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

1. Summary of Significant Accounting Policies (Continued)

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. The Nebraska Lottery is accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation of the Nebraska Lottery are included on the Statement of Net Assets. Fund equity (i.e., net total assets) is segregated into restricted and unrestricted net assets. The Nebraska Lottery's operating statements present increases (e.g., revenues) and decreases (e.g., expenses) in net total assets.

The Nebraska Lottery is accounted for using the accrual basis of accounting. Revenues are recognized when they are earned and expenses are recognized when they are incurred. Instant ticket revenue is recognized when tickets are sold to the retailer and on-line revenue is recognized after the drawing is completed for the respective wagers. A 5% retailer commission and prize expense are recognized at the same time. Revenues from the sale of on-line tickets for future drawings and the related agent commission and prize expense are deferred until the drawings are held.

Revenues generated from the sale of lottery tickets are reported as operating revenues. Transactions which are capital financing, non-capital financing, or investing related are reported as non-operating revenues. All expenses related to operating the Nebraska Lottery are reported as operating expense. All other expenses are reported as non-operating expenses.

Prize expense is recognized in the same period ticket revenue is recognized based on the predetermined prize structure for each game. Since the instant prize winning tickets are randomly distributed throughout the tickets and since some winning tickets will be lost, destroyed, or unredeemed for other reasons, there will be differences between amounts accrued and the amounts actually paid. These differences, denoted as unclaimed prizes, are recognized as a reduction of prize expense 181 days after the end of each instant game and 181 days after each draw for on-line games as prizes unclaimed for 180 days expire.

In September 1993, GASB issued Statement No. 20, "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting." This Statement is effective for financial statement periods beginning after December 15, 1993. As permitted by the Statement, the Nebraska Lottery has elected not to adopt Financial Accounting Standards Board (FASB) statements and interpretations issued after November 30, 1989, unless GASB specifically adopts such FASB statements or interpretations.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

1. Summary of Significant Accounting Policies (Continued)

D. Fund Accounting

The activities of the Nebraska Lottery are accounted for as an enterprise fund. Enterprise funds are used to account for governmental operations that are financed and operated in a manner similar to private business enterprises and where the governing body has decided that periodic determination of revenues earned, expenses incurred, and net assets is appropriate.

E. Cash

All cash is held by the Nebraska State Treasurer. These funds are held in pooled accounts and accordingly are not categorized as to credit risk as defined by GASB Statement No. 3. Investment of all available cash is made by the State Investment Officer on a daily basis based on total bank balances. Interest on funds held by the State Treasurer is periodically distributed to the participating agencies. These funds are considered to be cash and cash equivalents, which are defined as investments with maturities of three months or less.

F. Budgetary Process

The State's biennial budget cycle ends on June 30 of the odd-numbered years. By September 15, prior to a biennium, the Nebraska Lottery and all other State agencies must submit their budget request for the biennium beginning the following July 1. The requests are submitted on forms that show estimated funding requirements by programs, sub-programs, and activities. The Executive Branch reviews the requests, establishes priorities, and balances the budget within the estimated resources available during the upcoming biennium.

The Governor's budget bill is submitted to the Legislature in January. The Legislature considers revisions to the bill and submits the revised appropriation bill to the Governor for signature. The Governor can either: a) approve the appropriation bill in its entirety, b) veto the bill, or c) line item veto certain sections of the bill. Any vetoed bill or line item can be overridden by a three-fifths vote of the Legislature.

The appropriations that are approved will generally set spending limits for a particular program. Within the program, the Legislature may provide funding from one or more budgetary fund types. Thus, the control is by fund type, within a program, within an agency. The central accounting system maintains this control. A separate publication titled "Annual Budgetary Report" shows the detail of this level of control. The publication is available from the Department of Administrative Services Accounting Division.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

1. Summary of Significant Accounting Policies (Concluded)

All State budgetary expenditures for the enterprise fund type are made pursuant to the appropriations in the annual budget, as amended from time to time by budget amendments. The Tax Commissioner may allocate the appropriations between the major object of expenditure accounts except that the Legislature's approval is required to exceed the personal service limitations contained in the appropriations bill.

