

Introductory Section





Our Mission and Philosophy

AGENCY MISSION

Texas Lottery: Administer and market state Lottery games in an efficient and secure manner using appropriate marketing tools and innovative technology to generate revenue for the State of Texas while enhancing public confidence in the integrity and fairness of the games.

Charitable Bingo: Provide authorized organizations the opportunity to raise funds for their charitable purposes by conducting bingo. Determine that all charitable bingo funds are used for a lawful purpose. Promote and maintain the integrity of the charitable bingo industry throughout Texas.

AGENCY PHILOSOPHY

The Texas Lottery Commission combines private business management principles with public service standards of conduct in all its operations. While recognizing the importance of cooperation with our vendors, we also believe that the Commission must continue to operate independently and avoid any appearance of undue influence. Because public trust is essential for our success, we will hold our employees, retailers, licensees and vendor partners to extremely strict ethical standards, and we will adhere to procedures that ensure accountability and reliability at all levels. We will maintain an interest in and play a leadership role in state issues that affect and have an impact on the agency and on its industries. We will balance the state's interest in increased Lottery sales and revenues with a commitment to not unduly influence players to participate in our games. We will continue to examine and review the operations of charitable bingo to maximize the benefits to the charities. We will strive to ensure that all expenditures directly or indirectly generate revenues for the appropriate beneficiary, enhance the security of the games, improve customer service and/or boost employee productivity. We will continually improve our products and our services by soliciting and responding to the legitimate concerns expressed by our employees, retailers, licensees, and the playing and non-playing public.

November 7, 2003

The Honorable Rick Perry, Governor
The Honorable David Dewhurst, Lt. Governor
The Honorable Tom Craddick, Speaker of the House
The Honorable Carole Keeton Strayhorn, Comptroller of Public Accounts
The Honorable Members of the 78th Legislature
The Honorable C. Tom Clowe, Jr.
The Honorable James A. Cox, Jr.
The Honorable Rolando Olvera, Jr.
Mr. Reagan E. Greer
Mr. William L. Atkins

Lady and Gentlemen:

In accordance with the Texas Government Code Chapter 466, the State Lottery Act, we are pleased to present the Comprehensive Annual Financial Report (CAFR) for the Texas Lottery Commission (the "Commission") for the years ended August 31, 2003 and 2002. The purpose of the report is to provide the Governor, Legislators, oversight agencies, agency staff, citizens, and other interested parties with useful information concerning the Commission's operations and financial position. The Commission's management is responsible for the accuracy, completeness, and fairness of the data presented in this report.

To the best of our knowledge, the following report is accurate in all material respects. It has been prepared in accordance with standards prescribed by the Governmental Accounting Standards Board (GASB), the Government Finance Officer Association of the United States and Canada (GFOA) and other rule-making bodies. We believe the report contains all disclosures necessary for the reader to understand the Commission's financial affairs.

These basic financial statements are also accompanied by the independent auditors' report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States.

Finally, in accordance with the Texas Government Code Chapter 466.017(a), the independent auditors have issued a separate report dated November 7, 2003, containing their recommendations for improvements in internal controls and operating efficiency. These recommendations are based on their audit.

REPORT FORMAT

There are four main sections in this report:

- Section I, the introductory section, contains the Commission's mission statement, this transmittal letter, a list of principal officials, the Commission's organizational structure, and the certificate of achievement.

- Section II, the financial section, contains the auditor's opinion, Management's Discussion and Analysis (MD&A), the basic financial statements, and notes to the financial statements.
- Section III, the required supplementary information section, includes the budgetary comparison schedule.
- Section IV, the statistical section, includes current year and historical financial and non-financial data that give a context in which to understand the Commission's financial statements.

The transmittal letter is designed to complement the MD&A and should be read in conjunction with it. The Commission's MD&A can be found immediately following the independent auditor's report.

