Management Discussion and
Analysis and
Financial statements for:

MINNESOTA STATE LOTTERY

Years ended
June 30, 2003 and 2002

Minnesota State Lottery

Management Discussion and Analysis

Overview of the Financial Statements

This report consists of two parts: management's discussion and analysis and the basic financial statements. Included below and on the following pages are the financial highlights, summary results of operations for the years ended, a condensed version of the Balance Sheets as of June 30, 2003 and 2002, and management's analysis of significant changes from last fiscal year to the current fiscal year.

Financial Highlights

Minnesota State Lottery gross receipts for fiscal year 2003 were $328.95 million compared to $352.62 million in fiscal year 2002. Total funds raised for the state (General Fund, Environmental Fund and other programs) including net proceeds, transfers of unclaimed prizes and in lieu of sales tax, were $79.40 million in fiscal year 2003 verses $81.68 million in fiscal year 2002. Since its inception in 1990, the Lottery has raised over $1.1 billion for the state.

Operating income was down slightly over last year, one percent, while net proceeds dipped 2.80 percent in fiscal year 2003 due to higher transfers given to the state.

Operating expenses in fiscal year 2003 were $46.65 million compared to $49.36 million in fiscal year 2002. The decrease was due mainly to a more favorable contract with a new Online vendor as well as decreased costs associated with the production of Scratch Games and a significant decrease in promotional expenditures in fiscal year 2003.

Summary Results of Operations

	2003	2002
Gross receipts	$ 328,948,525	$ 352,618,471
Prizes and commissions	227,238,333	247,626,090
Gross profit	101,710,192	104,992,381
Operating expenses	46,646,271	49,358,867
Operating income	55,063,921	55,633,514
Non-operating revenues	1,471,266	1,532,522
Income before operating transfers	56,535,187	57,166,036
Unclaimed prizes and compulsive gambling paid to State	(8,415,107)	(7,658,452)
Net proceeds to State	(48,120,080)	(49,507,584)
Change in net assets	$ 0	$ 0

Summary Results of Operations – Highlights

Lottery Revenues – The following is a summary of Lottery revenues in each of the following years:

	2003	2002
Scratch ticket sales	$ 210,919,223	$ 241,051,521
Online ticket sales:		
Daily 3	14,123,024	13,894,476
Gopher 5	15,828,015	22,441,409
Powerball	99,052,849	91,485,515
Power Play	2,885,867	2,733,759
Hot Lotto	9,007,626	2,955,749
Slots Plus	0	7,260
Rolldown	0	2,562,366
Total operating revenue	351,816,604	377,132,055
Less in-lieu-of sales tax	22,868,079	24,513,584
Gross receipts	$ 328,948,525	$ 352,618,471

Gross receipts - Decreased by 6.71% due mainly to the decrease in Scratch ticket sales and Gopher 5 sales which were down 12.50% and 29.47% respectively from fiscal year 2002. These decreases in Scratch ticket and Gopher 5 sales were offset by an increase in Powerball sales and Hot Lotto sales of 8.27% and 204.75% respectively. The increase in Powerball sales was attributable to the larger jackpots experienced as a result of the change in the odds of the game. The increase in the Hot Lotto sales was attributable to a full year of sales in fiscal year 2003 verses a partial year of sales in fiscal year 2002.

Gross profit - Decreased from $104.99 million in fiscal year 2002 to $101.71 million in fiscal year 2003, or 3.13%. Gross profit decreased 3.59% less than gross receipts because of a more profitable sales mix. Direct costs for Online sales were approximately 16.99% less than the direct costs related to Scratch Game ticket sales for fiscal year 2003.

Unclaimed prizes and compulsive gambling – Appropriations to provide support for compulsive gambling in Minnesota decreased by $747,000. Unclaimed prizes to the State increased by $1,503,655 due to a higher percentage of prizes going unclaimed relative to the prior year. The net effect was an increase in operating transfers of $756,655 in fiscal year 2003.

Budget –Gross revenue is equal to total operating and non-operating revenue less in-lieu-of-sales tax. Based on gross revenues in fiscal year 2003, the Lottery had statutory authorization for operating costs of $49,562,969 (15% of gross revenues). However, actual operating costs for the fiscal year were $46,646,271. The difference between authorized and actual operating costs, or $2,916,698, was included in Net Proceeds Paid to State Treasury throughout the fiscal year.