G. Compensated Employee Absences

All permanent employees earn sick and annual leave and are allowed to accumulate compensatory leave rather than being paid overtime. Temporary and intermittent employees are not eligible for paid leave. State employees accrue vested annual leave at a variable rate based on years of service. Generally, accrued annual leave cannot exceed 35 days at the end of a calendar year. Employees accrue sick leave at a variable rate based on years of service. In general, accrued sick leave cannot exceed 180 days. In general, there is no maximum limit on the accumulation of sick days for employees under a labor contract. Sick leave is not vested except upon death or upon reaching the retirement age of 55, at which time the State is liable for 25 percent of the employees accumulated sick leave. Generally, employees under labor contracts can be paid for a maximum of 50 days. In accordance with GASB 16, the compensated absence liability is increased for accumulated sick leave for employees who are expected to become eligible in the future.

The Nebraska Lottery recognizes the expense and accrued liability when vacation and sick leave are expected to be paid as termination payments.

2. Capital Assets

A summary of the activity in the capital assets accounts during the period July 1, 2001 through June 30, 2002 is as follows:

Balance July 1, 2001	\$	418,301
Additions Fiscal 2001/2002		25,604
Removals Fiscal 2001/2002		-
Less Prior Accumulated Depreciation		(264,041)
Less Current Depreciation		<u>(70,826)</u>
Balance June 30, 2002	\$	<u>109,038</u>

Capital assets acquired or constructed for the Nebraska Lottery and costing in excess of \$1,500 were capitalized and depreciated. Assets costing \$1,500 or less were expensed in the period purchased. Depreciation of equipment is provided using the straight-line method over a period of three to seven years depending on the estimated useful life of individual items.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

3. Accounts Receivable

Retailers comprised principally of grocery stores, convenience stores, and off sale liquor stores serve as the primary distribution channel for lottery sales to the general public. No one retailer accounts for a significant amount of the Nebraska Lottery's sales or accounts receivable. Retailers must pay for instant lottery tickets 45 days after activation or when pack is 75% sold whichever comes first. Retailers pay for on-line tickets each Wednesday for balances due through the previous Saturday.

Accounts Receivable:	
Retailers (net)	\$ 3,159,809
Other	<u>469,213</u>
Total	<u>\$ 3,629,022</u>

4. State Employees' Retirement System

The Retirement System for State Agencies is a single-employer defined contribution plan administered by the Public Employees Retirement Board in accordance with the provisions of the State Employees Retirement Act. In the defined contribution plan, retirement benefits depend upon total contributions, age at retirement, investment earnings, and the investment options selected. Prior to April 18, 2002, membership in the System is mandatory for all permanent full-time employees on reaching the age of thirty and completion of twenty-four months of continuous service. Full time employee is defined as an employee who is employed to work one-half or more of the regularly scheduled hours during each pay period. Voluntary participation is permitted for all permanent full-time or permanent part-time employees upon reaching age twenty and twelve months of service within a five year period. Any individual appointed by the Governor may elect not to become a member of the retirement system. Legislative Bill 687 (2002), effective April 18, 2002, stated all permanent full-time employees shall begin participation in the plan upon completion of twelve continuous months of service. The plan provisions are established under State Statute and may be amended through legislative action.

Employees contributed 4.33% of their compensation until such time as they have paid during any calendar year a total of \$864, after which time they contribute 4.8% of their compensation for the remainder of the calendar year. The Nebraska Lottery matches the employee's contribution at a rate of 156% of the employee's contribution. The contribution rates are established by State Statute and may be amended through legislative action. The employee's account is fully vested. The employer's account is vested 100% after five years of participation in the plan (prior to April 18, 2002) or at retirement. Legislative Bill 687 (2002), effective April 18, 2002, changed the vesting requirement to a total of three years of participation in the system, which includes the twelve-month eligibility period or credit for participation in another governmental plan prior to actual contribution to the Plan.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

4. State Employees' Retirement System (Concluded)

For the fiscal year ended June 30, 2002, employees contributed \$41,948 and the Nebraska Lottery contributed \$65,439.

5. Risk Management

The Nebraska Lottery is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Nebraska Lottery as part of the primary government for the State participates in the State's risk management program. The Nebraska Department of Administrative Services (DAS) Division of Risk Management is responsible for maintaining the insurance and self insurance programs for the State. The State generally self-insures for general liability and workers compensation. The State has chosen to purchase insurance for:

- A. Motor vehicle liability which is insured for the first \$5 million of exposure per accident. Insurance is also purchased for medical payments, physical damage and uninsured and underinsured motorists with various limits and deductibles.
- B. The DAS-Personnel Division maintains health care and life insurance for eligible employees.
- C. Crime coverage with a limit of \$1 million for each loss with a \$10,000 retention per incident.
- D. Real and personal property on a blanket basis for losses up to \$250,000,000 with a self-insured retention of \$200,000 per loss occurrence. Newly acquired properties are only covered up to \$1,000,000 for 60 days or until the value of the property is reported to the insurance company. The perils of Flood and Earthquake are covered up to \$10,000,000.
- E. State agencies have the option to purchase building contents and inland marine coverage.