INTERNAL CONTROLS

The Commission's management is responsible for establishing a system of internal controls to:

1. Safeguard Commission assets from loss or unauthorized use or disposal.
2. Provide reliable financial records for preparing internal and external financial reports and for maintaining accountability over Commission assets.
3. Ensure compliance with applicable Federal and State laws, regulations and provisions of contracts and agreements.

No system of internal controls can be perfect. Therefore, internal controls are meant to provide "reasonable assurance". Reasonable assurance means:

1. The cost of a control should not exceed the benefits likely to be derived from that control.
2. The costs and benefits of internal controls are subject to estimates and judgments by management.

We believe that the Commission's internal controls reasonably safeguard assets, assure that financial transactions are properly recorded and reported, and ensure compliance with applicable Federal and State laws, regulations and provisions of contracts and agreements.

THE COMMISSION

History

In November 1991, Texas citizens voted to authorize the creation of a lottery. At that time, the Texas Lottery outsourced many aspects of its operations to a single lottery operator—an approach which remains in effect today. At start-up, first-day instant ticket sales reached \$23.2 million, surpassing the lottery's original projected take of \$17 million.

Lottery sales cover the costs of products, prizes, retailer commissions and administrative costs, with the remainder returned to the State of Texas. From 1992 through August 1997, lottery proceeds were deposited to the state's General Revenue Fund. In 1997, the Legislature designated that all Lottery profits be directed to the Foundation School Fund, which supports the public schools of Texas. In 1999, the Legislature designated that unclaimed prizes be directed to the Multicategorical Teaching Hospital Account and the Tertiary Care Facility Account.

In November 1980, Texas voters approved a Constitutional amendment authorizing Charitable Bingo on a local option basis. The amendment requires all bingo proceeds to be spent in Texas for charitable purposes. The first bingo licenses were issued in the spring of 1982; at that time Charitable Bingo was a

division at the Comptroller of Public Accounts. In January 1990, the regulation and administration of Charitable Bingo was transferred to the Texas Alcoholic Beverage Commission. In April 1994, the administration of Charitable Bingo was transferred to the Commission, where it remains today.

The Charitable Bingo Operations Division of the Commission oversees the licensing, accounting and audit operations of the Charitable Bingo activities based upon the Bingo Enabling Act and Charitable Bingo Administrative Rules. Since the issuance of the first licenses in 1982, Charitable Bingo has had positive benefits for charities and players as well as county and municipal governments in Texas.

Products

The Texas Lottery offers two types of lottery products to the playing public. The ‘Games of Texas’ include

- Instant ticket games, or “scratch-offs” - where players utilize preprinted tickets with symbols hidden under a latex covering. The player scratches off the latex and determines “instantly” whether a prize has been won. Game themes include Texas, western, gaming, money, sports, seasonal, and animals.
- On-line games - where tickets are generated from a terminal connected to a central system and a drawing is held to determine a set of winning numbers. Online games include the following:

Lotto Texas[™]



Sales for *Lotto Texas*, the Texas Lottery’s first on-line game, began on November 7, 1992. The first *Lotto Texas* drawing was held on November 14, 1992. When *Lotto Texas* began, players picked six numbers between 1 and 50. That matrix was changed in July 2000 to 6-in-54; and again in May 2003 to 5-in-44 and 1-in-44.

Lotto Texas drawings are held every Wednesday and Saturday, and have been made available via satellite to television stations across the state since the first drawing in 1992. Drawings were conducted at 9:59 p.m. Central Time. Since May 27, 2002, Night drawings for all on-line games are conducted at 10:12 p.m.

Pick 3[™]



Pick 3 was added to the on-line game mix in October 1993 and is the only game to see consistent increases in sales since it was introduced. It offers players a 50-cent play, twelve drawings a week (6 Day and 6 Night drawings), and a top prize of \$500 (on a \$1 play). In March 2002, the Texas Lottery Commission approved the addition of a *Pick 3* Day drawing. Sales for the Day drawing began on Sunday, April 28, 2002, and the first Day drawing took place on Monday, April 29, 2002. Drawings are held twice daily every Monday through Saturday at 12:27 p.m. and 10:12 p.m. Central Time.