Balance Sheets

	2003	2002
Assets:		
Cash and cash equivalents	$19,441,653	$17,144,787
Receivables	6,138,421	3,129,261
Prize annuity investments	3,467,327	3,085,863
Capital assets & other assets (Note 5)	5,169,344	3,779,562
	$34,216,745	$27,139,473
Liabilities and fund equity:		
Due to State and State Agencies	$11,307,622	$8,148,012
Accounts payable and accrued expenses	8,681,484	6,166,059
Current accrued prizes & prize annuity liabilities (Note 4)	10,109,328	9,221,963
Long term accrued prizes & prize annuity liabilities (Note 4)	4,118,311	3,603,439
Net assets	0	0
	$34,216,745	$27,139,473

Balance Sheet Highlights

The Lottery is required to advance net proceeds to the state of Minnesota and therefore fund equity remains unchanged from year to year. In general, short term assets and liabilities will fluctuate with the activity of games being played.

Cash and cash equivalents – Increase of $2.3 million due to a corresponding increase in Prize Expense Payable and Accounts Payable on the liability side of the balance sheet due to more outstanding prizes at the end of fiscal year 2003 as well as timing differences in the payable accounts.

Receivables – Increase of $3 million due to higher sales in the month of June of fiscal year 2003 relative to fiscal year 2002.

Accounts payable and accrued expenses, and current accrued prizes & prize annuity liabilities – Increase of $2.5 million due to reasons noted above.

Capital Assets and Other Assets – Additions to capital assets in fiscal year 2003 were $1.05 million mainly consisting of leasehold improvements, new On-line Drawing equipment as well as various computer hardware and software purchases. Retirement of capital assets were $98 thousand consisting of office equipment and a vehicle. Other assets increased by $2.2 million dollars due mainly to an increase in prepaid compulsive gambling contribution, for fiscal year 2004, of $1.9 million.

Due to State and State Agencies – Increase of $3.2 million is due mainly to the effect of higher sales in June of fiscal year 2003 relative to sales in June of fiscal year 2002.

Financial statements for:

MINNESOTA STATE LOTTERY

Years ended
June 30, 2003 and 2002

SCHECHTER
DOKKEN
KANTER
CERTIFIED PUBLIC ACCOUNTANTS • ADVISORS

INDEPENDENT AUDITORS' REPORT

The Director
Minnesota State Lottery
Roseville, Minnesota

We have audited the accompanying balance sheets of the Minnesota State Lottery as of June 30, 2003 and 2002, and the related statements of revenues, expenses and changes in net assets for the years then ended. These financial statements are the responsibility of the Minnesota State Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Minnesota State Lottery as of June 30, 2003 and 2002, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated August 20, 2003, on our consideration of the Minnesota State Lottery's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, and contracts. 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 audits.

The Management's Discussion and Analysis on pages 1 through 3 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of supplementary information. However, we did not audit the information and express no opinion on it.

Schechter Dokken Kanter
Andrews & Selcer Ltd.

August 20, 2003

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MINNESOTA STATE LOTTERY
BALANCE SHEETS
JUNE 30, 2003 and 2002

ASSETS	2003	2002
Cash and Cash Equivalents (Note 3)	$ 19,441,653	$ 17,144,787
Accounts Receivable	6,138,421	3,081,883
Interest Receivable		47,378
Scratch Ticket Inventory	463,487	822,065
Merchandise Prize Inventory	386,921	3,109
Prepaid:		
Expense	834,190	525,625
Compulsive gambling contribution transfer (Note 9)	1,896,000	
Prize Annuity Investments (Note 4)	3,467,327	3,085,863
Capital Assets, Net (Note 5)	1,588,746	2,428,763
Total Assets	$ 34,216,745	$ 27,139,473