No settlements exceeded commercial insurance coverage in any of the past three fiscal years. Health care insurance is funded in the Compensation Insurance Trust Fund through a combination of employee and State contributions. Workers compensation is funded in the Workers Compensation Internal Service Fund through assessments on each agency based on total agency payroll and past experience. Tort claims, theft of, damage to, and destruction of assets, errors and omissions, and natural disasters would be funded through the State General Fund or by individual agency assessments as directed by the Legislature, unless covered by purchased insurance. No amounts for estimated claims have been reported in the Nebraska Lottery's financial statements.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

5. Risk Management (Concluded)

Litigation. The potential amount of liability involved in litigation pending against the Nebraska Lottery, if any, could not be determined at this time. However, it is the Nebraska Lottery’s opinion that final settlement of those matters should not have an adverse effect on the Nebraska Lottery’s ability to administer current programs. Any judgment against the Nebraska Lottery would have to be processed through the State Claims Board and be approved by the Legislature.

6. On-Line Games

During the fiscal year ending June 30, 2002, the Nebraska Lottery offered a variety of on-line games as described in the following table.

Game Name	Operated by	Nebraska’s Share of Prize Reserves
POWERBALL®	MUSL	\$ 2,433,691
NEBRASKA PICK 5®	Nebraska Lottery	n/a
ROLLDOWN®	MUSL	23,565
2by2 ®	MUSL	813
		\$ 2,458,069

The amount of Reserve on Deposit shown as a current asset is the RollDown® prize reserve. The RollDown® game ended April 6, 2002. The prize reserve funds are refundable after the game has been closed for one year. The remainder of the Nebraska Lottery’s share of prize reserves is shown as a noncurrent asset as those funds cannot be refunded to the Nebraska Lottery in the next fiscal year.

The Nebraska Lottery is a member of the Multi-State Lottery Association (MUSL) which operates games on behalf of participating state lotteries. Each MUSL member sells on-line game tickets through its agents and makes weekly payments to MUSL in an amount equal to each game’s prize structure, less amounts retained for prizes paid directly to the winners by each member lottery. MUSL maintains prize reserve funds on each game to serve as a contingency reserve to protect from unforeseen prize liabilities. The money in these reserve funds are to be used at the discretion of the MUSL Board of Directors. The prize reserve funds are refundable to MUSL members if MUSL disbands or if a member leaves MUSL. Members leaving MUSL must wait one year before receiving their remaining share of the prize reserve funds.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

6. On-Line Games (Concluded)

The Powerball grand prize can be paid either as annual installments or a lump sum cash payment, depending on the selection of the winner when claiming the prize. If the winner selects annual installments, MUSL purchases bonds which are held in trust to fund the future installments. Maturities are staggered in order to provide adequate cash flow for each installment. MUSL is responsible for paying amounts owed to the grand prize winners. The assets and related liabilities are reflected in MUSL's financial statements and, therefore, are not reflected in the Nebraska Lottery's financial statements.

7. Significant Compliance Requirements

Neb. Rev. Stat. 9-812 R.S.Supp., 2001 requires at least twenty-five percent of the dollar amount of the lottery tickets which have been sold on an annualized basis to be transferred to the beneficiary funds. Of the money remaining after the payment of prizes and operating expenses; the first five hundred thousand dollars shall be transferred to the Compulsive Gamblers Assistance Fund. Thereafter, forty-nine and one-half percent shall be transferred to the Education Innovation Fund, forty-nine and one-half percent shall be transferred to the Nebraska Environmental Trust Fund, and one percent shall be transferred to the Compulsive Gamblers Assistance Fund.

Of the funds transferred to the Education Innovation Fund, for fiscal years 2002 and 2003, the Education Innovation Fund shall be allocated up to one million five hundred thousand dollars per fiscal year for distance education network completion grants. The remaining funds, after operating expenses for the Excellence in Education Council are deducted, shall be transferred by the Nebraska Department of Education to the State's general fund.