Players select three numbers from 0 to 9 and choose the way they want to play. They have four choices for how they can play their 3-digit number: Exact Order, Any Order, Exact/Any Order, or Combo. Players can choose to play their numbers for up to 12 consecutive Day Draws only, 12 consecutive Night Draws only or 12 consecutive Day and Night drawings, by using the multi-draw feature. The cost of a play is dependent on play style selected, the amount wagered and the number of drawings played.

Cash 5™



Cash 5 was added to the on-line game mix in October 1995. Cash 5 is a 5-of-39 lotto-style matrix. Players select five numbers between 1 and 39 for a chance to win cash prizes by matching 3-5, 4-5 or 5-of-5 numbers. All prizes are pari-mutuel and are paid in one lump sum. The statistically calculated average prize for matching three, four or five numbers is \$26, \$508 and \$57,575, respectively.

If no ticket matches all five numbers drawn, the prize pool set-aside for the top or 5-of-5 prize rolls down or is allocated to the 4-of-5 prize. The 4-of-5 prize increases accordingly. Players can play their numbers for up to 20 drawings in advance by using the multi-draw feature. Cash 5 also offers an Advance Play option where players can choose the day they want to start playing their numbers.

Cash 5 drawings are held every Monday, Tuesday, Thursday and Friday night at 10:12 p.m. Central Time.

Texas Two Step™



Texas Two Step was added to the on-line game mix in May 2001. Texas Two Step is a 4-of-35 plus 1-of-35 Bonus Ball on-line game. Players select four numbers plus a bonus ball number for a chance to win the jackpot prize. When no ticket correctly matches all four numbers plus the Bonus Ball, the jackpot rolls over (grows) until a ticket or tickets match all four numbers plus the Bonus Ball for a given draw.

Jackpots start at \$200,000. There are seven different ways to win and all prizes, including the jackpot prize, are paid in one lump sum. Players win a guaranteed \$5 prize for matching just the Bonus Ball. Players can also win a guaranteed \$7 prize for matching one number from the first set of four numbers plus the Bonus Ball. Players can play their numbers for up to ten drawings in advance by using the multi-draw feature. Drawings are held every Tuesday and Friday night at 10:12 p.m. Central Time.

Charitable Bingo Operations

Before the end of each calendar quarter, a licensed authorized organization must disburse, for charitable purposes, an amount not less than 35 percent of the organization's adjusted gross receipts, derived from Charitable Bingo activities from the preceding quarter, less the amount of authorized expenses, not to exceed 6 percent of the gross receipts. A comparison of the Charitable Bingo distributions to the top 100 foundations in Texas by grants from 1982 to 2000 shows Charitable Bingo distributions ranked with the top five foundations from 1984 to 2000.

The Charitable Bingo Operations Division contributes to the tax and revenue collection functions of the Commission by making quarterly allocations to local units of government for their share of prize fees. The Charitable Bingo Operations Division is made up of three sections: Licensing, Accounting and Audit Services. The Licensing section regulates Charitable Bingo operations in Texas by administering all aspects of the licensing process for organizations. The Accounting Services Section collects all taxes and prize fees associated with the conduct of Charitable Bingo and processes quarterly allocation payments local jurisdictions for their share of the prize fees collected. The Audit Services Section works closely with other Charitable Bingo Operations Division sections, the Security Division and the Legal Division to enforce the Bingo Enabling Act and the Charitable Bingo Administrative Rules. The Audit Services Section also conducts the statutorily required Operator Training Program, as well as the testing of all electronic bingo equipment submitted for approval.

THE REPORTING ENTITY

This report includes government-wide statements and fund financial statements for the Commission. Criteria for determining the reporting entity and presentation of the related financial data are established by the GASB. The criteria include legal standing and financial accountability. Note one of the Notes to the Financial Statements provides detail on the financial reporting entity.