LIABILITIES AND NET ASSETS

Liabilities

Net Proceeds Due to State (Note 7)	$ 4,658,550	$ 3,010,933
Unclaimed Prizes Due to State (Note 6)	6,619,107	5,115,452
Due to Other State Agencies	29,965	21,627
Accounts Payable	4,540,064	3,030,964
In-Lieu-of-Sales Tax Payable	1,958,163	1,751,274
Prize Liability	9,877,328	8,989,963
Compensated Absences Payable	1,233,186	1,156,003
Deferred Revenue	950,071	227,818
Current Prize Annuity Payable (Note 4)	232,000	232,000
Long Term prize Annuity Payable (Note 4)	4,118,311	3,603,439
Total Liabilities	34,216,745	27,139,473
Commitments and Contingencies (Note 8 and 9)		
Net Assets		
Net Assets (Note 7)	0	0
Total Liabilities and Net Assets	$ 34,216,745	$ 27,139,473

See Accompanying Notes to Financial Statements

MINNESOTA STATE LOTTERY
STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS
YEARS ENDED JUNE 30, 2003 and 2002

	2003	2002
Operating Revenues:		
Scratch Ticket Sales	$ 210,919,223	$ 241,051,521
Online Ticket Sales	140,897,381	136,080,534
Total Operating Revenues	351,816,604	377,132,055
Less: In-Lieu-of-Sales Tax	22,868,079	24,513,584
Gross Receipts	328,948,525	352,618,471
Direct Costs:		
Scratch Ticket Prizes	137,281,912	156,093,622
Online Ticket Prizes	67,763,872	67,586,542
Retailer Commissions and Incentives (Note 10)	22,192,549	23,945,926
Total Direct Costs	227,238,333	247,626,090
Gross Profit	101,710,192	104,992,381
Operating Expenses: (Note 11)		
Online Vendor Expense	9,931,627	10,827,918
Ticket Costs	5,273,205	6,155,242
Advertising (Note 11)	7,503,607	7,550,392
Salaries and Benefits (Note 12)	12,271,807	11,603,278
Promotion	3,299,586	4,100,993
Purchased Services	1,540,656	1,772,269
Communication	850,314	963,867
Occupancy Costs (Note 8)	1,974,079	1,947,856
Supplies and Materials	567,527	889,743
Computer and Omnipoint Maintenance	384,216	590,845
Depreciation	1,879,687	1,393,370
Other Expense	1,169,960	1,563,094
Total Operating Expenses	46,646,271	49,358,867
Operating Income	55,063,921	55,633,514
Non-operating Revenues:		
Investment Income (Note 3 and 4)	1,329,727	1,342,906
Other Income	141,539	189,616
Non-operating Revenues	1,471,266	1,532,522
Income Before Transfers	56,535,187	57,166,036
Transfers:		
Compulsive Gambling Contribution from Prize Fund (Note 9)	1,796,000	2,543,000
Unclaimed Prizes to State (Note 6)	6,619,107	5,115,452
Net Proceeds to State (Note 7)	48,120,080	49,507,584
Transfers	56,535,187	57,166,036
Net Income:	0	0
Net Assets at Beginning of Year (Note 7)	0	0
Net Assets at End of Year (Note 7)	$ 0	$ 0

See Accompanying Notes to Financial Statements

MINNESOTA STATE LOTTERY
STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2003 and 2002