2002 Special Session LB 1, Section 8, passed during the August 2002 Special Session, requires the State Treasurer to transfer a portion of the funds received by the Nebraska Environmental Trust Fund to the Nebraska Department of Natural Resources Interstate Water Rights Cash Fund and to the Low-Level Radioactive Waste Cash Fund.

The Nebraska Lottery develops game structures to comply with the minimum prize provision of its enabling legislation which requires a minimum of forty percent must be paid in prizes. Prizes are redeemable for 180 days after game end or applicable on-line drawing.

The Nebraska Lottery compares the social security number of each winner that has a per wager prize in excess of \$500 against a list of social security numbers having an outstanding State tax liability or delinquent child support payments. Any delinquent payments are withheld from winnings and forwarded to the appropriate State agency. During the fiscal year the Nebraska Lottery collected \$2,257 in delinquent State taxes and \$9,940 in delinquent child support payments.

NEBRASKA LOTTERY

NOTES TO FINANCIAL STATEMENTS

(Continued)

7. Significant Compliance Requirements (Concluded)

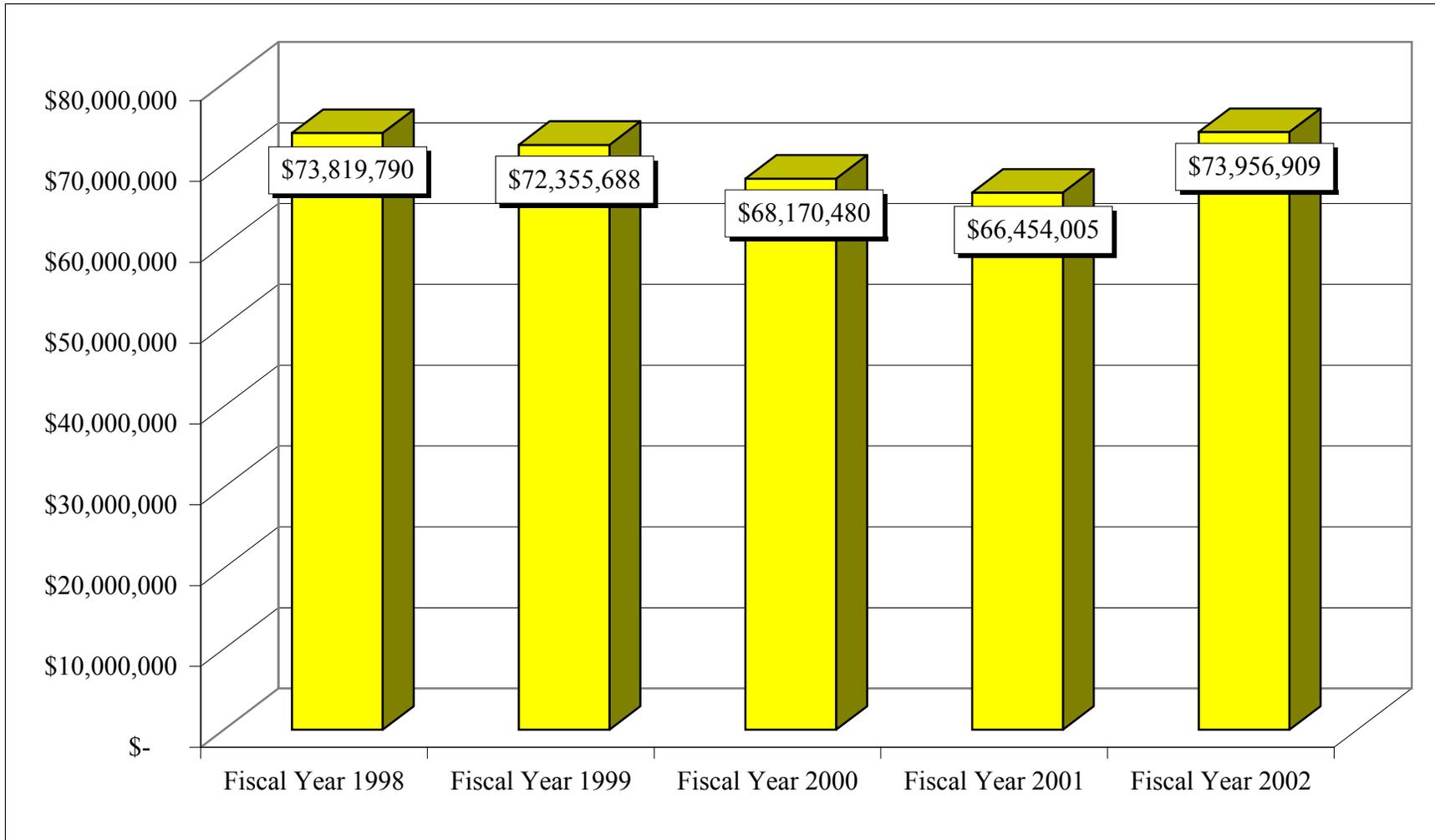
As required under its enabling legislation, transfers of \$18,235,953 had been made to other funds during the fiscal year. In addition to the above transfers, \$909,176 has been accrued as a current liability, Due to Other Funds, and will be included in future distributions.