All activities that would generally be considered part of the Commission are included in this report. These activities include the operation of a State Lottery, and enforcement of bingo laws. The operational results of these activities are reflected in both the financial and statistical section of this report.

ECONOMIC CONDITION AND OUTLOOK ¹

During the 2004-05 biennium, the Texas economy will gradually improve, but given the depth of the 2001 national slump, business conditions will likely not improve significantly until fiscal 2005. Year-over-year economic growth should average 4.2 percent in 2004-05, somewhat better than the 2.7 percent average annual growth rate during 2002-03, but well below the healthy 5.4 percent average annual gains enjoyed during the economic boom of 1995-2000.

Following the succession of job layoffs that occurred throughout 2002-03, statewide employment growth is expected to pick up steam in 2004-05 as economic output gradually accelerates. After remaining virtually static from 2001 through 2003, statewide non-farm employment is expected to increase at a 2.3 percent average annual rate in 2004-05. As wage growth accelerates, personal income growth can be expected to climb at a respectable 6 percent average annual rate. Consequently, unemployment should fall from 5.9 percent in 2003 to 5.2 percent in 2005.

The majority of Texas' population growth will continue to be driven by natural increase (i.e., births minus deaths), as opposed to migration, which is more sensitive to economic factors. The current population in Texas is 22 million. The rate of increase in the state's population growth rate is expected to remain relatively steady throughout 2004-05. From fiscal 2003 through fiscal 2005, Texas' population should increase by 696 thousand—about 3 percent—to reach 22.7 million.

Because the productivity of Texas workers has increased at a faster rate than the loss of jobs in the state, Texas has been able to avoid the national recession so far. Although Texas registered negligible economic growth in the spring and summer of 2001, productivity gains compensated sufficiently for the job losses to allow the state economy to remain in the black. Largely because of Texas' central Sunbelt location, relatively low costs, and overall attractive business climate, annual gross state product growth in Texas should continue to outperform the national growth rate by nearly half a percentage point annually through fiscal 2005, continuing a trend that traces back to the beginning of the 1990s.

INDEPENDENT AUDIT

The Texas State Lottery Act requires an annual audit by an independent certified public accountant of all accounts and transactions of the lottery. McConnell & Jones LLP, a firm of licensed certified public accountants, audited the Commission's financial statements. The goal of the independent audit is to provide reasonable assurance that the financial statements of the Commission for the fiscal year ended August 31, 2003, are free of material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The independent auditor concluded, based on the audit, that there was a reasonable basis for rendering and did render an unqualified opinion that the Commission's financial statements for the fiscal year ended August 31, 2003, are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP).

¹ Source: Texas State Comptroller's Biennial Revenue Estimate 2004-2005.

CERTIFICATE OF ACHIEVEMENT AND ACKNOWLEDGMENTS

The government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to The Texas Lottery Commission for its comprehensive annual financial report for the fiscal year ended August 31, 2002. This was the first year that the Texas Lottery Commission had received this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

The preparation of this report would not have been possible without the efficient and dedicated services of the staff of the Financial Administration Division. We would also like to express our appreciation to staff of the Texas Lottery Commission who assisted and contributed to the preparation of this report.

Sincerely,

Reagan E. Greer
Executive Director

**PRINCIPAL OFFICIALS
TEXAS LOTTERY COMMISSION**

<u>Commission Member</u>	<u>Date of Term</u>	<u>Hometown</u>
C. Tom Clowe, Jr.	February 1, 1999 - February 1, 2005	Waco
James A. Cox, Jr.	March 4, 2003 – February 1, 2009	Austin
Rolando Olvera	August 28, 2003 – February 1, 2007	Brownsville

Executive Director

Reagan E. Greer

Director of Charitable Bingo

William L. Atkins

TEXAS LOTTERY COMMISSION ORGANIZATIONAL STRUCTURE

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Texas Lottery Commission

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
August 31, 2002

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



A handwritten signature in black ink, appearing to read "Edward Haney".

President

A handwritten signature in black ink, appearing to read "Jeffrey R. Emer".

Executive Director