	2003	2002
Cash Flows from Operating Activities:		
Cash Received from Customers	$ 349,482,320	$ 377,683,695
Cash Received from Other Income	188,917	227,431
Payments to State (In-Lieu-of-Sales Tax)	(22,661,190)	(24,530,243)
Payments to Employees	(12,194,624)	(11,554,178)
Payments to Suppliers	(31,311,138)	(35,801,748)
Payments to Retailers	(22,192,549)	(23,945,926)
Payments to Prize Winners	(203,643,547)	(221,438,864)
Net Cash Provided by Operating Activities	57,668,189	60,640,167
Cash Flows from Non-Capital Financing Activities:		
Net Proceeds Paid to State	(46,472,463)	(51,761,730)
Compulsive Gambling Contribution Transfer	(3,692,000)	(2,543,000)
Unclaimed Prizes Transfer	(5,115,452)	(5,761,308)
Net Cash Used by Non-Capital Financing Activities	(55,279,915)	(60,066,038)
Cash Flows from Capital and Related Financing Activities:		
Purchases of Capital Assets	(1,039,670)	(542,295)
Net Cash Used by Capital Financing Activities	(1,039,670)	(542,295)
Cash Flows from Investing Activities:		
Proceeds from Redemption of Prize Annuity Investments	232,000	232,000
Investment Income	716,262	1,053,912
Net Cash Provided by Investing Activities	948,262	1,285,912
Net Increase in Cash and Cash Equivalents	2,296,866	1,317,746
Beginning of Year Cash and Cash Equivalents	17,144,787	15,827,041
End of Year Cash and Cash Equivalents	$ 19,441,653	$ 17,144,787
Reconciliation of Operating Income to Net Cash Provided by Operating Activities:		
Operating Income	$ 55,063,921	$ 55,633,514
Adjustments to Reconcile Operating Income to Net Cash provided by Operating Activities:		
Depreciation	1,879,687	1,393,370
Other Income	141,539	189,616
Net Change in Assets and Liabilities:		
Inventory	(25,234)	17,933
Other Assets	(3,317,725)	390,595
Current Liabilities	2,523,763	1,421,223
Prize Awards Payable	1,402,237	1,593,916
Net Cash Provided by Operating Activities	$ 57,668,189	$ 60,640,167
Noncash Investing Activities		
Net increase in the fair value of investments	$ 613,464	$ 288,994

See Accompanying Notes to Financial Statements

MINNESOTA STATE LOTTERY
NOTES TO THE FINANCIAL STATEMENTS
JUNE 30, 2003 AND 2002

1. ORGANIZATION OF THE MINNESOTA STATE LOTTERY

In 1988, Minnesotans voted to amend their Constitution to authorize a state-run lottery. In 1989, the Legislature approved and the Governor signed Minnesota Statutes Chapter 349A into law, officially creating the Minnesota State Lottery, the 33rd lottery in the country.

The Minnesota State Lottery (the Lottery), an enterprise fund of the State of Minnesota, is under the supervision and control of the Director of the Lottery, who is appointed by the Governor with the advice and consent of the Senate. Lottery operations began on October 9, 1989 when the first Lottery staff was hired. The Lottery sold its first Scratch tickets on April 17, 1990. The sale of Daily 3 and LottoAmerica Online tickets began on August 14, 1990. LottoAmerica was the first Multi-State Lottery Association (MUSL) game. The Lottery's sales mix currently consists of Scratch tickets and Online games: Daily 3, Gopher 5, Powerball, Power Play, and Hot Lotto.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Lottery is an agency of the State of Minnesota using proprietary type enterprise accounting. The financial statements are prepared in accordance with generally accepted accounting principles as applicable to governmental units. Following are the more significant accounting policies:

(a) Basis of Accounting

The financial statements of the Lottery have been prepared on the accrual basis of accounting. Revenues are recorded when they are earned and expenses are recognized as incurred.

Governmental Accounting Standards Board (GASB) Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that use Proprietary Fund Accounting,* provides that proprietary and similar trust funds should apply all 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 Opinions (APB), and Accounting Research Bulletins (ARB). As permitted by GASB Statement No. 20, the Lottery has elected not to apply FASB statements or interpretations issued on or after November 30, 1989, unless the GASB specifically adopts such statements or interpretations.

(b) Adoption of Newly Issued Accounting Standards

In June 1999, the Governmental Accounting Standards Board (GASB) issued Statement No. 34, *Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments.* This Statement established new financial reporting requirements for state and local governments. This statement also requires budgetary comparison schedules to be presented as supplementary information. The Lottery is not legally required to adopt a budget and therefore budgetary comparison schedules are not included as supplementary information.

(c) Measurement Focus

A proprietary fund is accounted for using the "economic resources" measurement focus. This means that all assets and liabilities associated with its activity are included on its balance sheet. The proprietary fund type operating statement presents increases (revenues) and decreases (expenses) in net total assets.

(d) Revenue Recognition

Packs of Scratch tickets are distributed to retail sales outlets. Scratch ticket sales are recognized as revenue upon settlement of ticket packs by retailers and are recorded at the sale price to the consumer. Sales of Online tickets are recognized as revenue on the date of the draw for which the tickets were purchased. Revenues from future Online ticket draw sales are deferred until the date of the draw for which the tickets were purchased.

(e) Cash and Cash Equivalents

Cash and cash equivalents include an amount in demand deposits as well as funds held in the State Treasury and invested by the State Board of Investment.