Operating Transfers In/Out will not balance and Due To/From Other Funds will not balance, within the Nebraska Lottery's financial statements, as the Nebraska Lottery only represents part of the State's primary government.

8. Net Assets

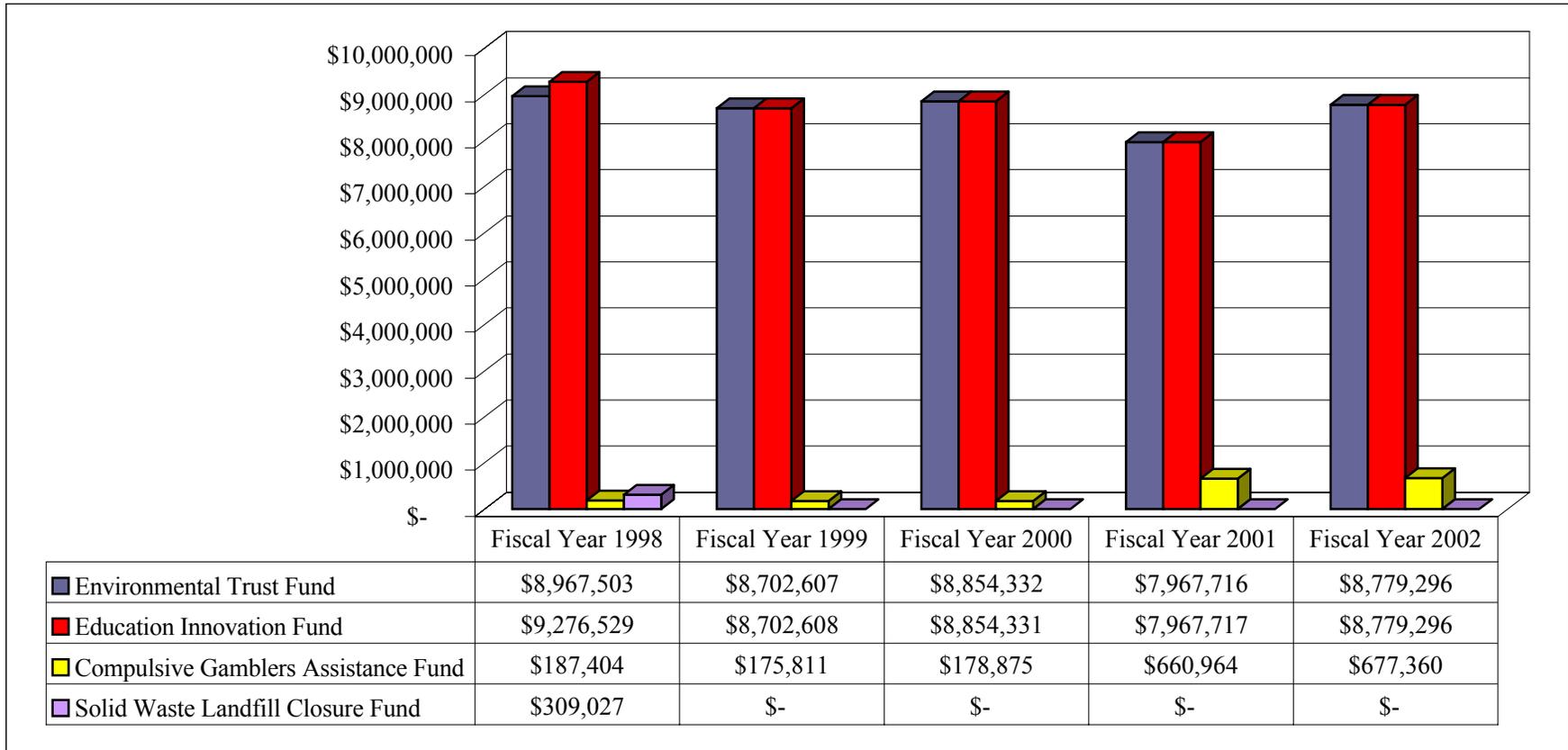
The Nebraska Lottery's unrestricted net assets represent funds not legally restricted for any specific purpose. The funds, however, may only be used to fund additional prize pay-outs, transfers to the beneficiary funds or additional operating expenses of the Nebraska Lottery. It is management's intention to use the unrestricted net assets to fund additional prize pay-outs, retailer incentives, and other game enhancements.