(f) Prizes and Reserves

Scratch ticket prize expense is recognized in accordance with the predetermined prize structure for each game and is accrued when revenue is recognized. High tier prizes for certain Scratch ticket games may also be structured and paid as an annuity. An estimate of the annuity prize payout is established based on actuarial tables, and the expense is incorporated into the prize pool structure.

Prize expense for Daily 3 is recorded based upon the actual winners on the date of the draw. Gopher 5 prize expense is recorded at 57 percent of draw sales. An additional percentage of Gopher 5 sales is expensed to provide a reserve for guaranteed grand prize amounts. Prize expenses for Powerball, Power Play and Hot Lotto are recorded at 50 percent of draw sales in accordance with the MUSL prize structure.

The Powerball, Power Play and Hot Lotto prizes are paid with funds held by MUSL. MUSL has established separate prize pool reserves for Powerball, Power Play and Hot Lotto to support payment of prizes in light of the remote possibility of claims greatly exceeding the expected amounts. In the event that the Lottery ceases to participate in one of these games, the Lottery may make claim to assets, if any, in the related prize pool reserve.

Included in the MSL Prize Liability for fiscal year 2003 is a $666,702 prize reserve which reflects funds due to the State Treasury that have been set aside in the lottery prize fund by the Director in accordance with Minnesota Statutes, Section 349A.10, subdivision 2(b) to assure proper funding for future lottery prizes.

(g) Scratch Ticket Inventory

Scratch ticket inventories are carried at cost using the specific identification method. Tickets are charged to operating expense over the estimated life of each Scratch game.

(h) Prize Annuity Investments

During fiscal 1998, the Lottery adopted GASB Statement *No. 31 Accounting and Financial Reporting for Certain Investments and for External Investment Pools.* At the adoption of GASB Statement No. 31, the Lottery reported the prize annuity investments at fair value using quoted market prices. Changes in the fair value of the investment are reported as nonoperating revenue or expense.

(i) Capital Assets

Assets costing a thousand dollars or more are capitalized and are carried at cost less accumulated depreciation. Depreciation is computed on the straight-line method using estimated useful lives from three to seven years. Computer equipment, PCs and printers are depreciated over three years. Vehicles, other than the warehouse truck, are depreciated over four years. Office equipment, Online draw equipment and signs are depreciated over five years. Office furniture and the warehouse truck and equipment are depreciated over seven years. Leasehold improvements are depreciated on a straight-line basis over the shorter of the useful life or length of the lease. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is recognized.

(j) In-Lieu-of-Sales Tax

From every dollar in Lottery sales, the Lottery sets asides six and one-half cents as in-lieu-of-sales tax and remits that amount monthly to the Commissioner of Revenue as required by Minnesota Statutes, Section 297A.259. Pursuant to Minnesota Statutes, Section 297A.94, subdivision 1(e) for fiscal year 2003, thirteen percent of the in-lieu-of-sales-tax is credited to the General Fund, the remaining 87% of the in-lieu-of-sales-tax is credited to the Game and Fish Fund and the Natural Resources Fund to be used for natural resources projects as specified by law. Minnesota Laws 2003, Chapter 128, Article 1, Section 154, provides that for FY04 and thereafter, 27.57% of the in-lieu-of-sales-tax is credited to the General Fund and the remaining 72.43% is credited to the Game and Fish Fund and the Natural Resources Fund to be used for natural resources projects as specified by law.

(k) Compensated Absences

A liability is recognized for unpaid vacation, compensatory hours, vested severance and anticipated severance pay when earned. Severance pay for non-vested employees is calculated based on a fiscal year 2003 estimate that 44% will become vested.

(l) Income Taxes

The Lottery, as an agency of the State of Minnesota, is exempt from federal and state income taxes. Accordingly, the Lottery makes no provision for income taxes.

(m) Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(n) Reclassifications
Certain 2002 amounts were reclassified to conform to 2003 presentation.

3. CASH AND CASH EQUIVALENTS

Minnesota Statutes, Section 349A.10, subdivision 7(a), requires the Lottery transfer all funds to a Lottery cash flow account in the State Treasury. Funds necessary to cover cash needs are transferred as needed from State Treasury to the Lottery fund. Funds in this account earn interest, which is credited monthly to the Lottery's account. Cash on deposit in the State Treasury is uninsured. Cash on deposit with financial institutions is covered up to $100,000 per institution by the federal depository insurance. At times, cash balances may be in excess of the FDIC insurance limit. As a result, the financial institutions are required to pledge collateral to the lottery in an amount equal to the funds in excess of the FDIC insurance limit. At June 30, 2003, the market value of the pledged collateral was $2,633,693.

The following table summarizes the Lottery's cash and cash equivalents at June 30, 2003 and 2002:

	2003	2002
Cash (checks issued but not yet presented for payment)	$ (89,486)	$ (1,110,181)
Cash on Deposit with the State Treasury	19,531,139	18,254,968
Total Cash and Cash Equivalents	$ 19,441,653	$ 17,144,787

Available cash in the State Treasury is invested by the State Board of Investment. In accordance with Minnesota Statutes, Section 11A.24, the State Board of Investment must invest in obligations and stocks of U.S. and Canadian governments, their agencies and their registered corporations, short-term obligations of specified high quality, restricted participation as a limited partner in venture capital, real estate, or resource equity investments, and restricted participation in registered mutual funds. Lottery funds on deposit in the State Treasury cannot be tied to specific investment securities.

4. PRIZE ANNUITY INVESTMENTS AND PAYABLES

(a) Investments

The prize structure of certain Scratch Games operated solely by the Lottery included prizes in the form of lifetime annuities. Since 1991, the Lottery has awarded sixteen Scratch Game annuity prizes. The Lottery has elected to fund payment of these annuities through the purchase of long-term investments consisting principally of zero coupon government securities. It is the Lottery's intent to hold all prize annuity investments until the securities mature. These securities are being held in trust by MUSL. As of June 30, 2003, all of these securities are backed by the full faith and credit of the United States Government or its agencies. In accordance with GASB Statement No. 3, these investments are classified as to level of risk in category 3, which includes uninsured and unregistered investment securities held by a third party.

(b) Payables

The prize annuity obligations are recognized as liabilities equivalent to the present value of future prize payments discounted at interest rates for government securities. The present value of the annuities' payable was calculated as of year end based on the life expectancy rates as stated in the Internal Revenue Service Publication 590; Table 1, Single Life Annuity. Prize annuity obligations were $3.8 million at the end of fiscal year 2002 and $4.4 million at the end of fiscal year 2003. The change in liability of just over $500 thousand relates mostly to the change in the current market rate of interest used to calculate the present value of the annuities owed at the end of each fiscal year.

Future cash payments on the prize annuity obligations for each of the next five years and thereafter are as follows:

Year	Amount
2004	$ 232,000
2005	232,000
2006	232,000
2007	232,000
2008	232,000
Thereafter	6,733,600
Total payments	$ 7,893,600
Less: Imputed Interest	(3,543,289)
Present value of payments	$ 4,350,311

5. CAPITAL ASSETS

Capital assets at June 30, 2003 and 2002 consist of the following:

	2003	2002
Omnilink Equipment	$ 3,541,126	$ 3,541,126
Office Equipment & Furniture	2,248,818	2,237,650
PC & Printer Equipment	1,820,197	1,735,990
Leasehold Improvements	2,356,235	1,976,396
Vehicles	1,197,693	1,217,464
Computer Equipment	1,157,971	1,096,349
Online Drawing Equipment	642,485	203,522
Signs	196,691	196,691
Warehouse Equipment	182,921	179,158
To Be Placed in Service	0	2,305
	$ 13,344,137	$ 12,386,651
Less Accumulated Depreciation	(11,755,391)	(9,957,888)
Capital Assets, Net	$ 1,588,746	$ 2,428,763

6. UNCLAIMED PRIZES

Minnesota Statutes, Section 349A.08, subdivision 5 requires that the Lottery transfer to the State Treasury 70% of unclaimed prize money at the end of each fiscal year. The transferred unclaimed prize funds are allocated as follows: 40% transferred to the Environment and Natural Resources Trust Fund and 60% to the General Fund. The remaining 30% of unclaimed prizes must be added by the Lottery to prize pools of subsequent Lottery games. The unclaimed prizes due to the State are $6,619,107 and $5,115,452 on June 30, 2003 and 2002, respectively. This law was changed effective July 1, 2003. Pursuant to Minnesota Laws 2003, 1st Special Session, Chapter 1, Article 2, Section 101, all unclaimed prizes will be transferred to the General Fund at the end of the fiscal year.