NEBRASKA LOTTERY
LOTTERY TICKET SALES
For the Fiscal Years 1998 through 2002



Note: These sales are shown on an accrual basis.

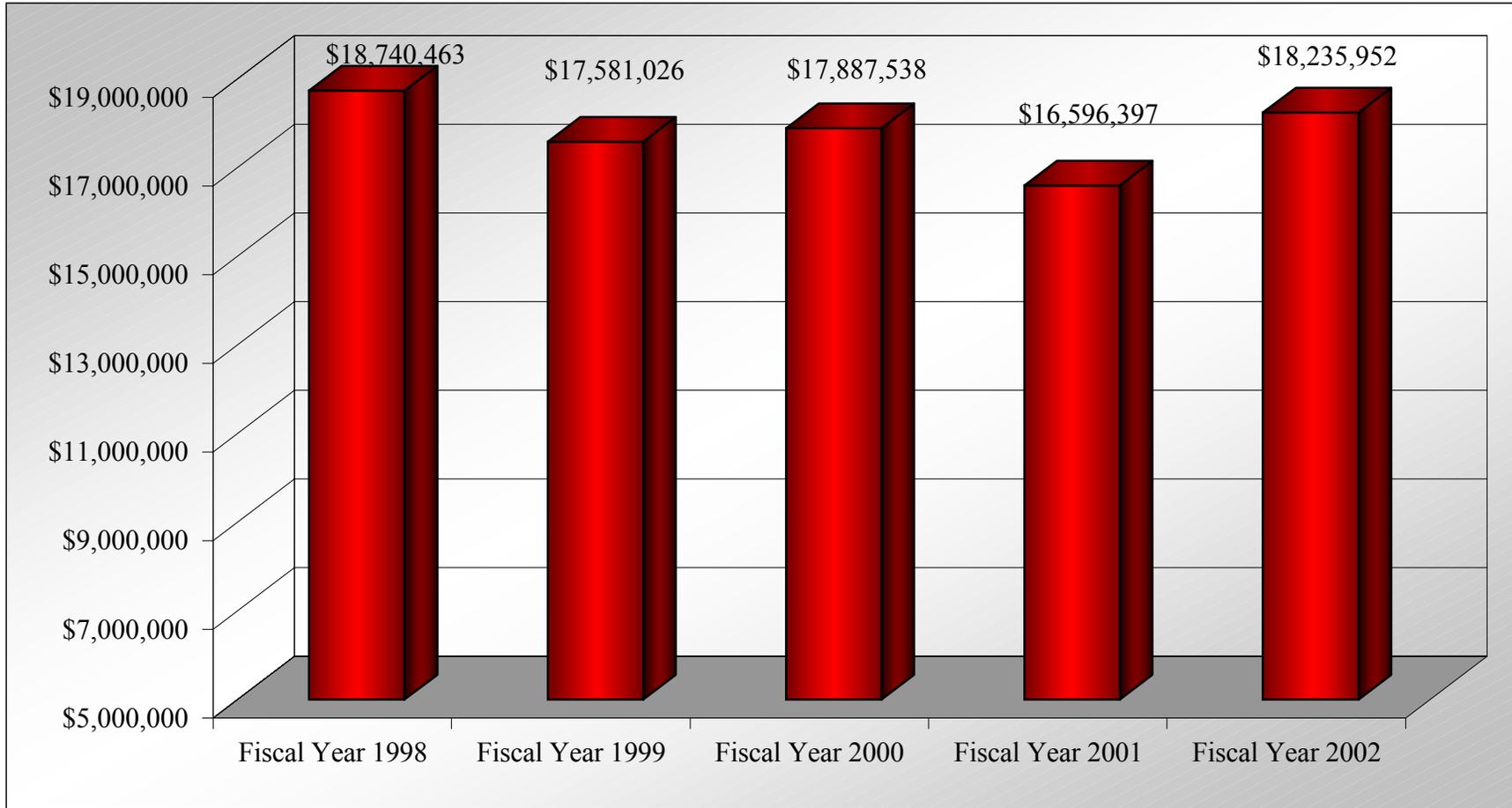
**NEBRASKA LOTTERY
OPERATING TRANSFERS**
For the Fiscal Years 1998 through 2002