7. NET ASSETS

Within 30 days after the end of each month the Lottery is required by Minnesota Statutes, Section 349A.10, subdivision 5 to deposit the net proceeds in the State Treasury. The monthly transfer of net proceeds leaves a zero balance in Net Assets. The amount to be paid for the month ended June 30, 2003 and 2002 is $4,658,550 and $3,010,933, respectively, shown as Net Proceeds Due to State on the accompanying balance sheets.

8. COMMITMENTS AND CONTINGENCIES

(a) Risk Management

The Lottery is exposed to various risks of loss related to torts, theft, damage to and destruction of assets, errors and omissions, injuries to employees, and natural disasters.

The Lottery participates in the State's Risk Management Fund for property, liability, crime and automobile insurance coverage. The Lottery pays annual premiums for this coverage. The State's Risk Management Fund covers all claims above the deductible. The Lottery has not experienced any settlements in excess of coverage in the past three years.

The areas of insurance coverage, limits and deductibles as of June 30, 2003 are as follows:

Coverage	Limits	Deductible
Property	$8,898,207	$1,000
Auto		
Bodily Injury & Property Damage	$300,000/$1,000,000	$500
Primary Crime		
Employee Dishonesty, Money & Securitires	$25,000	$1,000
General Liability	$300,000/$1,000,000	None
Excess Crime		
Employee Dishonesty	$1,000,000	$25,000
Forgery or Alteration	$1,000,000	$500
Computer Fraud	$1,000,000	$5,000
Wire Transfer	$1,000,000	$5,000
Robbery and Safe Burglary	$50,000	$100

The Lottery also participates in the State's workers' compensation coverage. The State is a member of the Workers' Compensation Reinsurance Association that pays for workers' compensation claims in excess of $450,000. The Lottery is responsible for all workers' compensation claims below $450,000. The Lottery accrues for workers' compensation claims when it is probable that a loss has occurred and the amount can be reasonably estimated. The Lottery does not have a workers' compensation accrual as of June 30, 2003 or 2002.

(b) Operating Leases

The Lottery is committed under various leases for building and office space. The leases are classified as operating leases for accounting purposes. For the years ended June 30, 2003 and 2002, the lease expense was $1,636,828 and $1,576,103, respectively. This is net of sublease rental income of $139,893 and $207,151, respectively. Sublease rental income is included within occupancy costs on the financial statements. Future minimum lease payments for existing lease agreements are:

Year Ending June 30		Amount	
2004		$1,595,391	
2005		1,638,111	
2006		1,682,459	
2007		1,719,363	
2008		1,676,625	
Thereafter		7,069,133	
	Total		$15,381,082

The Lottery is also committed to an equipment lease. The lease is classified as operating leases for accounting purposes. For the year ended June 30, 2003, the lease expense is $48,000. Future minimum lease payments for existing lease agreements are as follows:

Year Ending June 30	Amount	
2004	48,000	
2005	48,000	
2006	48,000	
2007	44,000	
Total		$188,000

9. COMPULSIVE GAMBLING CONTRIBUTION PROVIDED FROM PRIZE FUND

Minnesota Laws 1998, Chapter 407, Article 8, Section 11 directed the Lottery to pay $340,000 annually from the prize fund to a special Indian gaming account in the State Treasury. Funds in this account are transferred to the Department of Human Services for compulsive gambling programs.

Minnesota Laws 2001, 1st Special Session, Chapter 9, Article 17, Section 2, subdivisions 9(d) and 10 appropriated $1,453,000 in fiscal year 2002 and $1,456,000 in fiscal year 2003 from the prize fund to the Department of Human Services for statewide compulsive gambling programs. Minnesota Laws 2001, 1st Special Session, Chapter 10, Article 1, section 31, subdivision 5(d) appropriated $750,000 in fiscal year 2002 from the prize fund to the Department of Human Services for capital expenditures at a certain compulsive gambling treatment facility.

Minnesota Laws 2003, 1st Special Session, Chapter 14, Article 13C, Section 2, subdivision 9(d) and 10 appropriated $1,556,000 in fiscal year 2004 and 2005 from the prize fund to the Department of Human Services for statewide compulsive gambling programs.

The compulsive gambling contribution of $1,896,000 due in fiscal year 2004 as required by Minnesota Laws 1998 Chapter 407, Article 8, Section 11, and Minnesota Laws 2003, First Special Session, Chapter 14, Article 13C, Section 2, subdivisions 9(d) and 10, was transferred at the end of fiscal year 2003 resulting in a prepaid transfer at June 30, 2003.

10. RETAILER COMMISSIONS

Minnesota Laws of 1998, Chapter 366, Section 73 amended Minnesota Statutes Chapter 349A.16 by adding a provision that mandated increased retailer commissions in two ways. The provision increased the sales commission to 5.5% from 5.0% and added a cashing commission of one percent on the amount of each winning ticket cashed by that retailer. Both commission increases were effective July 1, 1998.

11. STATUTORY LIMITATION ON OPERATING AND ADVERTISING EXPENSES

Gross revenue is defined in law as ticket sales and all other income less in-lieu-of-sales tax. Direct costs include all prize payouts, retailer commissions and incentives. Operating costs include all other expenses of the Lottery.

Minnesota Statutes, Section 349A.10, subdivision 3, limits the Lottery's advertising costs to 2.75 percent and operating costs to 15 percent of gross revenue. The Lottery is in compliance with the statutory limits on advertising and operating costs. Advertising costs as a percentage of gross revenue were 2.27 percent and 2.13 percent for the years ended June 30, 2003 and 2002, respectively. Operating costs as a percentage of gross revenue were 14.12 percent and 13.94 percent for the years ended June 30, 2003 and 2002, respectively.

Minnesota Laws 2003, 1st Special Session, Chapter 1, Article 1, Section 23 provides that notwithstanding Minnesota Statutes, section 349A.10, the operating costs of the Lottery may not exceed $43,538,000 in fiscal year 2004 and $43,538,000 in fiscal year 2005.

12. RETIREMENT PLANS

The Lottery is involved in two pension programs as follows:

(a) General Plan - Defined Benefit Pension Plan - Statewide:

Plan Description

The Lottery contributes to the Minnesota State Retirement System (MSRS), which is a cost-sharing multiple-employer defined benefit pension plan administered by the MSRS. The plan provides retirement and disability benefits, annual cost of living adjustments, and death benefits to qualifying plan members and beneficiaries. Benefit provisions are established and may be amended by state statute and vest after three years of credited service. MSRS issues a publicly available financial report that includes financial statements and required supplementary information for MSRS. That report may be obtained by contacting MSRS.

Funding Policy

Plan members are required to contribute 4.0% of their annual covered salary and the Lottery is required to contribute at an actuarially-determined rate. The Lottery's current rate is 4.0% of annual covered payroll. The contribution requirements of plan members and the Lottery are established and may be amended by state statute.

The Lottery's contributions to MSRS for the years ending June 30, 2003, 2002, and 2001 were equal to the required contribution for each year, as follows:

	June 30		
	2003	2002	2001
MSRS	353,201	350,006	332,424

(b) Unclassified Plan - Defined Contribution Plan - Statewide:

Plan Description

The Lottery contributes to the MSRS, which is a multiple-employer defined contribution plan administered by the MSRS. The plan provides retirement and disability benefits, and death benefits to qualifying plan members and beneficiaries. Benefit provisions are established and may be amended by state statute and vest immediately. MSRS issues a publicly available financial report that includes financial statements and required supplementary information for MSRS. That report may be obtained by contacting MSRS.

Funding Policy

Plan members are required to contribute 4.0% of their annual covered salary and the Lottery is required to contribute 6.0% of the annual covered payroll. The contribution requirements of plan members and the Lottery are established and may be amended by state statute.

The Lottery's contributions to MSRS for the years ending June 30, 2003, 2002 and 2001 were equal to the required contributions for each year, as follows:

	June 30		
	2003	2002	2001
MSRS	46,572	46,917	44,913