Note 1: Beginning on July 15, 1993 and continuing through July 1, 1997, 24.5% shall be transferred to the Solid Waste Landfill Closure Assistance Fund, and 25% shall be transferred to the Nebraska Environmental Trust Fund. After July 1, 1997, 49.5% shall be transferred to the Nebraska Environmental Trust Fund.

Note 2: Effective July 13, 2000, the first \$500,000 was transferred to the Compulsive Gambler Assistance Fund. Thereafter, of the money remaining after the payment of prizes and operating expenses and the initial transfer to the Compulsive Gamblers Assistance Fund, 49.5% shall be transferred to the Nebraska Environmental Trust Fund, 49.5% shall be transferred to the Education Innovation Fund, and 1% shall be transferred to the Compulsive Gamblers Assistance Fund. These transfers are shown on a cash basis except for an adjustment of \$2,342,407 to the Environmental Trust Fund transfers. Fiscal Year 2001 was decreased and Fiscal Year 2000 was increased to better reflect the transfer in the year it relates to.

NEBRASKA LOTTERY
TOTAL OPERATING TRANSFERS
For the Fiscal Years 1998 through 2002



Note: The Total Operating Transfers include transfers to the Solid Waste Landfill Closure Fund, the Environmental Trust Fund, the Education Innovation Fund, and the Compulsive Gamblers Assistance Fund. These transfers are shown on a cash basis except for an adjustment of \$2,342,407 increasing the Fiscal Year 2000 transfer amount and decreasing the Fiscal Year 2001 transfer amount to better reflect the transfer in the year it relates to.

NEBRASKA LOTTERY
SCHEDULE OF CUMULATIVE OPERATING TRANSFERS

State Fiscal Year	Transfer Amount
1994	\$ 10,931,811
1995	19,308,170
1996	20,486,304
1997	23,363,387
1998	18,740,463
1999	17,581,026
2000	17,887,538
2001	16,596,397
2002	18,235,953
Total Cumulative Transfers	\$ 163,131,049

Note: Total Cumulative Transfers includes transfers to the Solid Waste Landfill Closure Fund, the Environmental Trust Fund, the Education Innovation Fund, and the Compulsive Gamblers Assistance Fund. These transfers are shown on a cash basis except for an adjustment of \$2,342,407 increasing the Fiscal Year 2000 transfer amount and decreasing the Fiscal Year 2001 transfer amount to better reflect the transfer in the year it relates to.

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NEBRASKA LOTTERY REPORT ON COMPLIANCE AND ON INTERNAL CONTROL OVER FINANCIAL REPORTING BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH GOVERNMENT AUDITING STANDARDS

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We have audited the financial statements of the Nebraska Lottery as of and for the year ended June 30, 2002, and have issued our report thereon dated October 3, 2002. The report was modified to emphasize that the financial statements present only the funds of the Nebraska 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.

Compliance

As part of obtaining reasonable assurance about whether the Nebraska Lottery's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*. We noted a certain immaterial instance of noncompliance that we have reported to the management of the Nebraska Lottery in the Comments Section of this report as Comment Number 4 (Restricted Players).

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Nebraska Lottery's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our

consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to the management of the Nebraska Lottery in the Comments Section of this report as Comment Number 2 (Meal and Lodging Reimbursements), Comment Number 3 (Documentation for Destroyed Instant Game Tickets), and Comment Number 4 (Restricted Players).

This report is intended solely for the information and use of the Nebraska Lottery, the appropriate Federal and regulatory agencies, and citizens of the State of Nebraska, and is not intended to be and should not be used by anyone other than these specified parties.

Handwritten signature of Timothy J. Chamber CPA in black ink.

Assistant Deputy Auditor

October 3, 2002